Draft
Not for quotation

COSTS AND BENEFITS OF REMOVING INSTITUTIONAL CONSTRAINTS ON NONTRADITIONAL EXPORTS

MADAGASCAR CASE

by

Christopher L Shaw
J Dirck Stryker
Louis Aucoin

with assistance from

Elaine Tinsley
Bjorn Gillsater
Azadeh Moini-Araghi

June, 1994

The project under which this paper was prepared was funded by the U S Agency for International Development, Contract PDC-0095-Z-00-9053-000, the Consulting Assistance on Economic Reform (CAER) Project The views and interpretations in this paper are those of the author and do not necessarily reflect the view of the U S Agency for International Development

Associates for International Resources and Development

55 Wheeler Street
Cambridge Massachusetts 02138-8166

(617) 864-7770 (Telephone)
(617) 864-5386 (Facsimile)
332031 (AIRDSOM) (Telex)
aird@world std com (e-mail)
MCI mail 639-6091

Table of Contents

List of tables

List of figures

Executive Summary

Through programs of structural adjustment, many developing countries have removed the major policy distortions hampering economic growth and development   As a result, attention has increasingly been focused on barriers to growth such as infrastructural inadequacies, lack of information on markets and technology, and institutional constraints concerning the role of the public sector and how it relates to private economic agents

Madagascar provides an excellent case study for an estimation of the costs of these institutional constraints to export growth for two reasons   First, economic reform in Madagascar is well underway and the period of recovery from the disequilibrium of the 1970s and early 1980s is past   Second, Madagascar is poised for strong growth

Madagascar's comparative advantage on world markets stems from a wealth of natural and human resources, including a well educated labor force   At the primary education level, the Malagasy compare very favorably with citizens of other low-income countries   But the labor force is also relatively inexpensive   Data clearly indicate that even compared with some of its African rivals, Malagasy labor costs are extraordinarily low, making the incentive for foreign investment clear, and the international business community is responding to these incentives   New investment and the increase in the number of new enterprises since the passage of the *Code des Investissements* and the *Zone Franche* in 1989 is marked

However, exporters face considerable costs, both real costs associated with simply doing business in Madagascar, and institutional costs imposed by policy   These costs are especially high for those firms not included in the *Zone Franche*, including many companies that qualify under the *Code des Investissements*

Real costs

Real costs are imposed by insufficient infrastructure for transportation and intermodal transfer, an underdeveloped financial sector that generates shortages in capital, especially for fixed investment, and a tangled and unreliable judicial system

The road network in Madagascar remains in a deplorable state, despite recent improvement in the primary road network, especially in the major roadlink between the capitol city and the port of Tamatave, the paving of which was recently completed   The seaport capacity of Madagascar is also strained   While ocean transit is the transport of choice for most of Madagascar's exports, the two ports at Mahajanga and Toamasina are operating at their theoretical capacity level, and by 1995 will face a capacity constraint   Among the most serious infrastructural shortcomings for exporters, especially since a majority of exporting companies are located in the capitol region, is the lack of a freight terminal in Antananarivo

The financial liberalization strategy included the opening of the banking sector to private capital in 1988, progressive liberalization of interest rates, which since November 1990 have been fully liberalized, and a move away from direct to indirect instruments of monetary control Despite these reforms, Madagascar's financial sector faces major difficulties The country has one of the lowest savings rates among developing countries and its financial depth, the M2/GDP ratio which measures efficiency of investment and economic growth, is among the lowest The financial system is biased toward short-term financing with little medium- or long-term finance available As a result, savings in real assets are, for most savers, more attractive and less risky The majority of the population finds it difficult to gain access to financial assets in the formal financial sector

Several recent reports, many of them financed by USAID, have documented the inadequacies of the Malagasy judicial system with respect to commercial law, dispute resolution, competition law, and judicial independence Taken together, these reports paint a picture of the Malagasy legal and judicial system as so entangled in inconsistencies, ill-developed jurisprudence, and misplaced discretionary authority that it renders the system "ineffectual and unreliable "

Institutional costs

Institutional constraints amenable to policy include export and import procedures, limited access to foreign exchange, and regulation and government control of air freight

The financial sector liberalization of 1988 permitted importers to request and receive any amount of foreign exchange and seek financing through any means for imports including their own resources, suppliers' credits or loans from the banking system Despite this liberalization, foreign exchange access is limited both by the government's method of valuing the FMg, and by strict regulations on who can hold foreign exchange and under what circumstances they may hold it The current system requires that exporters deposit 100% of their foreign currency receipts at commercial banks, which hold 60% in accounts at the Central Bank and turn in the remaining 40% to the Central Bank The 40% portion is thereby used for debt financing and imports by the government of energy and other commodities priced in hard currency The 60% portion represents reserves against which importers may draw on an as-needed/as-available basis for imports Importers who are not exporters face severe constraints on their ability to gain access to foreign exchange, and the rules restricting access by exporters to a maximum 60% of their receipts (and often less given the demand for foreign exchange), create an incentive for clandestine off-shore trading of the FMg for hard currency

In 1987, the government initiated the liberalization of the import sector All non-tariff barriers on imports were eliminated and a 30% surcharge was introduced on some previously prohibited imports in order to ease adjustment in the sectors concerned, primarily textiles and meat This surcharge was reduced to 10% in 1989 and was eliminated in 1990 Tariff variance was reduced by lowering the rates from 69 in 1987 to 14 in 1990 and by limiting them to multiples of five between a minimum of 10% and a maximum of 80%

Simplification and liberalization of the import tariff regime marks a substantial improvement over the prior byzantine system of import bans and taxes, but the system remains complex and expensive with respect both to taxes and procedures

Formal export taxes were practically eliminated in September 1988 (*decret* no 88-015 01 01 1988) Although legal irregularities remain with respect to the procedural elimination of export taxes as well as many of the regulations governing exports (see Annex A), only a few individual crops remain subject to export taxes, including coffee, cloves, and vanilla The 1988 *décret* also simplified many of the procedures faced by exporters The law eliminated the requirement of an export card, as well as quality checks for all exports except in the cases of meat and seafood

However, legal simplification of export procedures has not led to practical simplification The *décret* was not successful in relieving exporters of many requirements that can be numerous and cumbersome depending on the nature of the product to be exported While the legal underpinnings of these requirements may be suspect, since the 1988 law formally abrogates all pre-existing regulations at the same time as it leaves some discretion to individual Ministries, the practice of customs agents requiring approval for exports by one or more Ministries is reportedly common

Other costs borne by exporters include the costs associated with relaying on Air Madagascar's monopoly on air freight to and from the island and unnecessary fees paid for various export cards, the "professional tax," and tips to customs agents and other figures of discretionary authority This survey confirmed that the monopoly rents garnered by Air Madagascar limit capacity, increase shipping costs, and create a real constraint to growth and efficiency for exporters who are able to export by air The size of the monopoly rent may be less than what Malagasy exporters believe it to be, but Air Madagascar freight charges can be as much as 20 to 30% higher than comparable international rates

Fees range from the *taxe professionelle*, paid annually, and the *patente d'exportateur*, a one-time fee, to payments to a private shipping agent (*transitaire*), usually equal to 0 5% of the value of the imported or exported material, to customs fees There is, of course, broad variation among individual firms as to the amounts paid and the extent to which these fees represented onerous costs to the firm Among non-Code, non-Zone firms in the survey, these fees ranged from 0 04% of total sales FOB to about 1% However, fees for non-Code, non-Zone firms as a group represented a higher percentage of sales than did fees for firms under one of the incentive regimes Tips and other *gratuités* constituted a nearly negligible proportion of the total fees paid

Results of the analysis

Measures of efficiency were calculated on a per-enterprise basis using a variation of AIRD's IMPACT template to measure nominal protection coefficients, effective protection coefficients and domestic resource cost coefficients In each case, these coefficients were calculated according to traditional methods, and then calculated again accounting for institutional costs as reported by individual firms and as estimated by AIRD These institutional costs, per firm, were also used to estimate an export tax rate equivalent for each firm, calculated on the basis of total institutional costs divided by the value of total sales FOB Analysis of domestic resource cost coefficients and other measures of profitability and efficiency indicate the following

1 In general, all of the businesses surveyed are operating efficiently by world standards With few exceptions, exporting firms are making good use of Madagascar's comparative advantage in the world market

2 Institutional costs constitute a significant drag on efficiency, despite the efficiency of firms

3 Malagasy-owned firms, on average, appear to operate at least as efficiently as foreign-owned firms

4 Firms that qualify under both the Zone and the Code appear to bear less cost deriving from institutional constraints than firms that qualify under neither regime, or, notably, than firms that qualify under the Code only

5 Firms that are neither Code nor Zone firms experience a higher export tax rate equivalent

A ranking of the institutional costs in terms of their total costs as a percentage of FOB sales demonstrates that access to foreign exchange and overvaluation together constitute the most important constraint to efficiency and profitability, followed by delays in customs clearance, then by inflated air freight costs associated with Air Madagascar's monopoly, and finally by fees and tips, which are relatively unimportant Not all types of costs are borne by all firms

Conclusion

Madagascar is poised at the brink of strong, export-led growth The government has already laid the legal and economic foundation for future expansion of trade, but there remain certain constraints to permitting the private sector to realize Madagascar's full comparative advantage and economic potential in world markets

In the short-term, policy options designed to remove these constraints include devaluation, issuance of a *décret* to implement the law that permits Malagasy businesspeople to hold foreign exchange accounts, simplification and reduction of customs regulations, including the opening of *guichets* for export and import procedures, and opening up of air freight to competition Long-term measures include development of transport and storage infrastructure, continued financial liberalization, and comprehensive judicial reform through a legislative drafting of a modern Commercial Code and a Code of Civil Conduct, as well as clarification of the myriad of legal inconsistencies plaguing the regulatory environment for exporters

Perhaps the most important commitment to be made in order to encourage exports in the future is reducing the disparities between those within incentive regimes and those outside, by extending the benefits of the *Zone Franche* and *Code des Investissements* more broadly

1 Introduction

Through programs of structural adjustment, many developing countries have removed the major policy distortions hampering economic growth and development As a result, attention has increasingly been focused on barriers to growth such as infrastructural inadequacies, lack of information on markets and technology, and institutional constraints concerning the role of the public sector and how it relates to private economic agents AIRD has developed a methodology to estimate the costs and benefits of removing these constraints, as they apply to nontraditional exports This methodology is described in detail in the first project report, prepared by AIRD in 1993 [1]

The United States Agency for International Development in Washington, Africa Bureau, is supporting the testing of this methodology in two countries, Ghana and Madagascar A team from AIRD, consisting of two economists, J Dirck Stryker and Christopher L Shaw, and an expert in Francophone law in developing countries, Louis M Aucoin, traveled to Madagascar in June 1993 to launch the study That trip included interviews with key individuals in the private and public sectors, a pretest of the survey questionnaire to be administered by firms, and the subcontracting of a Malagasy consulting firm, Office Statistique et Informatique pour la Programmation du Développement (OSIPD) in Antananarivo to administer the final questionnaire OSIPD conducted the survey between July and December of 1993 and provided AIRD with the completed questionnaires and two preliminary reports AIRD then conducted the analysis during the first four months of 1994 This report represents the final culmination of this exercise in Madagascar

Madagascar was chosen as a country for testing this methodology for two reasons First, The national investment program of the 1970s (known as the *investir a outrance*) had been financed largely through external borrowing rather than internal savings The result by the early 1980s was a large balance of payments deficit and spiraling inflation This situation spurred the Ratsiraka government to launch a series of measures in 1982 which were designed to stabilize the economy and prepare for structural adjustment Improving demand management through control of the budget deficit and restrictions on bank credit was accompanied by reform measures on the supply side, the centerpiece of which was the liberalization of rice marketing [2] Reform continued throughout the 1980s and included privatization of the financial sector, establishment of a new investment code to attract foreign direct investment and the creation of

---

[1] J Dirck Stryker, Christopher Shaw, Joel Trachtman, Louis Aucoin and Julien Naginski, *Costs and Benefits of Eliminating Institutional Constraints on the Expansion of Nontraditional Exports*, AIRD, Cambridge, MA, March 1993

[2] Democratic Republic of Madagascar (DRM), *Policy Framework Paper 1990-92* prepared by the Malagasy authorities (in collaboration with the staffs of the World Bank and the International Monetary Fund), May 23, 1990, Clive Gray, J Dirck Stryker and Jeffrey Metzel, *The Current Macro Economic Situation and the Progress of Economic Reform in Madagascar*, Prepared for the U S Agency for International Development HIID, AIRD, January, 1991

a *zone franche* to promote exports

Second, Madagascar is poised for strong growth Its comparative advantage on world markets stems from a wealth of natural and human resources, including a well educated labor force At the primary level, the Malagasy compare very favorably with citizens of other low-income countries Primary school enrollment as of 1990 is well above the average of low-income countries for all children (92%) and for girls (90%) [3] Data gathered in 1980 on household expenditures indicates that the average household in a secondary urban center spent a little more than 4% of total expenditures on schooling [4] The level varied from 2 85% in Antsiranana to 5 03% in Toamasina

The labor force is also relatively inexpensive Table 1 provides data on the average monthly wages, valued at official exchange rates, for a number of countries The data clearly indicate that even compared with some of its African rivals, Malagasy labor costs are extraordinarily low, making the incentive for foreign investment clear

Table 1 Wage rates

		Local currency	Dollars
Madagascar (FMg 1993)			
Manufacturing		57,700	$ 32
Agro-industry		7,300	41
Forestry		83,300	46
Food processing		18,000	10
Mining		76,300	42
Manufacturing or nonagricultural wages elsewhere (1990)			
Ghana (1988)	(cedis)	21,411	105
Kenya	(shillings)	3064	134
Malawi	(kwacha)	177	65
Mauritius	(rupees)	3252	219
South Africa	(rand)	1654	639
Costa Rica	(colones)	24,776	271
Canada	(Canadian dollars)	2019	1731

Source AIRD estimates for Madagascar, 1993 ILO Yearbook (wage data), IMF International Financial Statistics (conversion rates) Note wages converted at nominal exchange rates

[3] World Bank, *World Development Report 1993*

[4] République de Madagascar, Direction Générale de la Banque des Donées de l'Etat, *Enquête sur les budgets des ménages, Depenses CUS 1980*, 1980 p 19

It is clear that the international business community is responding to these incentives New investment and the increase in the number of new entreprises since the passage of the investment code and *zone franche* legislation is marked Investments under the Code have increased from an estimated FMG 23 billion in 1990, when the Code was passed, to 81 billion in 1992 [5] The number of enterprises obtaining free zone status increased from 11 in 1990 to 53 in 1992 Many of these firms have generated employment for hundreds of Malagasy citizens

Real costs v institutional constraints amenable to policy change

The methodology distinguishes between real economic costs borne by firms as a result of their location, sector etc , from institutional costs that may be removed through policy change, thereby increasing the competitiveness of the private sector and enhancing their capacity to realize full comparative advantage

Real costs stem from insufficient infrastructure for transportation and intermodal transfer, an underdeveloped financial sector that generates shortages in capital, especially for fixed investment, and a tangled and unreliable judicial system Those constraints on exports that may be considered institutional constraints amenable to policy include export and import procedures, limited access to foreign exchange, and regulation and government control of air freight

Outline of the report

The report is arranged in six parts Part 2 outlines the salient features of the legal, regulatory, and judicial environment in Madagascar affecting exporters Part 3 provides some details of the sample and reports frequencies and standard deviations for the key variables in the survey, as well as preliminary results of the econometric analyses Part 4 provides results of the IMPACT analysis, comparing coefficients of efficiency for firms on the basis of their reported costs, and comparing these coefficients for each firm before and after accounting for institutional costs Part 4 concludes with a ranking of institutional costs according to their relative economic costs to firms Part 5 fills out the data analysis with case studies, revealing both the economic promise and the institutional burdens of firms operating in Madagascar Finally, Part 5 outlines potential policy directions

It must be underscored that the survey was administered to a sample of firms that were not randomly selected, and therefore results are not statistically representative of all exporters in Madagascar

---

[5] Ministère de l'Industrie et de l'Artisanat, Direction de l'Industrie, 1993

2 Salient features of the Madagascar legal, regulatory and judicial landscape

The legal environment

The Code des Investissements

The *Code des Investissements* (or "Code") was created in 1989 to encourage investments in the private sector The primary goals of the Code are 1) to encourage the creation of new enterprises, 2) to promote expansion, quality improvements and business diversification of existing enterprises, and 3) to encourage rehabilitation projects

Under the Code,[6] a broad range of industries and investment activities may be awarded preferential status These include mining, energy and water, transportation, veterinarian services, medical care, housing, land development, agriculture, livestock, forestry, crafts, fishing, shipping and telecommunications The range of activities and sectors encompasses almost all investment activities, but particularly those which contribute to the economic and social development of Madagascar

All firms qualifying under the Investment Code receive total exemption from import taxes[7] and the *taxe unique sur les transactions* (TUT) on equipment, materials, construction materials, factory accessories, office materials and information necessary for the implementation of investment project These exemptions only apply for those purchases made specifically for the investment project

Small and medium-sized business receive preferential treatment over larger firms To receive status as a *Petite et Moyenne Entreprise*, the firm must have fixed assets of less than or equal to 500 million FMG and labor costs of less than or equal to 25 million FMG [8] The major difference in benefits between small and medium firms and other firms is the percentage of tax reductions received, and the duration that the firm receives it Benefits apply for 10 years for investments aimed at establishing an enterprise, and for 5 years for investments aimed at expansion or rehabilitation All small and medium-sized firms receive exemption from public

---

[6] Ministère de l'Industrie et de l'Artisanat *Code des Investissements* République de Madagascar December 1992

[7] The Code is actually unclear on this point It stipulates that enterprises may take advantage of these benefits "*sous rèserve*," that is, "subject to," payment of a minimum import tax of 10%, and provided they are in accordance with Madagascar laws and regulations However, one of the benefits noted in the *avantages fiscaux* is total exoneration from import taxes

[8] These amounts are revised annually to account for the change in the foreign exchange value of the franc Malgache, these figures pertain to 1991

disclosure taxes on loans for applicable investments, as well as on downstream grants and credit guarantees from foreign sources

For investments leading to the creation of a new enterprise, small and medium firms receive total exemption on import and sales tax on working capital for up to three months, exemption from the *taxe professionnelle* for the first five years, exemption from the real estate registration fee for applicable real estate, and total exemption on taxes on profits and income for the first five fiscal years, with reduced rates for the next five (see Table 2)

