The Southern Africa Development Community (SADC) is an association of states promoting economic integration among the following countries: Angola, Botswana, the Democratic Republic of Congo (DRC), Lesotho, Madagascar, Malawi, Mauritius, Mozambique, Namibia, the Seychelles, South Africa, Swaziland, Tanzania, Zambia, and Zimbabwe. The SADC has been a free trade area since 2008 and has an ambitious regional integration agenda that includes the establishment of a customs union by 2012. The free trade area provides for the elimination of import tariffs and nontariff barriers to trade among members and aims for, among other things, the harmonization of customs procedures and technical standards, and the liberalization of trade in services within the free trade area. Since 2006, the SADC has also had a Finance and Investment Protocol (FIP) that seeks to harmonize the policies of member countries in the areas of investment promotion, labor codes, and immigration laws, with the ultimate goal of developing the region into an “SADC Investment Zone.”

This policy note examines the role of differences in business environments in impeding cross-border trade flows between Southern African countries. It also considers the cross-border integration of credit and labor markets based on microeconomic data on firms and households. The aim of the assessment is to help inform the policy and business environment harmonization agenda of the Community.

**Trends in trade integration**

SADC economies are far more integrated today within the region and with the global economy than they were in the mid-1990s. Most Favored Nation (MFN) tariffs have been reduced, intraregional trade flows have increased, and trade has risen as a share of GDP. On average, SADC countries export and import as much as would be expected

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relative to their income and distance from international and regional markets. Further, intra-SADC trade is relatively high in relation to what intraregional incomes and distance would predict. However, much of the increase in intraregional and extra regional trade occurred in the 1990s, and all indications are that progress has halted in recent years. In addition, substantial imbalances in trade flows persist. The South African Customs Union (SACU) continues to dominate intraregional trade flows, as both a destination for other SADC member exports and a source of their imports. Trade flows among non-SACU countries in the SADC area remain low.

Another feature of the nature of integration to date, posing a major policy challenge, is that, excluding South Africa, SADC exports to the rest of the world and within the SADC are comprised mainly of primary products, although Mauritius, Malawi, Swaziland, and Lesotho also export clothing and textile products. The high concentration in commodity-based exports has limited intra-industry trade flows and the productivity gains associated with the economies of scale and the diffusion of innovation that such flows facilitate. To realize productivity gains from intra-regional trade, many member countries need to diversify into nontraditional exports, including manufactured and service exports. Trade in manufactured goods and services is more sensitive to trade barriers and other cross-border transaction costs than the current trade in resource-based products. Its development in the region would therefore require greater openness to trade of member countries and significant reforms of the business environment within the region.

Adding to the urgency of diversifying members’ exports is that most SADC countries are labor-surplus economies, and many face problems of high unemployment and widespread poverty. To successfully grow out of these problems many need to diversify production and exports into labor-intensive industries in manufacturing and services. Future progress in further trade integration within the region will indeed largely depend on how far member countries succeed in this type of diversification.

**Business environment and trade integration**

The cross-country differences in manufacturing productivity and exports that we observe today among SADC members have a great deal to do with differences in business environment. Specifically, more successful exporters of manufactures and services are, on average, more open to trade; have lower trade costs on account of more conducive geography and lower transport and regulatory costs; have lower regulatory barriers to business formation; provide better access to long-term finance; and have more reliable public utilities and better governance in the sense of having less corruption in government agencies. Above all, more successful exporters of manufactures and services suffer far less from allocative inefficiency resulting from disparities in access to long-term finance, public utilities, and to government services among sectors, business size groups, and entry cohorts, as they provide a more level playing field to everyone on those key dimensions of the business environment.

The top exporters of manufactures and services in the region currently are South Africa, Mauritius, Lesotho, Namibia, Swaziland, and Malawi. These are also among the most open to trade. All except Lesotho owe their exporting status to the higher productivity of their manufacturing sectors. On the other hand, Angola, the DRC, and Zambia have manufacturing and
service sectors that are the least productive and least export-oriented in the region. One major source of the productivity gap between the two extremes of successful exporters of manufactures and services (South Africa, Mauritius, Namibia, Swaziland, and Malawi), and non-exporters of the same (DRC, Angola, and Zambia), is differences in technical efficiency (figure 1). Technical efficiency measures how efficiently an economy uses a given set of inputs; a higher score in figure 1 shows higher efficiency.

A second source of the manufacturing and services productivity gap between the two groups of countries is that, within the typical domestic industry, low productivity firms tend to have higher market shares in the non-exporting group than they would have in the group of successful exporters—a reflection of the lower allocative efficiency that characterizes industry in the non-exporting group (figure 2). Allocative efficiency measures how efficiently an economy allocates available resources for production; a higher score in figure 2 shows higher efficiency.