Table 2 Income/profit tax rate deductions for new enterprises under the Code

Year	Small and medium firms	Large firms
1st-5th	100%	100%
6th	90%	75%
7th	80%	50%
8th	60%	25%
9th	40%	n/a
10th	20%	n/a

Source Ministere de l'Industrie, et de l'Artisanat, *Code des Investissements*, 1992

For small and medium firms investing in expansion, quality improvement, or diversification of activities, the following benefits apply reduction of taxes on profits and income equal to 75% of the amount invested, exemption from the real estate registration fee, and exemption from contribution fees [9]

Larger firms, those firms not qualifying for *Petite et Moyenne* status, also receive benefits according to investment goals Benefits apply for 8 years for start-up enterprises, and 5 years for expansion, quality improvement or diversification investments New, large firms receive exemption from import and sales tax on working capital for the first three months of operation, exemption from the real estate registration fee, a 50% reduction in contribution fees, 100% exemption from profit or income tax for the first five years, and a continuous reduced rate for the next three years, and exemption from public disclosure taxes on bank loans, grants and credit guarantees

For investments in expansion, quality improvement, and diversification, large firms

[9] The Code apparently does not resolve an existing problem in investment laws dating to 1972 which distinguish between resident foreigners and non-resident foreigners, limiting business expansion severely for non-residents (see Annex A)

receive a reduction of taxes on profit and income equal to 75% of the amount invested, a 50% reduction in real estate registration fees, a 50% reduction in contribution fees, and 50% reduction on public disclosure taxes on loans, grants and credit guarantees

For rehabilitation projects, both small and large firms receive a reduction of taxes on profits as would be issued by the general tax code Large firms also receive a 50% reduction on taxes for advertising of bank loans and exemption for the amount of bank guarantees Small firms automatically have this benefit

As part of their requirements for continuance in the program, all firms must submit semi-annual reports on the progress of their investments After the start-up phase for new investments, the enterprise must submit other reports and documents to the authorities which ensure compliance to the agreement

The Zone Franche

Created in 1989 and amended several times since, the *Zone Franche* (the "Zone") is designed to encourage exports and foreign investment Zone firms fall under one of the four types of enterprises 1) promotion-exploitation enterprises (EPE), which are firms responsible for management and construction work, 2) manufacturing firms, 3) service firms, and 4) firms developing primary resources Firms must be located within a geographic *Zone Franche Industrielle* (ZFI) determined by local and regional governments, however for practical purposes, Zone firms may be located anywhere with local approval, the "Zone" is a legal concept, not a geographic one

To qualify for the *Zone Franche*, firms must fulfill certain criteria An EPE must be able to prove its technical and financial capacity to contribute to the development of a ZFI Manufacturing firms must devote their entire production to exports and satisfy particular criteria according to specific sectors Service firms must also "export" their product, i e provide services only to foreign entities or to other Zone companies

The main fiscal benefits and regulation for the Zone include tax holidays, customs concessions and special privileges with respect to maintaining foreign accounts [10] First, all firms in the *Zone Franche* are subject to a fixed 10% IBS tax (*Impôt sur les bénefices des societes*) However, EPE firms are exempted for a period of 15 years, manufacturing and primary resource firms are exempted for 5 years, and service industries are exempted for 2 years After this grace period, firms receive a tax reduction on profits equivalent to 75% of the tax on their new investments Second, all firms are subject to a fixed tax of 10% on distributed dividends Third, EPE firms who supply their own network for electricity, water or telecommunications,

---

[10] Ministère de l'Industrie et de l'Artisanat *Regime de Zone Franche*, Republique de Madagascar, December 1992

are exempted from the sales tax and the *taxe unique sur les transactions* (TUT) Finally, there is a 35% tax rate ceiling on expatriate salaries

Zone firms also receive special custom concessions Similar to the Code, inputs for the construction, preparation or implementation of an enterprise in the *Zone Franche*, are exempted from custom duties, import taxes, sales taxes, and the TUT Goods and services exported from a *Zone Franche* firm are exempted from all export duties and taxes (although inclusion of this provision is noteworthy in light of the legal annulment of all but a few export taxes on traditional commodities in 1988, implying that other export taxes may be payable in practice if not by law)

All benefitting companies may take on international loans and are allowed to maintain bank accounts outside the local banking system, a significant benefit in light of the restrictions forbidding Malagasy businesspeople to do so All firms are required to open a special account in francs Malgaches at one of the country's four commercial banks The law permits repatriation by foreign firms in the Zone of amounts equal to deposits made in foreign exchange (but denominated in FMg) Banks are required to maintain foreign exchange reserves at the Central Bank sufficient to guarantee that hard currency will always be available for repatriation Direct foreign investment is also permitted In fact, in a situation where capital in a firm is entirely owned by non-resident foreigners, the total amount of the initial investment and the initial working capital must be covered by the foreign exchange reserves of commercial banks

The regulatory environment

Land and property rights

One of the major shortcomings in Malagasy regulation is the inability of foreigners to own land In legal terms, this shortcoming is the result of a *note de service* issued by the *Ministère de l'Interieur* taking functional precedence over a constitutionally guaranteed right of ownership by foreign nationals (see Annex A) According to other sources, this *note* has been buttressed by a sequence of proclamations by the Ministry of Interior and individual public officials forbidding foreign ownership [11] This legal anomaly deters foreign capital investment, forcing businesspeople to secure long-term leases for property underlying whatever infrastructure they wish to develop The process of land rental by foreigners includes a requirement of authorization by the Ministry of Interior, and leases may be written for up to 50 years

Even for Malagasy nationals, however, land titling is not an easy process The Ministry of Interior in 1991 estimated, in light of the lack of a comprehensive land survey, that of the

---

[11] As recently as 1992, the Prime Minister stated, "*Ce sont les investisseurs qui m'interessent Cependant, qu'il n'y ait surtout pas de spéculations Les Malgaches tiennent a leur terre*" Madagascar Tribune, 14 August 1992 p 7, cited by Hilton Root, *Environment for Investment in Madagascar Institutional Reform for a Market Economy*, Center for Institutional Reform and the Informal Sector, University of Maryland, February 1993 p 17

country's more than 58 million ha, 2 million ha is held under community property ownership, 3 million ha in individually titled land (including corporate ownership), and the balance of more than 53 million ha remains state-owned property [12] The process through which nationals may acquire title is an egregious one reportedly consisting of dozens of individual legal steps hampered by continual delays in processing

Labor

The World Bank noted in 1991 that a number of Malagasy regulations hamper the efficient functioning of labor markets, including limitations on mobility and regulations governing the closing of businesses or the discontinuance of certain business activities [13] Certainly, the Code and Zone legislation attempt to remedy some of these problems through language that exempts qualifying firms from meeting these requirements in the event of ceasing operations However, no firm noted labor regulation as a burden to efficient business practice

There are clearly documented limitations on the ability of firms to hire foreign nationals (some of which are lightened for Zone and Code firms), and it is virtually impossible for foreign nationals to obtain Malagasy citizenship Foreigners must obtain a working permit from the Ministry of Labor if they themselves are to launch a business, or their Malagasy employers must seek authorization from the Immigration Service within the *Ministère de la Fonction Publique, du Travail et des Lois Sociales* These authorizations require formal written requests replete with copies of the proposed contract, and information provided on special forms for sale at other locations [14]

Capital

In the late 1980s, the government initiated a significant financial liberalization strategy after a decade of heavy state intervention in both the real sector and the financial sector The financial liberalization strategy included the opening of the banking sector to private capital in 1988, progressive liberalization of interest rates, which since November 1990 have been fully liberalized, and a move away from direct to indirect instruments of monetary control

Despite these reforms, Madagascar's financial sector faces major difficulties The country has one of the lowest savings rates among developing countries and its financial depth, the M2/GDP ratio which measures efficiency of investment and economic growth, is among the

---

[12] Interviews with the Ministry of Interior, April 1991

[13] World Bank, *Madagascar Beyond Stabilization to Sustainable Growth*, draft 1991

[14] Roland Marie Rasoamanarivo, *Lois, règlements, procedures et documentation relatifs aux exportations*, Projet MAELSP/USAID, p 12

lowest The M2/GDP ratio was stagnant between 1968 and 1988, remaining below the 25% level of GDP [15]

Part of the lack of financial depth can be explained by the fact that Madagascar is one of the poorest economies in the world However, there are a number of other factors reinforcing this trend Although nominal interest rates are determined freely by commercial banks real interest rates for short-term deposits are still negative [16] The financial system is biased toward short-term financing with little medium- or long-term finance available High rates of inflation and fluctuations in the real exchange rate in the past have led to a general distrust among economic agents concerning the attractiveness of holding financial assets As a result, savings in real assets are, for most savers, more attractive and less risky Furthermore, Madagascar's financial network is concentrated in the urban areas, thereby failing to capture the surplus resources of the rural areas The majority of the population finds it difficult to gain access to financial assets in the formal financial sector This is due to the nature of their activities, which are mostly agricultural, and the small size of enterprises

The financial system also does not function efficiently because of the inadequacy of financial infrastructure needed for intermediation and provision of payments services [17] There is a general lack of adequate financial information on lending terms and credit risks and financial transactions are not performed in a timely and secure manner There is lack of legal protection for lenders as well as borrowers The legal system is perceived as outdated—the Commercial Code dates from the colonial era The machinery of justice is slow, ineffective and unreliable These inadequacies have led to a pattern of finance in which transactions are limited to short-term maturities and to borrowers, who are personally known to the lender or able to provide easily attachable collateral The emerging shift towards a market economy in Madagascar requires withdrawal from previous legal provisions based on a state-controlled economy This process would involve both updating of existing legislation and creation of new legal instruments and financial infrastructure

International trade finance mechanisms and adequate exchange risk coverage are also crucial for the promotion of Malagasy exports The external payments crisis experienced in the 1980s eroded confidence among foreign suppliers To date, exporters rely heavily on self-financing from the informal sector, which places severe constraints on the scope and nature of their trade [18]

---

[15] World Bank, *Madagascar Financial Policies for Diversified Growth*, A World Bank Country Study, Washington, 1993 (hereafter World Bank, 1993) p 18

[16] Manfred Zeller, *International Finance And Food Security In Madagascar*, draft, International Food Policy Research Institute (IFPRI), Washington May 1993 p 6

[17] Zeller, 1993 p 39

[18] Zeller, 1993 p 7

However, with emerging liberalization of the financial sector, Madagascar should become increasingly eligible for supplier credit Foreign banks, including offshore banks, could provide trade finance both on imports and exports The recourse to offshore banks has already been useful for exporters operating under Zone In addition, preshipment finance, especially for producers of intermediate inputs, is likely to become more important as the world market begins to appreciate the reputation of Malagasy exporters Presently, there is reluctance on the part of financial institutions to intervene at the preshipment stage, especially because there is significant element of risk that final production, and hence payment, may not materialize Banks are worried that their funds may become tied up for too long and without any guarantee

Enlarging preshipment finance will require increased synergy between (a) exporters of intermediate goods and foreign manufacturers, and (b) exporting enterprises and the rest of the economy, in order to strengthen backward linkages Export credit guarantee schemes (ECGS) could also be an important mechanism through which exports could be promoted Experience shows that ECGS could become important for exports once nontraditional exports attain a minimum level Once Madagascar succeeds in diversifying its export market, when products must be sold in markets characterized by greater risk, an ECGS will become crucial This is not yet the case in Madagascar

Access to foreign exchange

The financial sector liberalization of 1988 permitted importers to request and receive any amount of foreign exchange and seek financing through any means for imports including their own resources, suppliers' credits or loans from the banking system Despite this liberalization, foreign exchange access is limited both by the government's method of valuing the FMg, and by strict regulations on who can hold foreign exchange and under what circumstances they may hold it

An overvalued exchange rate played an important role in Madagascar's trade imbalance throughout the 1970s and early 1980s Due to a combination of high inflation and a fixed nominal rate of 50 FMG to the French franc—a rate that had been applied since Madagascar left the franc zone in 1973—the Malagasy franc appreciated in real terms by 26% between 1977 and 1982, further reducing the competitiveness of Malagasy exports on the world market and making imports relatively cheap In 1982, as part of the stabilization program, the government began a series of nominal depreciations against the French franc, although import quotas remained largely in place both before and after the devaluations took place

In 1983-84, the focus of the reform program shifted from stabilization to structural adjustment, as the need became more apparent to the government for fundamental reform of price and trade policies Decontrol of post-factory prices and profit margins and removal of export taxes on the vast majority of goods in 1984-85 was accompanied by replacement of official maximum prices for paddy by floor prices, to promote private control of the rice market [19] Import liberalization followed in 1987, accompanied by a major devaluation of the Malagasy franc (58% against the SDR)

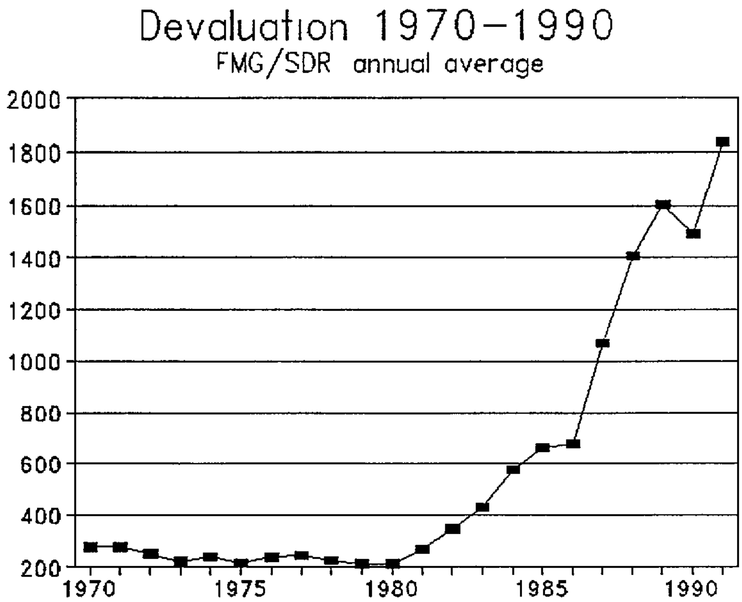

Figure 1 Nominal exchange rate 1970-1990
(note upward movement indicates depreciation)

The cumulative effects of these devaluations were mitigated by pent-up demand under price controls until the mid-1980s and by continued inflation through the end of the decade Figure 2 plots the nominal exchange rate ($/FMg) against the effective exchange rate (EER, including the effects of trade tariffs and quantitative restrictions), and the real exchange rate (RER, correcting the official exchange rate for disparities between changes in domestic prices and changes in prices of major trading partners) The figures show that the disparities between the nominal rate and the EER were greatest in the first half of the 1980s, when trade distortions in the form of import controls and export taxes remained in force The dip in the nominal rate below the EER between 1982 and 1986 reflects the growth in the strength of the dollar relative to other major currencies After 1985, although the removal of trade distortions aligned these rates, the real exchange rate remained well above the effective rate and the nominal rate due to the erosion of the FMg's purchasing power as a result of continued inflation, which totaled 67% between 1985 and 1988

---

[19] Paul A Dorosh, René E Bernier and Alexander H Sarris, *Macroeconomic Adjustment and the Poor, The Case of Madagascar*, Cornell Food and Nutrition Policy Program Monograph 9, Ithaca, New York, December, 1990, p 54

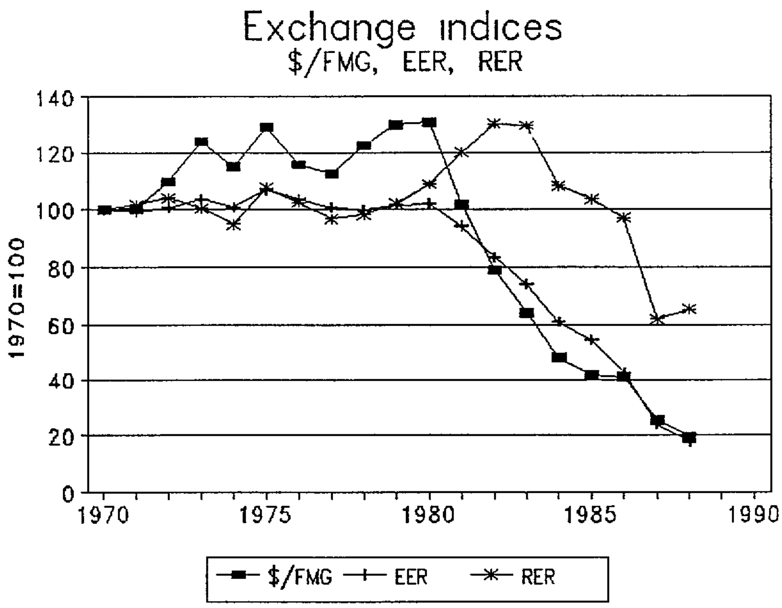

Figure 2 Exchange rate indices
(note upward movement indicates appreciation)

The major devaluation of 1987 was followed by a managed float policy through which the government allowed the value of the FMg to float against other major currencies within some predetermined range The agreement with the IMF also permitted the introduction of an open general licensing system of foreign exchange allocation through which importers could obtain foreign currency at the prevailing exchange rate and finance the purchase through a source of their own choice The system applied only to importers of goods, not services The OGL system remained in place until 1991, when the policy changed again in the aftermath of a run on foreign currency by importers, which drained national reserves to a few weeks' worth of imports by the end of 1990

The current system requires that exporters deposit 100% of their foreign currency receipts at commercial banks, which hold 60% in accounts at the Central Bank and turn in the remaining 40% to the Central Bank The 40% portion is thereby used for debt financing and imports by the government of energy and other commodities priced in hard currency The 60% portion represents reserves against which importers may draw on an as-needed/as-available basis for imports Importers who are not exporters face severe constraints on their ability to gain access to foreign exchange, and the rules restricting access by exporters to a maximum 60% of their receipts (and often less given the demand for foreign exchange), create an incentive for clandestine off-shore trading of the FMg for hard currency

The Central Bank in Madagascar (BCM) is the only institution authorized to hold foreign currency Since the nationalization of commercial banks in 1975, all payments transactions must go through the BCM and neither banks nor Malagasy companies may have foreign currency accounts or deal with foreign exchange [20] Thus, an importer goes to the bank with the required import documents The bank applies to the BCM to purchase foreign exchange Upon request by the BCM, the bank sends its applications every two weeks If an importer is unaware of the timing of this exchange, and registers his application at the wrong point in the cycle, his application could require extra time before it is forwarded After three to eight days, the BCM verifies the documents and effects the transfer with the corresponding foreign bank, which is credited with the foreign currency The need to involve the BCM at every step increases transactions costs for both banks and private traders

Madagascar maintains a requirement upon Malagasy exporters that foreign exchange proceeds should be repatriated and surrendered in exchange for local currency There is presently no adequate regulation for exchange rate risk coverage for exporting enterprises Exporters face continuously exchange rate fluctuations in their export and import transactions As already mentioned, there is no mechanism for retention of foreign exchange earnings and its management by Malagasy banks Thus, banks are not experienced in managing foreign exchange

The example of Mauritius is instructive, where the government has managed its foreign exchange system quite flexibly, allowing their exporters to retain foreign exchange balances in diverse currencies with domestic commercial banks so as to meet their foreign exchange commitments on imports [21] This system has helped the enterprises to offer coverage against exchange rate fluctuations In addition, it has enabled them to generate income from foreign exchange management In 1991, as part of a strategy to provide some stimulus to exports, the Malagasy Parliament passed a law enabling exporters to retain a portion of their income outside the country Final enactment of the law was contingent on a ministerial decree, which has not yet been issued [22]

Imports taxes and procedures

In the 1970s, the Malagasy government strengthened import prohibitions and quantitative restrictions By 1986, quantitative restrictions applied to all imports, and imports of goods produced in Madagascar were totally prohibited The tariff structure was quite complex and discriminatory There were 60 different tariff schedules ranging from 0% to more than 1000%,

[20] World Bank, 1993, p 44

[21] World Bank, 1993, p 197

[22] Cabinet de Conseille d'Entreprises, *Project de Promotion des Exportations Agricoles, Rapport sur l'aspect juridique et reglementaire*, Draft February 1993

resulting in high effective protection for some sectors and products[23]

In 1987, the government initiated the liberalization of the import sector All non-tariff barriers on imports were eliminated and a 30% surcharge was introduced on some previously prohibited imports in order to ease adjustment in the sectors concerned, primarily textiles and meat This surcharge was reduced to 10% in 1989 and was eliminated in 1990 Tariff variance was reduced by lowering the rates from 69 in 1987 to 14 in 1990 and by limiting them to multiples of five between a minimum of 10% and a maximum of 80%[24]

Simplification and liberalization of the import tariff regime marks a substantial improvement over the prior byzantine system of import bans and taxes, but the system remains complex and expensive, with respect both to taxes and procedures

Import taxes

The *Loi de Finance pour 1992* provides details of tax rates applicable to every sort of imported good, and provides rates of not only the *taxe d'importation* but also the *droits de douanes*, the *taxe de consommation* and the *taxe unique sur les transactions* The list of goods is exhaustive, requiring 319 pages of the *Journel Officiel* of the RDM, and rates vary markedly according to product and purpose For example, import taxes alone are 50% for mineral water, 45% for cut flowers and edible nuts, 40% for various spices, 35% for crustaceans and other types of seafood, 10% for chemicals and chemical derivatives, 30% for plastics and polymers in various forms, 15% for skins and leathers, and 25% for finished clothing

While there appears to be a certain pattern of higher rates for goods that are produced or producible in Madagascar than for goods that must by imported, this characterization is not uniform, nor is there any evidence of generally higher rates for finished goods versus intermediate inputs or for luxury goods versus real necessities eyeglasses incur an import tax of 40% while golf clubs are taxable at 25% As an example of the byzantine nature of the import tariff schedule, the law stipulates that imports of canvas pieces for shoe manufacture is subject to a customs tax of 35% and import tax of 5%, plus 15% TUT (it is exempt from consumption tax), but sheets of canvas weighing 400 grams or more per square meter are subject to zero customs tax, 40% import tax, 5% consumption tax and 15% TUT[25]

Moreover, taken together, some intermediate inputs can become prohibitively expensive when all of the various duties are added together Table 3 demonstrates that the total tax burden on imports of cotton fabric amount to 70%, the same rate as for finished clothing In fact, a

---

[23] World Bank, 1993 p 19

[24] Rasoamanarivo, 1992 p 16

[25] GDRM, *Journal Officiel* Loi de Finance, 27 July 1992 p 1322

typical Malagasy manufacturer of clothing, competing with ZF industries in the same sector, would need to pay duties at an unweighted average of 45% for the basic inputs outlined in Table 3

Table 3 Exemplary tax rates for imported inputs (% CAF)

	DD	TI	TC	TUT	Total
Cotton material	35	15	5	15	70
Thread	ex	20	ex	15	35
Sewing machines	5	15	ex	15	35
Needles	5	15	ex	15	35
Washing machines	10	30	ex	15	55
Paper and cartons for packing	5	15	5	15	40

Notes DD droits des douanes, TI taxe d importation, TC taxe de consommation, TUT tax unique sur les transactions
Source Journal Officiel, Loi de Finance, Tarif des droits et taxes perçues par la douane, 27 July 1992

Import procedures

The procedures governing imports of any kind also increase transaction costs The procedures require that goods are met by a personal representative of the importing company at the point of disembarkation Customs clearance is reportedly often a matter of negotiation rather than standard procedure, requiring a myriad of certifications, goods identification and securitization of property The procedures have proved to be so onerous that the government agreed after a year of negotiation with importers to pass along a large portion of the work of customs clearance for imports to a private firm, Veritas, which acts more or less like a Department of Weights and Measures, confirming that actual shipments conform to invoices and import documents

A large part of the problem in streamlining import procedures is the discretionary authority of customs officials in delaying delivery of goods for purposes of verification and payment of appropriate duties While the Veritas system has aided in avoiding fraud in the form of under- and over-invoicing, the system remains hostage to a large number of regulations that must be enforced by a small number of customs agents These agents have the power to disrupt the flow of goods and physically open containers for verification of contents at any stage of the process of importation While import and customs taxes are not paid directly to agents, but rather to banks which then provide written confirmation that must be furnished to the customs agents, agents do have an incentive to delay clearance and could potentially profit personally from cash bribes and other *cadeaux* to speed the process However, there is no evidence that this type of activity constitutes a major cost to importers While several exporters reported paying tips of one kind or another to customs agents, the amounts were paltry and paled in comparison to the cost of time delays in delivery of key inputs

The delays in obtaining clearance of imports range from a few days to many months, according to the firms surveyed Inclusion in the ZF does not insulate firms from this type of delay either One firm that cited almost no delays or operating problems in Madagascar reported that every shipment of imported inputs requires detailed chronicling of quantity and price, and proof of exoneration of these imports from import tax This firm reported that delays in confirming this information and processing forms took an average of two weeks per shipment, between the arrival of the goods in Madagascar and clearance for delivery to the firm Delays for firms that are not classified under the ZF were far longer, in some cases stretching up to several months Filing the paperwork alone would sometimes require several days

Part of the problem lies in the range of tax rates mentioned above—even the *Directeur des Ressources Fiscales* in the *Ministère des Finances* judged that the entire system would be easier to manage if there were a standard 5% import tax rate However, even a simplification of the tariff structure would not solve the problem cited as chief among the factors constraining the *Direction des Douanes* from efficient operation lack of personnel The *Direction des Douanes* reportedly employs 750 customs agents to administer all of the traffic across borders, including people and goods The *Directeur des Ressources Fiscales* reportedly does not have the personnel even to monitor the industries within the *Zone Franche* to ensure that imported intermediate inputs exonerated from import tax are actually reexported Short of a wholesale removal of regulations on international trade, or a sudden multiplification of customs agents, the costs associated with lack of adequate resources in the *Direction des Douanes* must be considered a real cost of doing business in Madagascar

Exports taxes and procedures

Export taxes

Formal export taxes were practically eliminated in September 1988 (*décret* no 88-015 01 01 1988) Although legal irregularities remain with respect to the procedural elimination of export taxes as well as many of the regulations governing exports (see Annex A), only a few individual crops remain subject to export taxes, including coffee, cloves, and vanilla

Export procedures

The 1988 *décret* also simplified many of the procedures faced by exporters The law eliminated the requirement of an export card, as well as quality checks for all exports except in the cases of meat and seafood

However, legal simplification of export procedures has not led to practical simplification The *décret* was not successful in relieving exporters of many requirements that can be numerous and cumbersome depending on the nature of the product to be exported While the legal underpinnings of these requirements may be suspect, since the 1988 law formally abrogates all pre-existing regulations at the same time as it leaves some discretion to individual Ministries, the practice of customs agents requiring approval for exports by one or more Ministries is reportedly common

Every exporter is required to obtain a *Domiciliation Declaration Exportation et Engagement de Répatriation de Devises* from their commercial bank, at a cost of up to FMg 5000 Generally exporters reported that banks furnished this documentation in a half-day or less Completion of the *Déclaration des Douanes (Serie E)* at the bank is also required of all exporters, and this procedure required more time since the form requires detailed descriptions of what is being shipped Phytosanitary inspection and approval by the Ministry of Agriculture is required for exports of meats and fish, and safety inspections of agricultural produce is legally optional but sought by exporters who wish to reassure their clients of quality control Other optional clearances include certificates of origin issued by the Chamber of Commerce, certificates of quality control in packing, certificates of merchandise traffic for goods headed to the European Community (issued by banks and used by only a few exporters), and exit authorization by the Ministry of Commerce (used by almost no one in the survey)

Other requirements apply on a product-by-product basis, and their application is rife with irregularity and subject to the discretion of Ministry and customs authorities [26] For example, export of any artifact or handicraft that might hold cultural significance requires inspection and approval by the Ministère de l'Industrie, Energie et Mines, which also must approve any export of mined material, whether stone, gem or mineral Export of any wood product also requires clearance by the *Direction des Eaux et Forêts* in the *Ministere de la Production des Animaux, des Eaux et Forêts* Export of a wooden artifact, therefore, would require clearance by both Ministries

Delays are reported to vary widely from case to case Some exporters report that their forms are processed quickly, within one day per Ministry, while others experience delays ranging from two to ten weeks Several business people complained of the lack of certainty surrounding export procedures, that some people appeared to receive unwarranted exoneration or special service as a result of personal relationships (not bribes, interestingly), that rules were in a constant state of flux, and that enforcement by customs agents was haphazard

The actual cost of these delays is unclear, since several exporters noted that export

[26] It is not clear whether the Ministries in these cases are implementing a unilateral *note de service* or are operating on the basis of practice dating to before the 1988 *decret* What is clear is that application of these procedures is clearly in conflict with the spirit and the letter of the 1988 legal reform and clarification of these and other legal inconsistencies is fundamental to reducing the uncertainty faced by exporters (see Annex)

procedures in general were cumbersome, but actual reporting revealed that costs incurred due to paperwork was minimal compared to customs delays and estimates of costs associated with limited shipping and storage capacity (see below)

The judicial system

None of the firms surveyed mentioned the lack of an indigenous legal system of dispute resolution as a major constraint to the growth of trade However, several recent reports, many of them financed by USAID, have documented the inadequacies of the Malagasy judicial system with respect to commercial law, dispute resolution, competition law, and judicial independence [27] Taken together, these reports paint a picture of the Malagasy legal and judicial system as so entangled in inconsistencies, ill-developed jurisprudence, and misplaced discretionary authority that it renders the system "ineffectual and unreliable "[28] Malagasy entrepreneurs and foreign investors are advised to stipulate in their contracts recourse to international arbitration rather than the Malagasy court system so as to ensure efficient and equitable resolution of conflict Where this stipulation occurs, there would be relatively little additional cost compared to the costs borne by any two parties in an international dispute However, where parties must turn to the Malagasy courts to adjudicate disputes, the costs in time and wasted resources could well be considerable, even if the final outcome is satisfactory from a legal standpoint to both parties, a result that is far from guaranteed

Other sources of constraints

Exporters in Madagascar must contend with other constraints, some of which are already well documented in the literature [29] A transport system plagued by decrepit infrastructure and a monopoly on air cargo, insufficient storage infrastructure, unskilled labor, and lack of information on external markets are among the most egregious

---

[27] They include Louis Massicotte, *Towards an Independent and Accountable Judiciary Report on judicial Reform in Madagscar*, Center for Institutional Reform and the Informal Sector (IRIS) University of Maryland at College Park, September 1993, Root, 1993 *op cit* , Louis Aucoin, *Dispute Resolution as an Alternative to the Ordinary Courts in Madagascar A Guide to Choice in the International Arena*, IRIS, October, 1993

[28] Aucoin, 1993 p 1

[29] J Dirck Stryker, Jeffrey C Metzel, Ashley S Timmer, *Regional Specialization and Agricultural Growth in Madagascar*, AIRD, Cambridge, Massachusetts January 1993

Transport

The road network in Madagascar remains in a deplorable state, despite recent improvement in the primary road network, especially in the major roadlink between the capitol city and the port of Tamatave, the paving of which was recently completed Some primary roads linking provincial capitals, most secondary roads and virtually all access roads are impassable for many months of the year, severely limiting transport of goods to major points of departure

The seaport capacity of Madagascar is also strained While ocean transit is the transport of choice for most of Madagascar's exports, the two ports at Mahajanga and Toamasina are operating at their theoretical capacity level, and by 1995 will face a capacity constraint [30] Projections for other smaller, eastern and southeaster ports are more hopeful, but the costs of exporting are driven up in these cases by the need for lighterage, i e transferring goods from a quay to a smaller vessel, which then transfers the cargo to oceanliners waiting in deeper water Lighterage costs are particularly high in the eastern ports because of exposure to heavy seas on the Indian Ocean side of the island, only the major eastern port at Toamasina offers adequate protection from weather Also, the vast majority of cargo in Madagascar is transferred from truck or train to ship manually When implemented, plans for port rehabilitation are likely to mitigate these high costs

Among the most serious infrastructural shortcomings for exporters, especially since a majority of exporting companies are located in the capitol region, is the lack of a freight terminal in Antananarivo Many of the exporters interviewed remarked on the need for a terminus in the capitol to provide a central location for storage and transfer of cargo among rail, truck and air carriers, to act as a point of contact for consolidating shipments and avoiding partial containers (thereby reducing domestic transport costs for exporters), and to serve as a collection point for available containers, of which there is apparently a constant shortage on the island

Smaller Malagasy exporters also lack any cold storage at the airport, a fundamental component of successful trade in seafood, meat, and other consumables and fresh produce That so many exporters in marine products have operated successfully without such facilities is testament to their tenacity, entrepreneurial skills, and size only larger export agents have been able to finance the infrastructure necessary

Finally, the transport system in Madagascar suffers from real inefficiencies created by the state monopoly over air cargo imposed by the government-owned airline, Air Madagascar This monopoly results in prohibitively high air freight rates for exporters, who cannot then take advantage of what little space exists on Air Madagascar's (and Air France's) backhaul to Nairobi, South Africa, Reunion, and Europe Many firms complained of high rates, unused

---

[30] Stryker, Metzel, and Timmer, 1993

space, and missed opportunities for markets abroad brought on by Air Mad's chokehold on the market Reports confirm this phenomenon, insofar as there is excess capacity on flights leaving Madagascar in all but the most intensive months of the litchi season [31] While air cargo prices appear to be competitive on runs to and from Reunion, Air Mad rates to European destinations are reportedly 20 to 30% higher than rates for comparable runs from Nairobi on private carriers

Labor

Several exporters remarked on the lack of skilled labor in Madagascar With better than average levels of educational attainment and high unemployment, Malagasy workers work hard, work productively, and work long hours Nevertheless, despite broad satisfaction with the general quality of labor, several exporters reported having trouble finding workers with the requisite skills and were forced to incur the costs of supplemental training Several companies in the *Zone Franche* actually set up quite extensive training units to transfer specialized skills to their workers

Market information

Finally, Malagasy exporters face significant competition in international markets, especially with respect to high value-added products destined for markets in Europe, Asia, and North America Information on these markets and on the nature of the competition is poor, and connections to overseas distributors and potential foreign partners require substantial investments of time and capital Despite the comparative advantage that Madagascar holds for supplying regional markets in Southern Africa, especially in the wake of the democratization of South Africa, most of the economic activity within the private sector remains domestically oriented, or oriented towards Europe [32]

3 Results of the general analysis of the survey

Analysis of the survey included two major steps The first step, reported here in Part 3, included the identification of a number of key variables and a series of regressions to reveal which variables are the most important in determining whether and to what extent institutional constraints are experienced by firms The second step, reported in Part 4, consisted of the use of AIRD's IMPACT template for calculation of a number of coefficients describing the rates of protection and efficiency of firms, both with and without accounting for institutional constraints, in order to calculate which constraints are the most costly in financial and economic terms

---

[31] Steedman, 1993

[32] J E Austin Associates and Management Systems International, *MAPS Private Sector Survey Madagascar*, prepared for USAID Madagascar, April 1991

Both steps of analysis support the major conclusion of this study, that firms not included in the Zone face significantly more delays and constraints than those included in the Zone Firms qualifying for incentives under neither the Code nor the Zone face the greatest constraints Such firms tend to be smaller firms, oriented to domestic production, attempting to export, and wholly Malagasy-owned

An additional conclusion emerges from the general analysis of the survey data, that procedures and regulations governing imported inputs are as costly as those affecting exports for those exporters outside of the Zone Although firms mentioned import constraints almost as frequently as export constraints, and these constraints were cited most of all the constraints, this conclusion could not be confirmed through deeper analysis of protection and efficiency coefficients given the lack of specific data Firms also did not distinguish between import taxes and the capital and opportunity costs of import delays It should be noted that for importing firms that do not fall into the Zone or Code, the costs of import taxes would compare with among the higher institutional costs borne by such firms (see Part 5)

Data description

Parameters of the sample

The sample includes 34 firms, all of which export goods from a base in Madagascar The sample represents a variety of sectors, and includes firms exporting to a range of markets Sectors represented include agricultural products (26% of the sample), garments and textiles (18%), marine products, processed foods and miscellaneous manufactures (12% each), wood products (9%), and handmade artisanal goods and semi-precious stones (6% each) Thirty-nine percent of the sample exports 100% of their production, and the rest export from 10% of production (19% of firms) to 80% of production (13% of firms) Average exports as a percentage of total sales (average denoted by μ) was 59 12, with a standard deviation (s) of 40 12, and 31 firms reporting (n=31) The percentage of all firms exporting to each market is as follows Europe in general (41%), the Indian Ocean (38%), France (35%), US (21%), Asia and Germany (15% each), other points in Europe (9%), Africa (6%—mostly South Africa), and the United Kingdom (3%), many firms export to more than one region or country

Size, age and capacity utilization

Firms vary greatly in size Of the firms reporting total sales, 10% (3 firms) gross FMg 100 million or less in total annual sales (about $55,000 at the official exchange rate), and 6% report sales falling between FMg 20 and 30 billion ($11 to 17 million) ($\mu$=4 4 billion, s=6 5 billion, n=31) More than two-thirds of the sample (68%) falls in the FMg 1 billion to 10 billion range ($0 5 to $5 million)

In terms of age of the firm, one-third of the sample registered officially with the *Registre* *de Commerce* during or before 1980, whereas 24% registered in 1990 or later ($\mu=1980$, s=14, n=33) Capacity utilization was high, with 58% (18 of 31 respondents to this question) reporting 90% or higher capacity utilization ($\mu=86\%$, s=16 52, n=31)

Factor intensity

One-third of the sample, 33% (11 firms) are labor-intensive enterprises, employing from 300 to 1000 workers, while 15% (5) employ ten or fewer people ($\mu=213$, s=245, n=33) All six of the garments/textiles firms fall into the labor-intensive category, and account for more than half of all labor-intensive firms (300 or more employees) All but two of those garment/textile firms are classified as *Zone Franche* enterprises

There is a negative correlation between exporters that are labor-intensive and those that are resource-intensive One of the working hypotheses that has yet to be disproved is that the Zone firms generally gain their competitive edge from low-cost labor and an almost total reliance on imported inputs for raw materials and production The inverse is also hypothesized those firms that are not in the Zone are more likely to rely on domestic raw materials and inputs, and be less labor-intensive and less export-oriented So far, the analysis has supported both hypotheses The five least labor-intensive firms either did not report legal status (4 firms) or explicitly stated that they were neither ZF nor Code enterprises (1) All five are wholly Malagasy-owned, whereas 3 of the 11 labor-intensive firms are wholly Malagasy-owned (another two did not report ownership status explicitly)

Constraints cited by firms

The survey reveals the following constraints facing exporters with respect to imported inputs (in the order of the frequency of their citation by firms)

- i import procedures (14 firms cited this as a problem)
- ii access to foreign exchange (13)
- iii transport capacity for imports (4)
- iv access to import financing—as distinct from foreign exchange access (2)

The major constraints facing exporters with respect to production and exporting finished goods include

i export procedures (16)
ii access to capital for fixed investment (11)
iii constraints on physical capacity and/or cost of transport off island (even though this cost was usually born by the importer) (10)
iv lack of working capital (6)
v inadequate skill levels of labor (5)
vi transportation infrastructure (5)
vii inadequate product quality (2)

It is noteworthy that no firm mentioned lack of markets overseas as a constraint on exports, and virtually every firm noted some form of foreign cooperation in the promotion of exports

The rules governing Zone and Code firms, as opposed to Malagasy firms that do not qualify under either regime, appeared early on to have made a significant difference in the propensity of firms to experience institutional constraints to trade This was borne out in subsequent analysis of the survey data, which also revealed two other important variables, both of which are linked to legal regime ownership status and industry type

Key variables in predicting constraints

Industry type

Exports were run against a total of ten dichotomous dummy variables indicating industry type The only significant result occurred in the case of garment and textile industry It is important to note that this model does not correct for size effects, and the results of subsequent models that did correct for size effects were not significant (due at least in part to sample size)

LEXP	=	β_0	+	β_1 DIND8	
Coeff		6 05		1 75	Adjusted R^2 = 0 13
s		(0 34)		(0 77)	df = 28
t		17 58		2 27	

where LEXP = Natural log of total exports in millions of FMg,
DIND8 = 1 for garment or textile industry, 0 for other

Ownership status

A two-parameter log function testing the impact of ownership status as a dichotomous dummy variable on exports revealed that wholly Malagasy ownership (as opposed to foreign-ownership and joint ventures) was significantly negative as a predictor of exports, suggesting that Malagasy businesses operate at a disadvantage compared with other firms As with industry type, correcting for size effects results in a negative but insignificant coefficient for the ownership variable, a result that requires further investigation

LEXP = β_0 + β_1 DOWN

Coeff	7 46	-1 41	Adjusted R^2 = 0 11
s	(0 55)	(0 67)	df = 27
t	13 47	2 11	

where LEXP = Natural log of total exports in millions of FMg,
DOWN = 1 for wholly Malagasy owned, 0 for other

Legal status

Finally, as expected, legal status had a significant impact on the degree to which export procedures posed a constraint to trade Those firms that do not benefit from the Code or the Zone are significantly more likely to report problems with exports

XPRO1 = β_0 + β_1 LEG4

Coeff	0 07	0 35	Adjusted R^2 = 0 14
s	(0 06)	(0 14)	df = 32
t	1 15	2 50	

where XPRO1 = Firm cited export procedures as constraint to trade
LEG4 = 1 for firms that are neither Code nor Zone, 0 for other

Testing the explanatory power of these three variables with respect to the ratio of exports to sales through a multivariate model does not reveal any discernible pattern due to the high degree of multicollinearity Not surprisingly, given the characteristics of the Malagasy export sector, correlation coefficients indicate negative significance between industry type (garments/textiles) and ownership status, and positive significance between industry type and status as a *Zone Franche* firm (Table 4) Other noteworthy coefficients for the purposes of further analysis a coefficient of +0 38 between firms that are neither Zone nor Code and those that are wholly Malagasy-owned, +0 38 between Zone firms and the ratio of exports to sales, +0 29 between Zone firms and labor-intensiveress, and -0 27 between Malagasy-owned firms and labor-intensiveness

Table 4 Correlation coefficients for descriptive variables

	EMP/S	X/S	OWN1	LEG1	LEG2	LEG4	DIND8
EMP/S	1 00	0 27	-0 27	0 35	0 29	-0 07	0 11
X/S	0 27	1 00	0 01	0 09	0 38	0 05	0 07
OWN1	-0 27	0 01	1 00	-0 06	-0 23	0 38	-0 48*
LEG1	-0 35	0 09	-0 06	1 00	0 13	-0 61**	-0 10
LEG2	0 29	0 38	-0 23	0 13	1 00	-0 28	0 51*
LEG4	-0 07	0 05	0 38	-0 61**	-0 28	1 00	-0 04
DIND8	0 11	0 07	-0 48*	-0 10	0 51*	-0 04	1 00

* significant at the 1% level
** significant at the 0 1% level

where EMP/S = number of employees/total sales in million FMg
X/S = value of exports in 1992 (or nearest year) in million FMg/total sales in million FMg
OWN1 = wholly Malagasy-owned
LEG1 = qualified under *Code des Investissements*
LEG2 = qualified under *Zone Franche*
LEG4 = qualified under neither Code nor Zone
DIND8 = garments or textiles firm

These results indicate that

a *Zone Franche* enterprises export more than enterprises in any other category,

b garment/textile industries export more than other industries (there is clearly direct overlap here with ZF industries),

c garment/textile firms tend to be labor-intensive capitalizing on the low cost of labor in Madagascar,

d *Zone Franche* industries are primarily foreign-owned, implying that Malagasy entrepreneurs are being shut out of export boom

One reason for these phenomena is that capacity and procedural constraints on imported inputs are at least as important as procedural constraints on exports for exporters, and, by definition, ZF/textile industries are not as constrained as others on the import side

4 IMPACT analysis

Measures of efficiency were calculated on a per-enterprise basis using a variation of AIRD's IMPACT template to measure nominal protection coefficients, effective protection coefficients and domestic resource cost coefficients [33] In each case, these coefficients were calculated according to traditional methods, and then calculated again accounting for institutional costs as reported by individual firms and as estimated by AIRD These institutional costs, per firm, were also used to estimate an export tax rate equivalent for each firm, calculated on the basis of total institutional costs divided by the value of total sales FOB [34] It should be noted that the export tax rate equivalent is inclusive of all institutional costs except those associated with import delays The results of the domestic resource cost comparisons appear in Table 5

Table 5 Domestic resource cost coefficients

	N	DRC	FDRC	Difference	Export tax rate equivalent
Average	14	0 61	0 47	0 14	15 5%
standard deviation		0 34	0 32		
Average no Code nor Zone	5	0 40	0 25	0 15	24 8%
Average both Code and Zone	2	0 65	0 65	0 01	0 6%
Average Code only	6	0 80	0 59	0 21	15 0%
Average Malagasy-owned	11	0 58	0 44	0 14	19 3%
Average foreign-owned	2	0 64	0 64	0 01	0 9%
Joint venture	1	0 88	0 43	0 45	3 2%

DRC Domestic resource coefficient
FDRC Domestic resource coefficient inclusive of institutional costs

Table 5 permits several conclusions, all of which must be tempered by remembering that the sample was neither random nor large enough to permit broad conclusions about exporters in Madagascar in general Nevertheless, evidence pertaining to the firms surveyed is clear

[33] See Dirck Stryker, Christopher Shaw, Joel Trachtman, Louis Aucoin and Julien Naginski, *Costs and Benefits of Removing Institutional Constraints on the Growth of Nontraditional Exports Methodology*, AIRD, Cambridge, MA, March 1993, for details of the calculation of these coefficients

[34] In cases where total sales included some portion of domestic sales as well as exports calculation of coefficients assumed 100% exports for purposes of comparison unless cost figures were recorded exclusively with respect to exports

1 In general, all of the businesses surveyed are operating efficiently by world standards Notwithstanding the fact that several firms seem to have underestimated total costs, the survey reveals that with few exceptions, exporting firms are making good use of Madagascar's comparative advantage in the world market

2 Institutional costs constitute a significant drag on efficiency, despite the efficiency of firms The average decline in the DRC coefficient across all firms was 14 points, once institutional costs were extracted from total costs [35]

3 Malagasy-owned firms, on average, appear to operate at least as efficiently as foreign-owned firms The standard deviations of the averages of DRC and FDRC in Table 5 indicate broad variance of coefficients across firms Nevertheless, the difference in average DRC between Malagasy firms and foreign firms appears to be in the same rage The difference in the average DRC for foreign firms, which is slightly higher than the average for Malagasy firms, is probably due to errors in reporting

4 Firms that qualify under both the Zone and the Code appear to bear less cost deriving from institutional constraints than firms that qualify under neither regime, or, notably, than firms that qualify under the Code only [36] This latter results may be due to the fact that most of the benefits pursuant to qualification under the Code run out within a few years after the initial investment by the firm

5 In spite of the similarity between Code-only firms and firms that are neither Code nor Zone with respect to changes in efficiency, the latter firms experience a higher export tax rate equivalent This appears to be clearly due to increased costs associated with export procedures borne by non-Code (non-Zone) firms as opposed to Code firms

Real costs

The calculation of export tax rate equivalents does not account for those costs judged as the real costs of doing business in Madagascar, that is, those costs that cannot be readily reduced through policy change The surveys indicate that these real costs are formidable and derive from inadequacies in the domestic transport and telecommunications infrastructure, the lack of depth in the financial sector, and the shortcomings of the judicial system

[35] This difference was statistically significant at the 1% level (see Annex D)

[36] The low number of cases of firms belonging to both the Code and the Zone prohibited reliable tests for statistical significance of this parameter

Infrastructure

The challenge posed to business people by Madagascar's poor infrastructure is well documented and will not be reiterated here (see Part 2) However, infrastructural inadequacies were often cited in the survey as sources of major costs and delays Five firms mentioned transportation infrastructure explicitly as a major constraint to exports (see general survey results, above) Many more related anecdotes during personal interviews that underscored the inefficiency inherent in, for example, relying on personal messengers for communication between the port of Tamatave and the capital city

The financial sector

The lack of depth in the financial sector affects exporters with respect both to working capital and capital for fixed investment First, the underdevelopment of the sector forces firms to assume the pre-shipment and post-shipment financing out of retained capital Banks report broad use of letters of credit by exporting firms, an assertion borne out by the reports of firms themselves Other forms of financing, however, including pre- and post-shipment financing of exports by the importer or by other public or private sources, are rare Those businesspeople who have access to other forms of credit are limited generally to foreigners with personal contacts or accounts abroad, including those who have created enterprises in the Zone or under the Code

The lack of working capital, however, was considered less of a constraint to exports than the lack of capital for fixed investment (see Part 3) [37] The high rate of capacity utilization and the expressed desire of many firms to expand is evidence of the lack of access by private firms to capital The existing capital market does not allocate resources according to functions of demand and supply Ceilings imposed by the Central Bank on credit to the four major commercial banks and the lack of intermediation have forced private sector cooperatives and associations to create their own credit and financing mechanisms These include FIVCAM, put in place by the business association FIVMPAMA (a Malagasy acronym for *Groupement des Opérateurs Privés Nationaux)* to which many of the exporters of nontraditional products belong, SIPEM created by GEM (*Groupement des Entreprises de Madagascar)*, another business association counting among its members many of the exporters of Madagascar's traditional exports, FIARO, a capital risk and capital development fund, MADINVEST, and Entreprendre à Madagascar [38] While these financing sources are not limited to lending capital for fixed investment, they do suffer in most cases from a lack of resources since they are dependent on

[37] The financial and economic costs associated with the lack of capital for fixed investment was not calculated, since estimates in other countries have been based on the growth rates of sectors and firms for which there is ample cost and operating data, this was not the case in Madagascar

[38] République de Madagascar, Groupe de Travail Technique, *Integration Economique Régionale, Projet de Rapport Final*, November 10, 1992

- members' contributions for capital resources

The judicial system

Estimating the costs of the lack of a modern commercial code or of an unreliable judicial system was not possible in light of the lack of any evidence that firms had actually employed the Malagasy court system to resolve commercial disputes In those cases where Malagasy firms did report having suffered some form of injustice, whether imposed by a contracting party or by public authority, these grievances appear to have gone largely unheard in any forum The ultimate cost, therefore, is the existence of strong disincentives to enter into any sort of business relationship in which the entrepreneur cannot bear the risks of large losses of orders or inventory in the normal course of doing business The opportunity cost lies in decisions *not* to conduct business in Madagascar This cost is a real cost within the Malagasy economy, and can only be reduced through continued legal and judicial reform

Institutional costs

Respondents to the survey identified several sources of institutional costs which accrue to the exporter at a number of points along the production and distribution chain These included unnecessary fees paid to government agencies and tips and other *gratuités* paid in order to speed the process, lack of access to foreign exchange, delays in obtaining clearance for entry of imported inputs or exit of finished goods, and transport capacity for both imports and exports All of these institutional costs, except for transport capacity (unless the pursuant costs in terms of lost business were explicitly estimated by the firm) and capital costs associated with import delays, were calculated as a component of the export tax rate equivalent

Fees and tips

Fees range from the *taxe professionelle*, paid annually, and the *patente d'exportateur*, a one-time fee, to payments to a private shipping agent (*transitaire*), usually equal to 0 5% of the value of the imported or exported material, to customs fees There is, of course, broad variation among individual firms as to the amounts paid and the extent to which these fees represented onerous costs to the firm Among non-Code, non-Zone firms, these fees ranged from 0 04% (34)[39] of total sales FOB to about 1% (35) As a group, however, fees for non-Code, non-Zone firms represented a higher percentage of sales than did fees for firms under one of the incentive regimes Since only Zone firms are formally exonerated from liability for the professional tax, Code firms also paid out considerable resources in unnecessary fees, ranging from 0 1% (25)

[39] Numbers in parentheses refer to the identification number of the company, for purposes of reference

to about 1% (23) Across the board, tips and other *gratuites* constituted a nearly negligible proportion of the total fees paid, falling in the range of FMg 10,000 to 50,000 per shipment for most exporters (or $4 to $20 at the shadow exchange rate)

Access to foreign exchange

Lack of access to foreign exchange constituted a frequently cited problem Malagasy law prevents any national from holding a foreign exchange account at home or abroad In order to evaluate the relative importance of the cost of turning in 100% of foreign exchange earned from sale of exports to commercial banks, Malagasy firms owned by Malagasy citizens were assumed to have no access to foreign exchange accounts, either in Madagascar or abroad Firms owned by foreigners and foreign firms were assumed to have access to such accounts, and to be able therefore to deposit up to 100% of their foreign exchange earnings in foreign accounts The institutional costs associated with loss of foreign exchange were estimated by calculating the difference between total sales FOB expressed in FMg, valued at the official FMg exchange rate, and total sales FOB valued at the shadow exchange rate (Throughout the exercise, a shadow exchange rate of 2250 FMg/$ is assumed, reflecting the assumption that the *franc Malgache* is currently 25% overvalued) This net loss in foreign exchange, expressed in FMg, is then added to other cash costs and calculated as part of the export tax equivalent It is also added to the total value of sales FOB for the purposes of calculating financial and economic profitability and the coefficients after accounting for all institutional costs (including the FDRC)

As a percentage of total institutional costs, the loss on foreign exchange experienced by Malagasy firms compared with foreign firms (or Malagasy firms owned by foreigners), as a result of the foreign exchange laws extant in 1993, is considerable The proportion ranges from 32% of total institutional costs to virtually 100% As a result of its importance among all institutional costs, loss on foreign exchange constitutes a large proportion of the export tax rate equivalent As a percentage of total sales FOB valued at the official exchange rate, loss on foreign exchange is a straight 20% for all firms unable to hold foreign exchange accounts, this standard percentage is a direct function of the assumed rate of overvaluation made in the calculation It also implies that removing this constraint to Malagasy firms would increase profitability markedly and would greatly ease their capacity to operate in world markets

Shipping capacity

Costs associated with export delays vary widely according to the experiences of individual firms Such costs include the costs of delays from customs clearance, as well as the delays associated with limited capacity of shipping infrastructure for goods traffic to and from Madagascar While some firms outside of the official incentive regimes do not bear any additional costs associated with customs or shipping capacity, others cite these as sources of costs amounting to FMg 15 to 20 million ($8000 to $12,000) in several unrelated cases These costs are borne by firms primarily in the form of spoilage and lost or cancelled orders, although the capital costs of delays are calculated as a part of the total cost in a few cases For several firms both in and outside of the *Code des Investissements*, these costs amounted to 15 to 25% of total FOB sales

The institutional costs associated with limited shipping capacity were estimated on the basis both of anecdotal reports by individual firms and on estimates of the extent to which costs are in excess of comparable world shipping rates from the Center for Research on Economic Development (CRED) [40] It must be noted that costs associated with limited shipping capacity as well as air and sea freight charges were not included in the calculation of the export tax rate equivalent, since these charges are often borne by the importer and do not appear in the FOB price of exported goods They do, however, affect competitiveness to the extent that they are reflected in CAF prices in the importing country, and to the extent that their reduction or elimination can boost profits for exporting firms and/or reduce CAF prices in the importing countries, increasing the competitiveness of Malagasy products sold abroad

With respect to sea freight, problems cited by individual firms did not focus on rates or sea freight capacity, which was considered adequate by all but a few exporters Shipping rates are higher from Madagascar to Europe than from Mauritius to Europe for reasons unrelated to restricted capacity or oligopoly, according to the CRED report [41] This research reveals that while rates are roughly 30% higher for higher value-added products (such as sweaters) leaving Toamasina compared with St Louis—1300 ECU per container from the Malagasy port compared with 1000 ECU for the Mauritian—the two ports operate at similar levels of efficiency Although there are some pricing distortions due to historical pricing patterns and the nature of the public/private interface in freight management in Madagascar (see CRED report for details), the differential is due largely to structural and navigational problems in the Toamasina port which require capital investment for improvement The Société Nationale Malgache de Transport Maritimes (SMTM) considers that shipping rates are quite competitive with the world market now and cannot be lowered much further, a claim that is supported by private shipping concerns such as the Mediterranean Shipping Company [42] Therefore, the higher costs of shipping by sea should be considered a real cost of operating in Madagascar for the purposes of this analysis

Air freight is another matter The CRED report revealed, and this survey confirmed, that the monopoly held by Air Madagascar on all air traffic to and from the island limits capacity, increases shipping costs, and represents a real constraint to growth and efficiency for exporters who are able to export by air The size of the monopoly rent may be less than what

---

[40] Charles Steedman, *Do Telecommunications and Air/Sea Transport Problems Limit Madagascar's Exports?* Center for Research on Economic Development, The University of Michigan, Ann Arbor, January 1993

[41] Steedman, 1993 pp 22 *et seq*

[42] Steedman, 1993 p 23

Malagasy exporters believe it to be, however The CRED report stated that air freight rates between Madagascar and Europe charged by Air Mad were competitive with rates between Mauritius and Europe charged by the private carriers servicing Mauritius However, since Air Mad rates are the result of negotiations between the airline and Air France, and since Air Mad reportedly offsets the costs of its domestic flights with higher proportional charges on its long-distance international service, international air freight charges can be as much as 20 to 30% higher than rates to Europe from Kenya Admittedly, private carriers operating the Kenya-Europe route can charge less for reasons both of distance and of high back-haul capacity on a large number of commercial flights

A reduction in air freight costs of 10 to 20% for those exporters dependent on air freight could amount to a considerable savings in the CAF prices of their products abroad A representative of Transport Aerien de Madagascar, an air freight subsidiary of Air Madagascar, estimated that CAF charges for lobster from Fort Dauphin arriving in Paris amounted to 100FF/kg, thus the savings could total 10 to 20FF/kg, or up to about $3 50/lb wholesale

Table 6 shows that an exporter of another high value-added food product that cannot be frozen but requires refrigeration pays 12 25 FF/kg for air freight to France Allowing for insurance charges of 9% FOB (about 20 FF/kg), savings from a 20 to 30% reduction on air freight would amount to 2 50 to 3 75 FF/kg, or up to $0 68/kg on the CAF price in France Since total value FOB at a shadow exchange rate of 2250 is about $11/kg, the savings could amount to as much as 6 to 7% of total value FOB Savings from reduced charges on lower value-added products would be less, since the per unit charges on air freight of lower value-added products is generally lower

Table 6 Air and sea freight rates

Industry	Destination	Price as reported	Units	Qualifier	Standardized*
Air Freight Rates					
Processed foods	France	12 25	FF/kg	min 45 kg	3835 FMg/kg
Process foods	France	10-14	FF/kg		3757 FMg/kg
Agriculture-livestock	France	10 7	FF/kg		3350 FMg/kg
Plants	France	3310	FMg/kg	>300	3310 FMg/kg
Textiles	France	3500000	FMg/shipment		
Marine products	France	3880	FMg/kg		3880 FMg/kg
Marine products	France	3770	FMg/kg	>500kg	3770 FMg/kg
Agriculture	Europe	3770	FMg/kg	>500kg	3770 FMg/kg
Agriculture	Europe	11000	FMg/kg	<500 kg	11000 FMg/kg
Textiles	Germany	8450000	FMg/ship		
Processed foods	Reunion	2035	FMg/kg	min 45 kg	2035 FMg/kg
Agriculture-livestock	Reunion	6	FF/kg		1878 FMg/kg
Agriculture	Reunion	2034	FMg/kg		2034 FMg/kg
Agriculture	Mauritius	3195	FMg/kg		3195 FMg/kg
Sea Freight Rates					
Agriculture	Europe	1000-1200	$/container		6325 FF/container
Agriculture	Europe	1000	$/container		5750 FF/container
Agriculture-livestock	Europe	3300	ECU		16500 FF/container
Wood	Europe	15000	FF/TC 20		1500 FF/container
Processed foods	France	9000	FF/container		9000 FF/container
Agriculture	Reunion	1500000	FMg/container		4477 FF/container
Wood	Reunion	4500	FF/TC 20		4500 FF/container
Wood	Japan	12000	FF/TC 20		12000 FF/container
Agriculture	Asia	1500	$/container		8625 FF/container

Exchange rates 1800 FMg/US$, 5 75 FF/US$, and 1 15 ECU/dollar
Source for ECU and FF rates Wall Street Journal

Customs clearance

The financial burden of air freight premiums, however, appears to be less than the burden due to delays in customs clearance, particularly for those companies exporting perishable items such as meats, fish and other consumables The same company that exports that high value-added product to France reports that export delays can cost up to FMg 15 to 20 million per year, or up to about 15% of the value of total sales FOB The costs of delays reported by other companies was in the same range in FMg terms, and ranged from 3% to 10% of total sales in most other cases [43]

Part of the problem in customs clearance of food products is due to the nature of the product while it is necessary to move the goods quickly, it is also essential to meet sanitary standards in order to protect not only the particular customer involved but also the international reputation of Malagasy consumable exports It is in these cases, therefore, that the shortage of customs personnel and the need to prioritize shipments for their attention is felt most acutely

Prioritization of institutional costs

The general analysis of the survey coupled with the analysis of protection and efficiency permits the following prioritization of institutional costs according to their relative economic cost to firms This list of priorities is not driven strictly by the relative costs of constraints since costs vary according to different types of firms Table 7 presents a ranking of institutional costs, an estimate of their costs expressed as a percentage of total FOB sales, the type of firms that must incur these costs, and comments

It should be noted that for those firms not included in the Zone or Code, import taxes would theoretically rank high on this list, depending on the reliance of a firm on imported inputs and the relative cost of those inputs in relation to sales Table 3 provides examples of total effective tax rates inclusive of import taxes, consumption taxes, and the TUT, and shows that the burden for firms can be considerable

[43] In the most extreme case encountered, one company reported losses of FMg 10 million (24% of FOB sales) in export-related administrative costs and delays, and another FMg 7 million (another 17%) in costs associated with unloading and delivery of merchandise in France, resulting in cancelled orders

Table 7 A ranking of institutional costs

Rank	Institutional cost	% of sales FOB	Type of firm affected	Comments
1	Foreign exchange access	20 to 25%	Malagasy firms outside the Zone	Cost dependent on extent of overvaluation
2	Customs clearance	0 to 25%	All firms	Net of import and other taxes Affects Zone firms much less than Code or other firms Applies to both imports and exports, although delays to exports clearance related to lack of infrastructure as well
3	Air freight monopoly	0 to 8%	High value-added firms	Limited to those firms able to use air freight
4	Fees	up to 1%	Non-Zone	Variable and dependent on professional tax, payment of exporter patent association fees, etc
5	Tips	negligible	All firms	

Note Real costs of poor infrastructure, capital constraints and unreliable judiciary not included

5 Case studies

Firm A wood products
Code, joint venture, 50% exports, resource-intensive
DRC 0 88, FDRC 0 43, Export tax equivalent 3 2%

Firm A was created in 1987 for production of intermediate wood manufactures It qualified in 1989 under the *Code des Investissements* as a joint Malagasy/foreign venture with an Asian partner and began to export to Asia and Mauritius Exports are currently equal to approximately 50% of sales, which total FMg 400 million ($220,000) annually The firm is resource-intensive, relying on indigenous woods as major inputs It is less labor-intensive than other exporters, employing 110 people in production and another nine in management The firm is reliant on imports of production equipment and inputs such as wood paste

The firm notes several major problems with respect to imports and exports First, the Directeur Général (DG) estimates that the costs of import procedures and delays annually in terms of production stoppages can equal up to FMg 100 million—25% of sales These delays are due primarily to import delays of up to five months for shipment and customs clearance of equipment by boat, or 45 days by air The DG reports that no local supplier carries the necessary inputs with sufficient reliability for his operation Moreover, when local stores carry the equipment or supplies, the quality is inferior and the price exorbitant

The firm estimates that export procedures require from 15 to 60 days to complete, and cost up to FMg 2 million per shipment While the specific export procedures were not delineated, export of wood products does require notification of and approval by the Direction des Eaux et Forêts (DEF) in addition to regular customs procedures

The firm is operating efficiently by world standards, with a domestic resource cost coefficient of 0 88, but could be operating far more efficiently, its FDRC is 0 43 Notably, the firm's export tax equivalent is relatively low at 3 2%, reflecting the fact that institutional costs pertain to import procedures rather than exports It is assumed that the joint venture enables this firm to obtain foreign exchange readily, thus incurring no institutional costs associated with access to foreign exchange A high nominal protection coefficient (NPC) of 1 21 indicates that consumers are being taxed by existing trade policies, and the NPC increases with the inclusion of institutional costs to 1 67 An effective protection coefficient (EPC) of 0 60, measuring the incentives to producers that affect prices of both outputs and tradable inputs, reflects the fact that this producer received negative protection, i e that he is operating at a disadvantage on the world market given the trade distortions in Madagascar Inclusive of institutional costs, the EPC drops even lower to 0 10

Firm B marine products
No Zone or Code, Malagasy-owned, 90% exports, resource-intensive
DRC 0 73, FDRC 0 53, Export tax equivalent 16 8%

Firm B is wholly Malagasy-owned and classified under neither the Code nor Zone Founded in 1989 as a middleman for export of marine products, the company exports 100% of its "production" which actually consists of collection of fresh crustaceans, refrigerated storage and export to Europe and the Indian Ocean The firm is resource-intensive, and non-labor intensive, employing 21 people altogether but grossing FMg 1 2 billion annually (about $670,000), value-added is high

Major export constraints for this firm include refrigerated storage capacity at the airport, which limits volume, and capital for fixed investment The firm does not import any inputs, but is prevented from purchasing imported plastic bags because of bank delays in obtaining financing and foreign exchange The firm notes that local bags are 30% more expensive but of a similar quality to imported bags Although production slowed in 1991 due to the manifs, by September 1992 collection and processing had recovered sufficiently to export 2 to 3 containers per month of fresh, living seafood Other constraints include a lack of personnel trained in handling this specialized product, minor problems in the regularity of air shipments, capacity of sea freight to the Indian Ocean and domestic transport problems in the rainy season There are also bitter complaints about the monopoly imposed on air freight by Air Madagascar Export requirements include a certificate of origin and health from the Direction Pêche et Aquaculture (no formal fee required but a customary tip of FMg 10,000 to 35,000) and a free certificate of origin from the Chamber of Commerce Although the firm qualifies as neither a Code nor Zone enterprise, it has periodically obtained exoneration from the TUT (tax unique sur les transactions) due to the high proportion of its production going to exports

This firm is also efficient, with a domestic resource cost coefficient of 0 73, but like Firm A, it could be operating far more efficiently if institutional constraints were removed the FDRC is 0 53 The major source of costs in this case is revenue lost from the overvaluation of the FMg and from the firm's lack of access to foreign exchange This cost alone is estimated at FMg 240 million annually, 20% of FOB sales Consumers in this case are also taxed by the nominal protection afforded the firm, however the NPC of 1 11 does not change after accounting for institutional costs The firm suffers from negative effective protection, with an EPC of 0 74, and this coefficient shrinks to 0 54 after accounting for institutional costs The reason for the change in the EPC is primarily the difference between the shadow exchange rate and the official exchange rate the firm is less competitive on world markets as a result of FMg's overvaluation

Other institutional costs per shipment are minimal in comparison, however adding up unnecessary fees and tips over 32 individual shipments is not negligible total annual costs are close to FMg 2 5 million

Firm C plants and oils
No Zone or Code, Malagasy-owned, 100% exports, resource-intensive
DRC 0 04, FDRC -0 12, Export tax equivalent 37 9%

Firm C exports plants and oils indigenous to Madagascar It is wholly Malagasy-owned, qualifies under neither the Code nor the *Zone Franche* and exports 100% of its production to Europe The firm is resource-intensive, non-intensive in its direct use of labor (employing five people) and small in comparison to other exporters Total sales in 1991 were FMg 42 million ($23,000) This firm provides an example of what many very small, indigenous exporters may experience in the Malagasy business environment

Major export constraints for this small firm include irregularity of shipments (only one shipment in the first half of 1993), due reportedly to problems of authorization both by the

Government of Madagascar and by customs officials of importing countries Like Firm A, Firm C estimates that the cost of these delays in terms of lost orders and low client confidence has reached 25% of total sales, or in this case FMg 10 million The authorization problems occur as a result of delays in export approvals from the *Direction des Eaux et Forêts*, and as a result of substandard crating and processing by shippers which delay approvals in destination countries The firm does not import any inputs

The firm's domestic resource cost calculations are somewhat misleading in that the firm did not report family labor costs, and inputs are gathered directly from the forest Therefore, the financial costs of this business are not reflective of full economic costs in terms of the opportunity costs of time and labor, and DRCs are likely to be artificially low Nevertheless, the difference between the DRC and the FDRC reflects considerable potential savings in the absence of institutional costs Loss on foreign exchange totals FMg 8 4 million, again calculated on the basis of an overvaluation of the FMg and foregone retention of the full value of exports expressed in dollars This cost, however, is second to the estimated cost of customs clearance due to the requirements imposed by the *Direction des Eaux et Forêts*, coupled with substandard packaging To these costs are added additional unnecessary fees of FMg 700,000, including the *patente d'exportateur*, and various other fees associated with clearance and export While some of these expenditures could be classified as normal start-up costs—this company was founded in 1991—the overall export tax rate equivalent of 37 9% does signify the problems faced by an average Malagasy entrepreneur interested in launching an export concern

Firm D garments
Zone Franche, foreign-owned, 100% exports, labor-intensive
DRC 0 46, FDRC 0 45, Export tax rate equivalent 1 6%

Firm D is a foreign-owned manufacturer of garments founded in 1992 It is non-intensive in resource use, importing all of its primary materials, but quite intensive in labor, employing more than 400 people in production and management It qualifies as a *Zone Franche* enterprise, and therefore is able to import all of its materials tax-free as long as the agreement is presented with each import shipment and the goods comply with primary materials itemized in the original agreement The firm's gross sales were approximately FMg 2 2 billion for the first six months of operations in 1992, and all of its production was exported, primarily to European markets

Firm D notes three constraints on exports One is adequately trained workers, and the firm solved this problem by creating its own training school for production line labor The other is delays in imports Although imports are tax-free, the firm spends an average of 15 days obtaining clearance and authorization for its imported primary materials, filing forms at the Ministry of Industry, the Ministry of Finance and the Ministry of Trade The third is adequate and reliable export transport capacity in the form of available containers to carry finished goods by rail or road from the factory in the capital city to the port at Tamatave Due to formal ties with foreign entities, the firm has no constraints on financing capital investment or recurrent costs, and no problem accessing foreign exchange

These costs are minimal in the overall cost structure of the firm The firm operates efficiently, and accounting for institutional costs does not improve that efficiency dramatically However, the delays associated with customs clearance and transport delays and capacity amount to an effective export tax rate equivalent of 1 6%, which is still high considering all of the other advantages afforded this firm as a *Zone Franche* enterprise Interestingly, the nominal protection efficient on inputs at 1 37 and the effective protection coefficient at 0 78 indicate the existence of inefficiencies stemming from trade distortions, but these stem from the real costs of doing business in Madagascar and do not change after accounting for institutional costs

Firm E processed foods
Code and Zone, Malagasy-owned (ex-pat), 100% exports, labor-intensive
DRC 0 28, FDRC 0 28, Export tax rate equivalent 0 6%

Firm E qualifies both under the Code (1989) and under the *Zone Franche* (1992) Its business is in a fairly simply processing of agricultural produce, packaging and export to Europe Although wholly Malagasy-owned, it is run by a foreigner who has made use of all of the benefits pursuant to both legal regimes The business is labor-intensive, employing 65 full-time workers and providing income for another 800 rural farmers who provide the agricultural produce that is then processed for export Total sales were more than FMg 2 billion in 1991 (sales dropped more than 50% in 1992 due to the social and political disruption of 1991)

The firm reports no problems with imported inputs, they consist of a single item used for packaging that is not available locally The firm has also experienced no problems with export procedures, and finds the sea freight capacity and procedures affordable and timely The only problem the firm faces is that it is operating at full capacity and would like to expand production facilities but cannot due to the lack of medium- and long-term credit Since these costs are not included directly in the calculation of the coefficients or the export tax rate equivalent, these indicators are lower than those for Firm D since there are no complications associated with imported inputs The only institutional costs borne by the firm stem from the payment to obtain a *Autorisation de Sortie* from the *Ministère du Commerce* for each monthly shipment, coupled with the labor required to clear customs These costs amount to approximately FMg 6 7 million annually, or less than 1% of total sales FOB

6 Policy recommendations

The results of the general survey analysis, the IMPACT analysis and the case studies underscores the fundamental importance of the exchange rate for promoting exports and growth in the private sector However, the analysis also suggests that several other short- and long-term policy initiatives could contribute to further growth of nontraditional exports Short-term measures, in addition to devaluation of the FMg and increased access to foreign exchange, include extension of the *Zone Franche* beyond a select number of primarily foreign companies, and opening of the Air Madagascar air freight monopoly to competition Longer term measures include infrastructure development for improved intermodal transport and cargo transfer, continued liberalization of the financial sector, and judicial reform

Short-term measures

Devaluation and implementation of Loi No 91-014 12/08/1991

Ongoing policy discussions within Madagascar include continued devaluation within the context of broader liberalization of the exchange rate regime and the financial sector The importance of such measures cannot be underestimated for the growth of nontraditional exports, and for economic growth in general Madagascar has taken all of the difficult steps necessary to remove the major policy distortions hampering trade and growth, yet the method of valuation of the FMg and the strict limits on access by commercial banks and importers continue to thwart efforts to capitalize on the progress to date of economic reform

Certainly, a ministerial *décret* implementing once and for all the law that permits Malagasy businesspeople to hold foreign exchange accounts would accomplish much in the way of streamlining business procedures and reducing the gap between foreigners and Malagasy, and between those firms in the Zone and those outside of it [44] This policy action would not be costless, of course, which is one of the reasons that it has not been enacted to date Chief among them is the potential loss of resources through capital flight In concert with a devaluation of the FMg, however, and continued fiscal and monetary control, the establishment of a more flexible method of exchange rate valuation and a simple stroke of the pen to enact *Loi No 91-014 12/08/1991* could complete a major and necessary reform and contribute greatly to the ability of exporters to realize Madagascar's comparative advantage

Customs simplification

Second only in importance to the FMg's value is the ability of traders to move goods in and out of the country The delays associated with customs clearance affect every exporter and importer regardless of their legal status and nationality (although Malagasy traders appear to suffer longer delays than foreign traders) The government may either increase the resources of the *Direction des Douanes* in order to provide better implementation of the existing regulations and procedures, or reduce costs of those regulations and procedures through a reduction in their number and complexity Clearly, the latter option is more consistent with the overall goals of increasing efficiency within the context of a growing market economy

[44] *Journel Officiel* 2076 of 13/8/1991, p 1241

Simplification and reduction of import regulation and tariffs would greatly assist in the demands on a limited customs workforce Given that Zone industries are flourishing and are hiring considerable numbers of Malagasy workers, it would seem desirable to reduce the disparity in incentives between firms operating within the Zone and outside of it This could be accomplished in one of two ways Either the government could broaden the scope of the Zone to include firms that may not be oriented completely toward exports, in order to encourage those firms that are exporting some but not all of their production An alternative option, which is entirely consistent with an expanding, outward-oriented economy, would be to reduce tariffs further and simplify import procedures regarding imported inputs and capital equipment for all firms, whether Malagasy-owned or not, to enable them to compete on a more level playing field

Establishment of a *guichet unique* for import clearance is another option for increasing the mobility of goods and services without increasing the costs of the *Direction des Douanes* Given the success of the *guichet* for investment in Madagascar, the government has experience in this type of systems creation In lieu of, or in addition to, simplifying and standardizing import procedures to reduce the disparity between ZF firms and non-ZF firms, the government could establish a single location for information, tariff collection and clearance of all imports Even the *Zone Franche* firms complain of egregious import procedures in order to document their exoneration from tariff liability This *guichet* need not constitute a new layer of inter-ministerial bureaucracy It could be formed under the aegis of customs as part of a broad-based institutional effort to increase the efficiency and improve the standards of the Direction des Douanes within the Ministère des Finances

Establishment of a *guichet unique* for export clearance is another option Chief among the concerns of many exporters is the complexity and irregularity of export procedures In the same spirit as a *guichet* for imports, a single window for exports clearance would reduce the uncertainty and increase the efficiency with which exports leave the country Among the problems described by exporters is the number of ministries that must be consulted for clearance of certain types of goods (such as wood products, semi-precious stones and foods) A single office empowered by the relevant ministries to rule on issues of sanitation, authenticity, or legal authorization could reduce the need for extra personnel by firms and the frequency of shipment delays, increasing efficiency and reducing costs Another complaint voiced by even the *Zone Franche* firms is the lack of agents available for on-site customs clearance prior to packaging for shipment The *guichet* could consolidate its operations at key embarkment points, such as the port at Tamatave and Ivato airport, relying on a few special agents for periodic on-site checks prior to packaging

Increased competition

Encourage competition within the air freight and sea freight service sectors The constraints imposed on exports by sea and air freight limitations could be lifted quickly through a few major policy changes These include finalizing and implementing liberalization of domestic air cargo operations, for which regulations have existed in draft form since 1990, and lifting the monopoly on domestic passenger flights in aircraft with more than nine seats (which was due to be ended on June 24, 1993) [45] Such reform of current policy could represent the first step towards eventual privatization of Air Madagascar, opening up the market to other private cargo and passenger carriers Clearly, the constraints imposed by the continued monopoly of Air Madagascar on air freight are contributing to the bottleneck experienced by exporters of higher value-added goods [46] Finally, lifting of the requirement that *cabotage* (using smaller vessels for cargo transfer to larger ocean-going ships) be limited to vessels flying the Malagasy flag would open competition in this fundamental service, freeing up coastal trade

Long-term measures

Infrastructure development

Streamlining the regulations and inefficiencies surrounding intermodal transfer of imports and exports (i e from railroad car or truck to cargo ship) would relieve a major constraint to efficient, market-rate transport Some of the shipping capacity problems *and* customs clearance problems could be solved through creation of terminal and storage facilities in Antananarivo (with a terminal at the airport) and in Tamatave These facilities could provide headquarters for the *Direction des Douanes*, refrigeration facilities for lease by smaller entrepreneurs, and a collection point for containers, which are currently in constantly short supply at either end of the Tana-Tamatave line The terminals would also provide, of course, a locus for intermodal transfer of cargo and would optimize connections among rail, road and air transport

Financial sector liberalization

Madagascar is already well on its way to deepening the financial sector The reforms that were launched with the 1988 Banking Law, initiating at least partial privatization of all but one of the four primary banks in the country, have profound implications for export and trade An increased emphasis on financial market development by the private sector, so as to remove or at least reduce the limitations imposed by the needs of public finance, is essential in this regard Continued liberalization and freeing up of the private sector must come hand in hand with improved (not increased) regulation by public authorities to ensure transparency, to improve

---

[45] Steedman, 1993

[46] The real constraint imposed by the Air Madagascar monopoly seems to result more from its legal hold on the market for transport services than on its limited capacity, since for all but two months of the year (litchi season) only 35% to 40% of international cargo capacity is used (Steedman, 1993 5) However, limited capacity was mentioned by several firms in the context of the problems associated with air freight and the limits are due at least in part to the higher rates charged by Air Mad in comparison to world rates

contract enforcement, and to increase the public's faith in the banking system [47]

Judicial reform

Perhaps the most sweeping reform that is necessary to reduce institutional constraints to nontraditional export growth in Madagascar is the development of the rule of law in Madagascar Annex A speaks directly to the distortions and irregularities of the judicial system in place at present While resorting to international arbitration represents a good short-term solution for businesspeople in Madagascar, it may not represent the optimal long-term solution Comprehensive legislative reform is needed with respect to business registration, the Commercial Code (which dates in certain places to colonial times), the power of judges to make law, the Code of Civil Procedure, arbitration, export regulations (where inconsistency remains as a result of the adoption of conflicting laws), regulation of foreign participation, and banking law

Annex A also underscores the availability of significant research on the changes needed in order to establish the rule of law within the context of the new Constitution The next step, according to its author, is not additional research but legislative drafting by Malagasy *juristes* in concert with those who have experience in developing commercial codes that are consistent with international business practice

Conclusion

Madagascar is poised at the brink of strong, export-led growth The government has already laid the legal and economic foundation for future expansion of trade, but there remain certain constraints to permitting the private sector to realize Madagascar's full comparative advantage and economic potential in world markets

This report has outlined the major institutional constraints to growth of nontraditional exports The short-term policy recommendations to remove these constraints are all logistically easy The economic benefits of these policy changes are self-evident Perhaps the most important benefit lies in opening the economic opportunities that have already been realized by mostly foreign companies in the *Zone Franche* to average Malagasy businesspeople The long-term policy recommendations, designed to lower the real costs of doing business in Madagascar, require a deeper and more fundamental commitment to investment in the future and change in the legal, regulatory, and judicial environment Whether or not these policy changes are implemented, economic growth and growth of exports is likely to continue The question is who will benefit from this growth and to what extent Madagascar can optimize the use of its extraordinary human and natural capital

---

[47] Other studies have documented the present challenges and future potential of continued financial sector liberalization They are listed in the bibliography

Annex A

A General Overview of the Legal Environment in Madagascar as it relates to the Evaluation of the Costs and Benefits of Elimination of Institutional Constraints to the Growth of Nontraditional Exports

by

Louis M Aucoin

of
Boston University Law School

for
Associates for International Resources and Development

June, 1994

Table of Contents

45

Introduction

In June of 1993, a mission study was conducted under the auspices of Associates for International Resources and Development (AIRD) in Antananarivo in Madagascar The purpose of the study was to evaluate the costs and benefits of institutional restraints on the expansion of non traditional exports in that country The AIRD team conducting the study was composed of two economists, J Dirck Stryker and Christopher Shaw, and a jurist, Louis Aucoin The economists have prepared a separate but related report examining costs and other economic factors This report is submitted in an effort to identify aspects of the general legal environment in the country which tend to inhibit or discourage exports and to make recommendations for reform It also will the law as it relates specifically to exports in order that recommendations can be made in that area as well

A few comments on the scope of the report are necessary at the outset Since the law relating to the Investment Code and the law relating to the establishment of a *zone franche* (free trade zone) are so closely related to the economic issues, they have been examined in the report by the economists and will not be included here

In addition, it is necessary to point out that a considerable amount of work related to this subject has already been done For instance, Mr Cordahi or the International Development Law Institute has prepared a comprehensive report on the legal environment in Madagascar, entitled "Evaluation du Cadre Juridique Pour le Dévelopment du Secteur Financier à Madagascar," IRIS, September, 1993 In addition, a report entitled, "Projet de Promotion des Exportations Agricoles Rapport sur l'aspect juridique et réglementaire," (hereinafter the P P E A Report) was conducted for the World Bank by the Cabinet de Conseils d'Entreprise in Antananarive in February, 1993 Finally, a report by Mr Louis Massicotte entitled "Toward an Independent and Accountable Judiciary Judiciary Report on Judicial Reform in Madagascar, IRIS Sept 1993, has dealt significantly with the subject of judicial reform References will frequently be made to those reports in an attempt to underscore the relevance of the information contained in them to the expansion of non-traditional exports

This report will first look at the relevance of the problems in the general legal environment to the expansion of non-traditional exports It will then examine the legal problems which are specific to exports, and finally it will examine some new developments, relevant to the export area in the areas of banking and mining law

The report will conclude with a summary and review of the recommendations which have been made in all three of these sections

The author of this report is indebted to all of those who participated in this study in Madagascar A list of those persons is contained in the report dealing with the economic aspects of the study However, this author would like to express particular thanks to Marguerite Davis of the USAID Mission, Madame Madeleine Ramaholimihaso Manamihaso, M Bergem Ravelomjoma of the Ministry of Mines, M Ives Ratrimoarivomy of the Ordre des avocats and M Bertholier Ravelontsalama of the Ministry of Justice for their invaluable assistance in conducting the legal aspects of this study

I General Problems in the Legal Environment

The problems which emerge from a general overview of Madagascar's legal system can be grouped roughly into two conceptual categories One category of problems stems from Madagascar's recent legal history Its legal system had taken on a strong socialist flavor in the post colonial period, and since 1989, sweeping legal reforms have been made to complement the evolution toward democratic institutions and the liberalization of the economy The reforms, while definitely constituting progress, leave certain ares of the law in a state of confusion The other category of problems is conceptually related to the establishment of the rule of law In this category, a long list of inadequacies can be listed, which, when taken together, serve to impede the rule of law Many of these problems relate to Madagascar's adaptation in the post colonial period of the French legal system which it had received under French rule

The two conceptual categories referred to in the previous paragraph merely constitute a way of grouping and analyzing related problems Consequently, there is overlap between the them Nevertheless, the following two sections will analyze each category separately in an attempt to identify specific problem areas while associating them with an underlying cause

A Problems relating to recent reform efforts

In the first category, the underlying cause of the problems described is the difficulty associated with translating the evolution from a socialist to a free-market economy into legal terms While efforts and accomplishments since 1989 have been impressive, many areas of the law are characterized by a confusion of authority between laws that were enacted during the socialist period and the laws which have been adopted as part of the recent reform This confusion of authority is exacerbated by the use of broad terms which require implementation and the overuse of the prescription, "This law abrogates all pre existing legislative provisions to the contrary " This boilerplate which figures frequently in recent reform legislation fails typically to specify or repeal previously existing relevant provisions This state of affairs leaves a confusion as to which laws are applicable

Business registration procedures, for example, constitute an area of the law where there is a confusion of authority between former laws and those recently adopted Prior

41

to recent reforms, business registration procedures were characterized by a kind of formalism and significant state involvement which are typical of business registration procedures that exist in other former French colonies [1] They provide for a series of requirements which must be met before an *agrément*[2] can be obtained from the Ministry of Commerce which gives a person desiring to do business in Madagascar the formal status of *commerçant* or merchant After having enrolled with the Ministry of Commerce, where the business registration is kept, and after having paid a tax for doing business, a person may begin to engage in business Under these procedures foreigners are required to obtain a special professional identity card [3] These requirements originate from the French law of 18/3/1919 which was made applicable in Madagascar by an administrative ruling dated 29 09/1929 [4] They involve several other ministries and have been reported to be burdensome

While some of the formalism in this area could have been justified during the French colonial period and in the socialist era by the need of the state to obtain necessary information for the establishment of price controls, the procedures are now clearly unnecessarily onerous in light of recent reforms [5]

The *ordonnance* of 1988 establishing major reform in the export area (this law will be discussed in detail in the section dealing with export reform) states a general principle of liberalization of internal commerce However, as the authors of the P P E A Report of the World Bank so aptly point out on page 14 of their report, it remains unclear as to whether all of the specific requirements of the procedures have been implicitly repealed by the general terms of the 1988 *ordonnance*

In addition, the role of the state as a preponderant source of control in the economic sphere is very strongly felt in the law adopted during the socialist period As part of recent reforms aimed at liberalizing the economy, an attempt has been made to limit the role of government in the private sector However, due to the fact that the

---

[1] "Projet de Promotion des Exportations Agricoles Rapport sur l'aspect juridique et reglementaire (hereinafter the P P E A Report), conducted for the World Bank by the Cabinet de Conseils d'Entreprise in Antananarivo in February, 1993 See also Aucoin, Louis, Current Status of the Legal System and the Rule of Law in Chad and its Effect on the Private Sector IRIS, Country Report No 10, October, 1992, page 54 (Hereinafter Aucoin's Report of the Rule of Law in Chad) and Cordahi Alexander, Evaluation du Cadre Juridique Pour le Development du Secteur Financier a Madagascar,' IRIS, September, 1993, page 24

[2] PPEA Report, *supra*, page 7

[3] *Loi* no 62-006 of 6/06/1962

[4] Cordahi, *supra*, page 24,

[5] PPEA Report, *supra*, page 7

presence of the state was so far reaching in the socialist era[6], many areas of the law affecting the private sector are still characterized by excessive state involvement in spite of reform efforts engaged in up until now This is felt perhaps most keenly in the existence of statutorily established state monopolies in some sectors of the economy which still exist Since, as noted above, some reforms are not specific enough in their abrogation of pre-existing norms, it is feared that the remaining provisions will continue to be applied in the future [7]

B Problems related to the Rule of Law

The underlying cause associated with the problems in the second conceptual category described above is failure of the legal system to establish the rule of law in Madagascar Some of the factors which serve to impede the imposition of the rule of law in the system are the failure to observe the hierarchy of legal norms, lack of publication of laws and regulations, inconsistency, gaps in certain legal areas, and the discrepancy between law and practice Each of these will be considered in the following paragraphs and their relevance in the context of exports will be underscored It should be noted that problems relating to enforcement are also related to the establishment of the rule of law As a result of their importance, they will be considered separately in Sections C

The failure to observe the traditional hierarchy of legal norms is a frequently encountered phenomenon found in the legal systems of African countries which received the French legal system during the colonial period [8] The hierarchy of laws has been inherited from the French legal system In general, constitutional law is supreme Next in the hierarchy are the *ordonnances* and the laws which are adopted by the legislature, and finally there are a series of administrative orders which themselves have an internal hierarchy At the top of that hierarchy is the *décret* followed by the *arrête*, and the *circulaire* [9] The *Note de Service* is at the bottom of the hierarchy and could be compared to an administrative policy statement in an American administrative agency In many instances in the post colonial era of former French colonies, respect for this hierarchy falls off As a result major policies established by the written law of parliament or by an *ordonnance* are often modified or even superseded in practice by administrative orders These *décrets* and *arrêtés* are issued by the ministries responsible for the area of the law related to the previously established policies Were the hierarchy of norms to be

---

[6] It was reported to me by Madame Madeleine Ramaholimihaso Manamihaso that all private enterprises were nationalized in a comprehensive socialist law adopted in 1975

[7] Cordahi, *supra*, page 14

[8] See, for example, Aucoin's Report on the Rule of Law in Chad, page 42

[9] Id

observed, they could not be used to modify or revoke the superior laws or *ordonnances* Failure to observe this hierarchy undermines the effectiveness of major policy reform

One of the clearest examples of this failure to observe the hierarchy of norms in Madagascar concerns the way in which restrictions have been placed on property rights of foreigners doing business in the country These restrictions of course reflect an underlying fear of foreign domination which is again typical of former colonies Professor Cordahi describes the problem succinctly in his report [10] Part of the problem lies in the fact that in practice foreigners are not allowed to own land This fact was reported to us in many of our interviews with investors involved in exports It was cited by them as a major factor inhibiting foreign investment It was also cited as the reason for the use by foreign businessmen of the long term lease (*bail emphytéotique*)

Ironically, an examination of the relevant law reveals an anomaly In fact, foreigners were expressly granted the right to own property in the constitutions of 1959 and 1992 In addition, Law 06/06/1962 on immigration clearly granted the right in 1962 and charged the Ministry of the Interior with implementation However, a simple *Note de Service*, no 2926PM/SGG/OJ of 13/06/78, a policy which emanated from the Ministry of Interior, turns out to be the source of the restriction currently practiced This fact operates in clear violation of constitutional doctrine inherited from traditional French constitutional law Article 82 of the Constitution currently in effect clearly establishes that property rights are to be decided by the legislature, and regulatory measures are limited by the terms of the law

This same example, however, can be used to illustrate the failure to consistently publish legal texts or review them for their consistency with other laws Procedures must be established requiring administrative regulations to be reviewed prior to adoption for their conformity with the law and the Constitution This is another set of problems related to the establishment of the rule of law which is encountered in other former French colonies [11] Mr Cordahi notes in his report

> Ignorance of the applicable legal rules constitutes an obstacle to the development of the financial sector in Madagascar Late publication of new texts in the Official Journal, and the absence of published codes, general or specialized, are also factors which can place the investor outside of the law or deprive him of his rights [12]

Cordahi notes that many legal provisions which are adopted are either published

---

[10] Cordahi, *supra* page 14

[11] See Aucoin's Report on the Rule of Law in Chad, page 34

[12] Cordahi, *supra*, Page 15 Translation by author

late or never published at all Yet in some cases these measures are considered applicable by those concerned [13]

These factors are at the root of the inconsistency found in laws and regulations Cordahi makes some sound recommendations for the coordination and definition of the roles of the Secretary of the Government and the Ministry of Justice in the monitoring of laws and regulation and of their publication [14]

These problems are evident in the export context as well The World Bank team studying the legal restraints on exports in 1993 noted that many of the regulatory measures which they were forced to review as part of their study had in fact never been published Yet the team frequently found that the measures were nonetheless applied [15] As Cordahi has indicated, such a state of affairs puts, investors, in this case exporters, in a rather untenable position *vis à vis* the law since they are likely to ignorant of laws under which they may very well be held accountable

Another example of the confusion arising from these factors is the inconsistency between the terms of *Loi* no 62-006 of 6/06/1962 and *l'arrêté interministeriel* no 3516 of 25/10/1966 The law requires foreigners to have a professional identity card or a work permit before they can obtain a residence visa and the administrative ruling requires them to have a residence visa before they can obtain a professional identity card This is obviously a glaring inconsistency which will need to be cleared up by a clearly drafted law on immigration requirements for foreigners doing business in Madagascar

The other two factors which have been cited above as problematic in terms of the establishment of the rule of law are the lack of law in many areas and the discrepancy between law and practice In reality, it would be artificial to separate a discussion of these two factors This is so because where there is a lack of law, practices naturally emerge to meet the exigencies of economic and social life in this period The result is that if one examines the state of the law in Madagascar, one often discovers that the law which is technically applicable, if one were to follow the rule of law, dates from the French colonial period Since the law dating from this period is clearly outdated, it falls into disuse and practices , customs or uses emerge which seem to presume, falsely, the existence of the kind of supporting legislation which legitimizes these same practices in other countries, most notably in France This phenomenon can be found in other former French colonies as well where judges frequently apply modern French law as if it had

---

[13] Id

[14] Id

[15] PPEA Report, page 2

been adopted subsequent to the colonial period [16] The phenomenon raises havoc with the concept of the rule of law since it involves application of norms which have not been adopted in any uniform way by either the legislature or the judiciary

This reflection evokes a consideration, which merits parenthetical discussion, of the role of the judiciary and the legislature in civil law and common law countries If one were constrained to paint the differences which exist between the two legal traditions with a broad brush, one could make the following observations In civil law countries, in theory, the legislature makes the law, and judges are limited in their role to application of the law, whereas in common law countries law is made by the legislature, but judges are also empowered to create enforceable rules in the absence of legislation In common law countries, legal methods are developed in order that a hierarchy of court rulings can be determined so as to create the rule of law with respect to judge-made law

In reality, this broad distinction is becoming less and less clear since judicial decisions have taken on increased importance in civil law countries This development is of some potential significance for legal systems in developing countries which follow the civil law tradition If jurists in these countries could take cognizance of the evolving role of judges throughout the world in actually making law, perhaps more effective steps could be taken by judges in Madagascar to address the problems related to the lack of law mentioned above There are problems with this potential solution since it would depend upon good training and education of judges and would presume the development of some legal method to determine the hierarchy of judicial rulings and ensure their uniformity Nevertheless, it would be advisable for the legislature in Madagascar to consider statutory reform which would clearly grant judges the power to create enforceable rules Such a reform would need to include measures to address the establishment of a hierarchy of rules and ensure their uniformity Such a law would serve to fill the void which currently exists in many areas of the law where the legislature has not yet acted or engaged in reform [17]

In light of the lack of law and the discrepancy between law and practice, the following paragraphs will analyze the state of the law in different areas which are relevant to exports In each area, the lack of law and the practices which have emerged to fill the gap will be described In addition, certain recommendations for reform will be made in the course of analysis

This first area of law, and perhaps the most basic, which has relevance to

---

[16] See Aucoin's Report on the Rule of Law in Chad, pages 34-40

[17] Obviously, were such a reform to occur, it would have to be included in any training program for judges This report is not addressing training of judges since that area is covered in the report was authored by Mr Louis Massicotte and is entitled "Toward an Independent and Accountable Judiciary Judiciary Report on Judicial Reform in Madagascar IRIS Sept 1993

investors and exporters, is the law of contract In countries of the civil law tradition, particularly in those which have followed a French model, the law of contracts emanates from two primary sources--the Civil Code and the Commercial Code In the Civil Code, the basic contract principles are found in the Law of Obligations, which groups what American lawyers would call tort and contracts together The Commercial Code contains the concepts of contract law which apply in the commercial area In modern France, these concepts frequently correspond with the same concepts found in the Uniform Commercial Code in the United States The modern French Commercial Code and the UCC reflect a palpable trend at this period in history toward universality of legal norms in the commercial area which consequently rise to the level of international standards

In Madagascar, both of these codes were adopted during the French colonial period There exists both a Civil Code and a Commercial Code, which, for all intents and purposes followed the same development and evolution as the Civil Code and Commercial Code which existed in the metropole at the same time [18] However, as was reported to me in interviews of jurists in Antananarivo, with the exception of a few *ordonnances* adopted after 1967, there has been almost no adaptation of these codes since 1960 Nevertheless, as was also reported to us in many of the interviews conducted, modern contract forms and principles are practiced and applied in the commercial area The problem with this state of affairs is that there is no underlying law which serves as the basis for conflict resolution when a dispute concerning these practices arrives This fact undermines the rule of law

In reality, judges can and do apply modern commercial norms in cases that come before them in the commercial area However, due to the lack of legitimately applicable law in Madagascar, they have to base their decisions on *their knowledge* of international standards or modern French law This fact evokes the necessity for training and education of judges Since it is widely reported that judges are often poorly trained,[19] their knowledge and training vary considerably, and their decisions are often inconsistent The result is that investors and exporters uniformly report a sense of a lack of reliability on the part of the courts for the resolution of their commercial disputes This is one of the factors engendering the mistrust of and lack of confidence in the courts which exists in the private sector

Mr Cordahi succinctly describes this problem when he states

> Banks and other business enterprises use modern contract forms and standards But they exist in a legal system whose law is outdated This dichotomy

---

[18] PPEA Report, page 13

[19] See footnote 18, above

constitutes a risk in the area of contract enforcement [20]

Mr Cordahi makes several recommendations for reform in this area and one of them is related to the general recommendation for the empowerment of judges discussed above He notes that in the contract area the Civil Code specifically recognizes that customary uses in the contract area may be considered as binding rules and applied by judges [21] Consequently, there is currently statutory authority for judges to recognize and enforce rules which are based in practice in the area of commercial contracts This is a fact which needs to be taken into consideration in the training of judges in the future in Madagascar [22]

Corporate law and company law are other related areas where there is a lack of law and a wide discrepancy between the law and practice In addition to their being a lack of law in this area, there is also a basic conflict between the two sources of law which do exist

On the one hand, there exists a whole panoply of *ordonnances* , laws and regulations which emanate from the socialist period These provisions provide for various forms of business enterprises all of which are characterized by varying degrees of state ownership and control The forms of business established by these laws are as follows

1 *Société d'économie mixte L'ordonnance* no 60 004 of 23 February, 1960, *Loi,* no 67 007 of 28 June, 1967 and *décret* no 70 175 of 31 March 1970

2 *Société d'intérêt national Ordonnance* no 73-045 of 09/08/1973

3 *Société anonyme d'état L'ordonnance* no 60 004 of 23 February, 1960 [23]

In addition, the *Charte des Entreprises Socialiste* (Charter of Socialist Business Enterprises) was adopted by *Ordonnance* no 78-006 of 01/05/ 1978 This law introduced many changes in the prior socialist law In general, since 1992, there has been a move toward reform which has involved repealing at least some of these laws with the ultimate goal being the elimination of the role of the state in business However, businesses which are partially or wholly owned by the state, and which often exercised a monopoly

---

[20] Cordahi, *supra* page 16

[21] Id page 17

[22] See footnote 18

[23] See page 19 of Cordahi's report for a brief description of the major characteristics which distinguish these socialist forms of business

54

in certain areas of the economy still exist and are governed by these laws This will be apparent in the examination below of laws relating to exports

The other source of law which exists in this area dates from the colonial period and authorizes the forms of business which are currently used in France and in other former French colonies They and the laws which create them are as follows

1 *Société en nom collectif* Articles 18-64 of the Commercial Code

2 *Sociéte en commandite simple* Articles 18-64 of the Commercial Code

3 *Société en commandite par actions* Articles 1-20 of the law of 24 July 1867

4 *Société à responsabilité limité* The French law of 7 March 1925 made applicable in Madagascar by the decree of 7 March 1925 [24]

The conflict between these two sources of law lies in the fact that during the socialist period the socialist forms of business were used, and now that there has been a commitment toward the liberalization of the economy, there has been a return to the use of French forms of business

This conflict underscores and illustrates many of the problems which have been discussed First, since the law establishing the French forms of business is so outdated, it emphasizes the lack of law described above Moreover, since the law has not been updated since the colonial period to reflect modern French law and practice, the state of practice in this area is inconsistent with the outdated law Consequently, while some reform has already been undertaken to address these problems, new clearly drafted laws need to be adopted repealing inapplicable old laws and adopting new provisions reflecting current practices

Another gap in the law is found in the area which Americans would refer to as tort law In civil law countries tort and contract liability are treated together in an area of the law known as the Law of Obligations The lack of law in this area was raised in our interviews with exporters For example, in meeting with M Roland Razakanaivo, a "*transitaire*," it was reported that there was no law on liability which could be used to resolve disputes which arise when exported goods are lost or damaged at some point in transit It is interesting to note that M Cordahi discovered that these kinds of disputes form a non-negligible part of the court back-log which is being reported by the Commercial Court in Antananarivo [25] Madame Madeleine Ramaholimihaso reported to the author that there is a law of 1966 which is entitled "*La Théorie Générale de*

---

[24] See BRIEF, no 29-30, janvier 1991 Cabinets Madeleine Ramaholimihaso Manamihaso

[25] See Cordahi's report at p 39

Obligations" (the General Theory of Obligations) The author was not able to find this law during his stay in Madagascar, but it is likely that the law, as indicated by its title, deals only with basic concepts and doesn't give courts enough to work with in resolving disputes in this particular area These kinds of disputes are often governed by law which is included in commercial codes in other countries This is the case in the United States and France, for example

Mr Cordahi suggests a major reform of the Malgache Commercial Code, and any such reform should take this area of the law into consideration In the meanwhile, one suggestion for those who are concerned about how to resolve these kinds of disputes for parties to export transactions would be to use arbitration where possible Often, arbiters in an arbitration can be empowered to create rules or refer to other legal systems for rules to resolve conflicts where no such rules exist in the law governing the arbitration [26]

This section does not include an exhaustive list of the gaps in the law in Madagascar's legal system An attempt has been made to illustrate the effect of lack of law in those areas of the law which would be likely to be relevant to exporters However, even here, the list is not exhaustive For example, there has not yet been any discussion of those areas of the law which could be used to address one of the problems frequently raised in our interviews of exporters--the lack of access to capital This problem relates to banking and finance, securities regulation, and secured transactions, *inter alia* The inadequacies of these areas of the law are the main focus of Mr Cordahi's report, and he treats them exhaustively, providing concrete recommendations for law reform in these areas as well Consequently, this report will defer to Mr Cordahi in these areas

Nevertheless, Section III of this report will contain a brief description of relatively recent developments in two areas of the law which were not discussed in any detail in Mr Cordahi's report One source of new developments in banking law is *Ordonnance,* no 88-005 In addition, there is a law and administrative regulations dealing with mining law which constitute some new developments in that area of the law

C Enforcement

Another area of difficulty relating to the general legal environment in Madagascar frequently cited in the interviews which we conducted is the area of enforcement of judgments As noted above, since this area of the law has such bearing on the general weakness of the legal system, it will be discussed here in a separate section

When parties to the various transactions that occur in the export context can not

[26] Aucoin, Louis, Dispute Resolution as an Alternative to the Ordinary Courts in Madagascar A Guide to Choice in the International Arena,' IRIS, October, 1993

count on the courts to resolve the disputes that arise between them, this fact operates as an inhibition which contributes to the ill health of the export market One of the reasons why it is felt in Madagascar that the courts are not reliable in resolving such disputes is that, even in those cases which are brought to judgment, enforcement of these judgments is excessively slow and therefore not effective Mr Cordahi reports, for example, that in the Commercial Court in Antananarivo, in more than ten cases where enforcement of judgment was sought in 1988, there had been no resolution in the fall of 1993 [27]

This lack of reliable enforcement stems at least in part from procedures which are established under outdated law This again is a problem which is found in other former French colonies where the procedures are inherited from legal provisions which date from the colonial period [28] These procedures typically allow debtors lengthy periods during which they can file a defence to the action, and they even provide for substantial periods of time during which the debtor could request a rehearing or "*renvoi* " even after a default has entered And these are only some of the examples which give bad faith debtors the opportunity to take advantage of dilatory tactics

The Cordahi report provides a comprehensive study of this problem and makes concrete proposals for reform that make sense in a legal system based upon the French model [29] He points out that the law in this area was updated by a code which was promulgated on September 24, 1962 and updated on December 19, 1966 Nevertheless, he cites the ignorance of this code by judges as indicating that another aspect related to the enforcement of judgments is the inadequate education and training of judges This fact, as he illustrates, often gives debtors the opportunity to engage in delay tactics even where the updated law would otherwise provide for expedited procedures He also points out that a"fast track" procedure for enforcement of judgements was enacted by *Ordonnance* no 93-012 However, that procedure is limited in its availability to national banks and state enterprises He strongly advocates for a significant broadening of the availability of these procedures

His recommendations call for a two-pronged approach which would include new legislation addressing a whole panoply of problems which he discusses on the one hand and training for lawyers and judges on the other [30]

Another potential remedy for the inadequacies of Madagascar's legal system with respect to enforcement is the use of arbitration and other forms of alternative dispute

---

[27] See Cordahi's Report, page 38

[28] See Aucoin's Report on the Rule of Law in Chad, pages 52-54

[29] Cordahi report, pp 37-43

[30] See footnote 18

resolution The author of this report has written another report in which the alternative of international commercial arbitration is considered in depth as a strategy for addressing this problem in Madagascar [31] The report explains that arbitration, in addition to encouraging the parties to a dispute to resolve it in good faith, also affords efficient mechanisms for enforcement of the arbitral award in countries where the parties may have assets As the report points out, these mechanisms of enforcement are available because Madagascar is a member of the *New York Convention,* which provides for the enforcement of arbitral awards in any member country This solution could be of benefit to a Malgache resident who wishes to pursue execution of a judgment against a foreign investor with whom he has a dispute It could also be of benefit in the export context for foreign investors who wish to enforce a judgment against a Malgache resident exporter This is particularly true in light of the *Loi* no 91-014 of 12/08/1991 (JO no 2076 of 13/08/1991, p 1241), which allows Malgache exporters to keep assets outside of the country

The report provides basic information about all the choices of rules and institutions which are available to resolve disputes arising out of transactions occurring in Madagascar through the use of international commercial arbitration It also strongly advocates the adoption of two separate laws in Madagascar--one dealing with domestic arbitration and the other with international commercial arbitration [32] It reviews all of the questions which will need to be answered and issues that will need to be considered in the adoption of such laws

There is some additional information not contained in that report which merits some discussion here In considering international commercial arbitration as an alternative for private sector operators doing business in Madagascar, there are some recent legal developments which are relevant to the viability of that alternative for banks

Mr Cordahi, on page 48 of his report, makes the point that banks traditionally shy away from arbitration as a mechanism for loan recovery However, there may be some change on the horizon in this respect, at least in the case of American banks The change results from the recent development of the concept of *lender liability* in American law A recent article published in French in the *McGill Law Journal* by the American scholar in banking law[33], Prof William Park of Boston University School of Law, describes this development, and strongly recommends the use by American banks of international commercial arbitration as a method of avoiding lender liability in their dealings with foreign debtors

---

[31] See footnote 26

[32] The Cordahi report makes similar recommendations on pp 47,48

[33] Park, William, L'arbitrage et le recouvrement des prêts consentis a des debiteurs etrangers 37 *McGill Law Journal* 376 (August, 1992)

The article describes lender liability as a vague concept covering many different situations in which American courts have recently awarded damages against banks where courts have found that the banks have engaged in bad faith in lending to foreign debtors Liability has been found and damages imposed, for example, in cases where courts have found banks in bad faith in refusing to advance additional credit to foreign borrowers Prof Park suggests that banks could avoid the courts and escape the risk of liability that the courts are imposing by requiring arbitration in their contracts with borrowers As this author has pointed out in his report on international commercial arbitration for Madagascar, one of the salient features of the *New York Convention* is that it requires parties who invoke it to commit to arbitration as their exclusive means of dispute resolution In addition, Prof Park suggests specific language for inclusion in arbitration clauses of contracts which would allow banks to clearly avoid the risk of lender liability [34] Consequently, in an effort to avoid the courts and the imposition of lender liability, banks, at least American banks, may be increasingly encouraged to use arbitration in loan recovery By invoking the *New York Convention* and using Prof Park's suggested arbitration clause, banks may be encouraged to make loans in Madagascar

II Law and Exports

Any analysis of existing legal or institutional constraints on exports needs to take into consideration the meticulous work which has already been done in this area by the World Bank as reflected in the report referred to above prepared by the *Cabinet de Conseils d'Entreprise* in February of 1993 The team involved in that study gathered all the *ordonnances,* laws, and administrative rulings, published and unpublished relating to exports, and has analyzed them one by one in the voluminous annex (237 pages) to the report In that annex each enactment is described, and information is provided, indicating which provisions have been abrogated and which provisions still require some reform In general, it can safely be stated that the vast majority of pre-existing institutional restraints on exports have been eliminated, though specific problems persist

---

[34] The suggested language in French is as follows

1 Tous differends ou litiges decoulant du present contrat, ou en rapport avec lui, y compris un pretendu dommage delictuel ou contractuel subi par le debiteur suite au comportement de la banque, seront tranches définitivement suivant le Reglement d'Arbitrage de la Chambre de Commerce Internationale par unou plusieurs arbitres nommes conformement a ce Reglement

2 Le lieu de l'arbitrage sera [ ]

3 Le president du tribunal arbitral ou l'arbitre unique, selon des circonstances, sera un avocat ou un juge retraité

4 La langue de l'arbitrage sera [ ]

5 Aucune disposition de la presente clause compromissoire ne limite le droit de chacune des parties d obtenir des mesures provisoires ou conservatoires de la part d'un tribunal competent

The report itself summarizes the reforms and describes how they relate to the major reform goals aimed at curing some of the general problems existing in the legal environment as described in Section I of this report This section will underscore the salient points of that report highlighting the areas where reform is still needed Recommendations will be made to address how new reforms could alleviate existing problems and address the concerns raised by exporters whom we interviewed in Antananarivo in June of last year

The first part of the report, pages 4-10, describes the general legal climate in which exports took place prior to the period of reform in this area which began in 1983 This description touches upon some of the historical aspects of the economy prior to the recent reforms which were discussed in the previous sections The economy was characterized by state owned monopolies, and strict controls on profit margins, including price controls, which were imposed by *arrêté* no 951-FIN/COM/SPO of 4/03/1970 Moreover, export procedures were onerous and formalistic as were the business registration procedures discussed above In fact, prior to being given authority to export, the exporter had to comply with those procedures in order to obtain the status of "*commerçant*," (merchant) before he could continue with export procedures He then had to obtain an exporter's card which, like the status of *commerçant*, was issued by the Ministry of Commerce In addition, exports were subject to heavy taxes and fees

Then, as mentioned, starting in 1983, a major series of reforms aimed at liberalizing the economy was undertaken By 1989, the Ministry of Commerce had identified broadly defined goals aimed at liberalization They were the disengagement of the state in the economy(i e the gradual reduction of state monopolies and privatization), the suppression of price controls, free access to the status of "*commerçant*" (merchant), and removal of administrative constraints inhibiting free trade Several measures were taken during the eighties in the spirit of this reform to reduce the number of state monopolies, although some remain, e g sugar cane, vanilla, and tobacco Price controls on agricultural products were loosened by *décret* no 86-092 of 2/04/1986 and *décret* no 88-070 of 2/03/1988 which established a floor price rather than a maximum price for certain products In addition, all limits on profit margins for these products were eliminated by *arrêté* no 989/89 of 20/02/1989

After describing these general reforms, the report goes on to describe some of the specific reforms affecting imports and exports

In fact, in the area of exports, *décret* no 88-328 of 01/09/1988 established an independent committee, the purpose of which was to hear exporters' grievances in order to proceed with reforms The report notes that the committee has become inactive and should be revitalized so that some of the reforms which have not yet been realized can move forward However, by far and away the most significant measure which was taken in the export context was *ordonnance* no 88-015 of 01/09/1988, which was complemented by décret no 92-424 of 3 April 1992

The *ordonnance* did away with the requirement of an export card, and the decree dispensed exporters from all formalities in the case of certain specified products The *ordonnance* also abolishes the requirement of quality control except in the case of meats (*arrêté* of 28/12/1965) and seafood *(décret* no 62-213 of 18/05/1962) It also establishes the principle that export taxes and fees should be abolished

However, many problems remain in the aftermath of the adoption of these legal provisions, which were once again stated in broad terms The 1988 *ordonnance* contained the common prescription "all prior legislative provisions to the contrary are abrogated," and that overly general provision has left a distinct lack of clarity in the law relating to exports

For example, while the *ordonnance* did away with the **requirement** of quality control, it allows for quality control to be conducted by the officials who were formerly responsible for it in the Ministry of Commerce, when an exporter requests it (e g where it is stipulated in a contract) or where it is required by some other law It is in connection with this latter qualification that a lawyer examining the question encounters a quagmire of outdated laws and regulations, some dating from the colonial period Since the 1988 *ordonnance* states both that former inconsistent laws are abrogated and that quality control can be required by other texts, the effect of theses outdated provisions is unclear This lack of clarity leaves doubt about the applicability, for example, of an *arrêté* of 22/12/39 which requires quality control for all "*produits naturels*" (natural products The same is true for *arrêté* no 95 of 19/06/1947 These outdated administrative rulings should be clearly and specifically repealed so that they will not continue to be applied

Similar confusion exists with respect to the abolition of export taxes The *ordonnance* provides that all taxes on exports should be abolished in the annual *"loi de finance"* (budget bill) In recent years the budget bills have repealed certain former laws establishing export taxes and have retained them for certain exports, as in the case of coffee and cloves The question therefore remains as to the status of all the laws and regulations establishing export fees and taxes which have not yet been specifically repealed This area of the law needs a comprehensive analysis, and the annual budget bill should specifically repeal the laws establishing the unwanted taxes and fees

Another problem area concerns the attempted elimination of formalities in export procedures As noted above, the requirement of the export card has been abolished and the 1988 *ordonnance* establishes the broad policy of liberalization of export procedures Once again since the policy is so broadly stated, it is unclear as to whether specific procedures required by other laws have been repealed For example, *décret* no 65-046 of 10/02/1965 requires the *agrément* of the Ministry of Commerce for harvesting of local products Are exporters exempted from this formality? In the same vein, is the professional identity card still required for foreign exporters?

The above description of specific problems in the law relating to exports raises not only the need for clarity in the law, but it underscores the need for the development of policy with respect to certain issues as well

For example, in addition to the need for clarity in the law relating to quality control, there is a policy question which needs to be considered Should quality control continue to be exercised by the Ministry of Commerce? In fact, it was reported to us in several of the interviews conducted that in practice, private entities, such as Veritas, were being used when export contracts called for inspection and quality control This raises the question of whether this should be a private or public function or one shared by government and private entities For example, perhaps the Ministry of Commerce should continue to inspect meat and seafood, as required by the law, and all other non-obligatory inspections should be conducted privately This policy issue should be debated by the committee considering export reform, and a law clearly delineating the role of the public and private sector must be adopted

Finally, there is one more problem area in connection with exports which needs to be discussed, and that is the general difficulty experienced by foreigners who wish to export While this subject does not involve laws which relate directly to exports, laws in other areas have a significant negative impact on this particular class of exporters Some of the difficulties have already been touched upon above

For example, traditionally business registration procedures required foreigners to obtain a professional identity card It has also been pointed out that it is not clear from the broad terms of the *ordonnance* of 1988 as to whether this requirement has been eliminated along with some of the other formalities formerly required of exporters which have been abolished It has been reported to us that, in practice, the professional identity card is still required In Section I B , above it was noted in practice foreigners are not allowed to own land, and it was shown that this practice results from the application of an administrative ruling of the Ministry of the Interior which is in violation of the law and the Constitution It was also shown in that section that there was an inconsistency in immigration requirements which is very confusing to foreigners The inconsistency lies in the fact that one legal provision requires the professional identity card as a condition of a foreigner's obtaining a residence visa (*carte de séjour*), and another provision requires a *carte de séjour* in order to obtain a professional identity card Finally, it must be noted that *arrêté* no 4100 of 25/11/1972 dealing with foreign investments severely restricts "non-residents" in their ability to expand their business enterprises in Madagascar, and it takes two years in Madagascar to achieve the status of "resident "[35] This restriction was the subject of vociferous complaints among foreign exporters whom we interviewed

These restraints, taken together, serve to significantly inhibit foreign investment

---

[35] PPEA Report, *supra*, page 40

in exports in Madagascar The most effective way to remedy these difficulties would be for Madagascar to adopt a law dealing with the topic of foreigners doing business in that country In that law, all of these problems and inconsistencies could be cleared up Indeed, all steps should be taken to remove these restraints There is no longer any need for the professional identity card, and its elimination could solve the problem of the inconsistent immigration requirements The grievance committee discussing exports should consider proposing a significant reduction in the amount of time it takes to acquire resident status, and the restrictions on expansions by non residents should be seriously reconsidered

Moreover, the committee should consider the problems in connection with the prohibition against foreigners owning land Since that right already appears to be granted in law and in the Constitution, this should not create such a large problem In the alternative, if it is strongly felt that there needs to be some restriction, the P P E A Report has a concrete suggestion for alternative legislation The team suggests that the purchase of land by foreigners could be limited to one house per family and only as much land and buildings as is necessary for the functioning of a foreign corporation [36]

III. Recent Developments in Banking and Mining Law

Thus far, this report has analyzed the state of the law in those areas which relate generally to exports It has also examined specific recent legal reforms to determine the extent to which they serve to encourage exports It will now examine recent legislation in banking and mining laws to determine their effect on exports and to determine whether further recommendations need to be made in these areas

According to its terms, and as described in the annotation which accompanies the law, *Ordonnance* no 88-005 of 18 April, 1988 is intended as the first step in a major reform designed to fill the pre-existing gap in banking legislation

In some ways the annotations are more important than the law itself in that they state the general goals of the intended reform The law stets up the basic structures and provides for some of the general principles of the banking reform It states that*décrets* and other administrative measures will need to be adopted to implement the law The major goals of the policy reform in this area are described in the annotations as

1 To fill the pre-existing gaps in this area of the law

2 To enable banks to be more successful in providing private business enterprises with access to capital

[36] Id page 41 9

3 To open up the banking sector to the private sector as required by the Investment Code, including privatization of the three national banks

4 To encourage foreign investment

5 To create uniform banking laws that will apply to all banks

6 To create a government agency to supervise all banking operations

The law itself sets up a government agency for the supervision of banking operations Article 66 provides for the creation of *"La Commission de contrôle des banques et établissements financiers"* (The Commission for Review of Banks and Financial Establishments In addition, Title II of the law sets out the procedures for the awarding of banking charters *(agréments)* which will be required for all banks within the purview of the law Applications for a charter are to be submitted to the Central Bank, and the charters shall actually be issued by the Ministry of Finance Title I of the law excludes the following institutions from its application international financial institutions, aid organizations chartered in Madagascar, development banks, savings banks, and insurance companies

All other banks and financial institutions will be subject to the rules established by this law and any of the administrative measures implementing it Consequently, they will come under the supervision of the above mentioned Commission The Commission has broad authority including the imposition of disciplinary sanctions and the authority to place recalcitrant banks in receivership The supervisory function of the Commission shall be shared with the Central Bank All banks are required annually to submit an accounting to the Central Bank Refusal to cooperate with the Central Bank or the Commission can result in criminal sanctions The Central Bank shall also specifically oversee mergers, acquisitions, and liquidation of bank assets

While the law contains some substantive rules, they relate principally to conflict of interest and engaging in the banking business without authority Consequently, implementing administrative measures will be required particularly in the area of supervision of banking operations

Although the law primarily sets out broad concepts of policy and authority, there are nevertheless some clear signs that it represents a step toward the modernization of the law in this area For example, Title I one contains a definitional section which includes definitions of many of the modern banking operations previously ignored by the law, including the "*crédit bail*," which was so strongly recommended by Mr Cordahi on page 31 of his report In addition, the law is clear in requiring that banks be set up as either *Société Anonyme, Sociéte Anonyme à Responsabilité Limité,* or *Société Cooperative* The terms of the law indicate that the authority to set up the banks under these forms of business is derived from the law of 24 July 1867 Through this reference

64

there is no longer any doubt that provisions of law dating from the colonial period are to be applied rather than the more recent socialist laws dealing with forms of business This clarity also serves to close the gap between law and practice (See discussion of the law relating to forms of business, above) Furthermore, unlike other laws adopted as part of the country's program for economic reform, it leaves no doubt as to what former provisions are repealed as a result of the new law Even though it contains the prescription "All provisions contrary to the present law are hereby abrogated," the law clearly states which provisions of the *Charte des Entreprises Socialistes* are repealed See Section I A , above

Nevertheless, the law, according to its own terms, needs implementing measures, i e , *décrets, arrêtés,* etc These measures must consider and address the questions and many of the specific recommendations made by Mr Cordahi in the areas of finance, credit, securities exchange, and secured transactions Without these more specific measures the broad terms of this legislation will do little to foster confidence in the private sector or facilitate access to capital Without these more specific reforms little effect on the general legal and economic environment can be expected, and the law standing alone will do little to encourage increased exports

In mining law, both a law and implementing administrative measures have been adopted However, taken together, they do not offer the signs of encouragement noted in the banking area In our interviews of those involved in export of semi-precious stones, several legal and administrative problems were cited We were told that there was a lack of clarity as to who actually had mineral rights In addition, a need was expressed for procedures which would allow for the establishment of the fob price of stones by the Ministry of Mines It was also suggested that any legal reform in the area should provide for coordination of the procedures required to obtain the authority of the Ministry of Mines to extract the stones with those required by the customs authority The exporters felt that it would be much less burdensome if at least some of these procedures could take place at the same time and place Complaints were also registered in terms of the delays incurred in complying with the procedural requirements Finally, a desire was expressed for legal reform clarifying the rights of foreigners in this area

An examination of the relevant law, the *décret*, and the *arrêté* indicates that almost none of these issues have been addressed in the new legislation The legal provisions involved are *Loi* no 90-017 of 20 July 1990 *portant Code Minier, Décret* no 90-384 of 28 August 1990, and *Arrêté* no 678/91 NIEM/DMG/O of 8 February 1991

With respect to the issue of mining rights, the administrative measures appear to be clear They set out detailed procedures for obtaining the authority to mine which require the identification of the specific parcels of land to be mined, the substances to be extracted, etc The authority is to be granted to a specific person or corporation Consequently, if the law is being implemented, there should be little room for

65

questioning who actually possesses mineral rights The observations of the exporters in this area lead this author to suspect that the new legislation is not yet being implemented, but no conformation of the suspicion was obtained as part of the mission conducted in June of 1993 If this information is not known, inquiries need to be made to see whether these measures are in fact being implemented

Little is done in the legislation to address the issue of the participation of foreigners in the industry Title I of the *arrête* provides that only Malgache nationals can be issued mining permits individually Otherwise, they can be issued to corporations, including foreign corporations Other than allowing foreign corporations to receive mining permits, this new legislation does nothing to address the multitude of problems encountered by foreigners attempting to do business in Madagascar

Otherwise, the issues raised by the exporters are not addressed On the contrary, the legislation provides a complicated and burdensome system which reflects the kind of formalism which characterized the colonial laws dealing with business registration and export procedures (See the discussion of these areas of the law, above) The *arrête* even requires compliance with some of those very remaining business registration procedures which have been identified as unnecessary and burdensome in the P P E A Report of the World Bank

Consequently, in spite of recent legislation in the area, new legislative reforms will need to be undertaken to address the concerns of exporters in order to encourage exports in the mining area

Conclusion

In light of the review of the general legal environment in Madagascar and the law relating to exports specifically, it is clear that significant reform will need to be undertaken in order to eliminate the institutional restraints which still serve to inhibit the progress which has been made in connection with recent reforms designed to promote the expansion of exports This concluding section will group the recommendations for reform which is still needed into two categories those which involve legislation and those which do not

As this report has frequently noted, a great deal of work has already been done in Madagascar to identify problem areas in the legal environment and to make recommendation for reform In addition, it has been shown that some impressive and beneficial reforms in certain areas have already been undertaken At the same time it is evident that reforms undertaken at this point have not been as coherent and comprehensive as they need to be in order to really solve the larger problems which have been so clearly identified It is therefore the sense of the author of this report that the reform process needs to move from the stage of discussion, analysis and recommendation to the stage of comprehensive legislative drafting

This stage of reform will require an entirely new focus and methodology A great deal can be learned about the process and methodology of reform at this stage from those who have been involved in the process of law and development in other parts of the world A few examples can be cited One example is China where the UNDP has recently undertaken a massive five year project of legislative drafting in 22 different areas which have been identified as problem areas The overall goal of the project is to establish legislation which will be appropriate to the transition from a socialist to a market economy Some of the salient features of the methodology which will be used in that project involve identifying experts in specific areas and involving them in a centralized and supervised project of legislative reform The centralization and supervision are designed to ensure consistency and coherence both in substance and approach The approach taken involves using experts who can teach the Chinese to draft laws themselves in the areas identified A similar approach is being taken with very similar goals in Cambodia where the author of this report has been involved in the planning and approach to legislative reform

It has been the experience of those working in law and development that when laws are drafted by foreign experts, there is a significant risk that the reform efforts which the legislation addresses will fail It is vastly preferrable to use experts with knowledge in specific fields to teach natives to draft in those areas While an in depth discussion of this methodology and approach is outside the scope of this report, it is the recommendation of this author that they be taken into consideration in planning legislative reform efforts in Madagascar in the future

With those recommendations in mind, comprehensive legislative reform is necessary in the following areas

1 Business registration procedures
Specific legislation needs to be adopted to create clarity with respect to which procedures have been retained and which have been repealed See Section I A , above

2 Commercial Code
A massive effort needs to be undertaken to update the Commercial Code, which dates in many areas from the colonial period The revised code should include modern concepts of contract law, corporate and company law (forms of business), the law of negotiable instruments, and secured transactions See the body of this report and Mr Cordahi's report for the specifics of reform in these areas In addition, it should specifically address the issue of the liability of the parties to export transactions when goods are lost or damaged in transit

3 Power of judges to make rules

A law needs to be drafted clearly empowering judges to make rules when there is a gap in the written law This law will need to take into consideration the hierarchy and consistency of the judges rulings and will need to becoming part of the training for judges See Section I B , above

4 Code of Civil Procedure

The Code of Civil Procedure needs to be revised and updated to eliminate the delays inherent in the law dating from the colonial period The availability of the fast track procedures of Ordonnance 93-102 needs to be expanded See Section I C , above

5 Arbitration

Two laws need to be adopted, one addressing domestic arbitration, and the other addressing international commercial arbitration Any legislative reform in the area of international commercial arbitration will need to take into consideration the issues considered in this author's previous report on this subject [37]

6 Export taxes and fees

All export taxes and fees will need to be reviewed, and the next annual "*loi de finance*" must specify which taxes have been repealed and which ones are retained See Section II , above

7 Quality control in exports

Consideration needs to be given as to when quality control is obligatory Also, there needs to be a decision as to when this will be a private or public function When these decisions have been made, a law needs to be drafted addressing these issues specifically

8 Foreigners doing business in Madagascar

A comprehensive law needs to be drafted addressing all of the issues raised in this connection in Section C, i e , should foreigners be required to have a professional identity card, should they be prevented from owning land? Should they be restricted in expanding their business enterprises? In addition, the inconsistency in the laws and regulations regarding immigration procedures needs to be clarified

9 Banking law

The recently enacted banking laws and regulations need to be specifically implemented through new administrative measures which will cover the modern banking operations and credit mechanisms as recommended in Mr Cordahi's report See Section III

---

[37] See footnote 26

10 Mining laws
Recently enacted laws and regulations relating to mining need to be revised to eliminate burdensome procedural requirements, coordinate mining and customs procedures, and clarify the ability of foreigners to participate in the industry See Section III

In addition to these specific legislative reform, steps will also need to be taken to

1 Establish procedures for the review of all legislation for consistency and observance of the hierarchy of laws See Section I B , above

2 Revitalize the grievance committee established by *décret* no 88-328 for consideration of reform in the export area See Section II

3 Integrate all of the reforms recommended in this report with the reform and training of the judiciary, which is the subject of Mr Massicotte's report [38]

It is the sincere hope of this author that such a comprehensive approach to legislative and judicial reform will insure a healthier legal environment and encourage the expansion of non-traditional exports in Madagascar

[38] Se footnote 18