The relatively lower allocative efficiency of industries in the non-exporting group in turn is partly caused by the fact that there is greater in-country disparity of business environment in those countries than there is within the more successful exporters, where the playing field is more level for all firms regardless of how large they are, how long they have been in business, and where in the country and in which sector they are operating.
Business environment reforms and FDI

Cross-country differences in the business environment have also been a major factor in recent trends in inward foreign direct investment (FDI) in the region and in its allocation among member countries. In recent years SADC has attracted higher FDI on a per capita basis than most other developing regions (figure 3). Though most of the inflow has been to mining, resource-poor countries have also attracted more than their share of FDI. In almost every case, FDI inflows have financed large shares of domestic savings and helped improve productivity, without which growth rates would have been significantly lower than they turned out to be.

However, given cross-country patterns in expected rates of return, Tanzania, Malawi, Mozambique, Swaziland, and Namibia should have attracted far more FDI than they actually did, while Angola, DRC, and Zambia are unlikely to sustain current levels of FDI as these far exceed those warranted by expected rates of return shown on the dashed line in figure 3. Sustaining high levels of FDI in the second group and raising levels in the first group will require significant improvements in the countries' business environments. The type of improvements needed differ among countries, however. In at least one country (DRC), what is needed is reduction of investment risk through greater political stability. In almost all the others, there is an urgent need for reducing corruption and business start-up costs.

Figure 3: FDI inflows and the marginal productivity of capital
In the recent past, reforms that lowered start-up costs in Madagascar, Mauritius, and Mozambique have had drastically positive and visible impacts on FDI flows, while greater political stability in Zambia and Mauritius has had a similar effect in those countries. On the other hand, major declines in the control of corruption seem to have led to a sharp fall in FDI in Namibia and Swaziland in the early 2000s. One indication of the scope for positive changes in these business environment factors is that start-up costs have steadily declined in nearly all resource-poor countries to converge with or to a lower point than the South African norm, while start-up costs are very high and have generally remained unchanged in most resource-rich countries.

DRC and Zimbabwe aside, the trend in the SADC as a whole has been one of members’ convergence towards greater political stability, with steady improvements in every country’s score on the stability index. Botswana, Mauritius, and Namibia are the most politically stable members; the larger countries—South Africa, Mozambique, Malawi, and Zambia—converge around something of a normal (or mean) score for the region.

On the other hand, there is not much evidence of convergence over time among SADC members in terms of control of corruption. Indeed, countries in the region fall into three distinct groups: relatively “corruption free” members, namely, Botswana, Mauritius, Namibia, Madagascar, and Lesotho; those with moderate corruption, namely, Zambia, Malawi, Mozambique, and Swaziland; and those where corruption is a serious problem—Angola, DRC, and Zimbabwe.

**Issues in financial market integration**

Greater financial integration in the SADC should help improve the allocation of FDI and capital more generally within the region. It should also help promote trade integration. Some of the influence of business environment on investment and trade integration therefore occurs as an effect on financial integration and financial development.

At this point the level of financial integration is quite low, an indicator of which is the large variance in real interest rates among member countries: some have excessively high rates (Mozambique, Tanzania, and Zambia), while others report negative rates (DRC, Botswana, Madagascar, and Angola). Countries also vary hugely in terms availability of financial products and their accessibility to different sectors of the economy.

One major impediment to greater financial integration is that institutions of contract enforcement are weak in many member countries. The SADC scores lowest among all regions on time to enforce contracts, with Angola, Mozambique, Botswana, and Swaziland recording the longest times. Another barrier is that credit information is lacking in several countries, including DRC, Lesotho, Madagascar, Malawi, Tanzania, and Zambia. Capital controls constitute the third impediment. The SADC region has the most restrictions on capital flows, both in de jure measures of capital account restrictions and in de facto measures of actual capital flows during the past few years.

**Employment regulation and labor market integration**

Compared to other regions, employment contracts are not heavily regulated in the SADC. Seven countries have an overall
Doing Business employment rigidity index that is well below the OECD average. The same index is below Sub-Saharan Africa's average for three other members. However, there is enormous variation in the degree of employment regulation within the region itself. Angola, DRC, Zimbabwe, Botswana, and Madagascar regulate the labor market the most heavily. In Lesotho, Malawi, Mauritius, Swaziland, Namibia, and Zambia, employment contracts are the least regulated.

These differences in the intensity of labor regulation have significant implications for cross-country differences in employment and earnings, and for cross-country differences in trade integration. It is not by coincidence that the countries where employment is least regulated have attracted more FDI per capita and have more export-oriented manufacturing and service sectors than other member countries. Intraregional differences in employment regulation also generate differences in the price of labor and in labor market integration.

The reason for this linkage is that a country cannot sustain wage rates that exceed a global or regional norm unless it somehow restricts the flow of goods, services, capital, and people across its borders. Even where trade is restricted, labor market integration can be driven by the flow of capital among countries. When FDI is driven by a positive wage shock in the sending country labor market, it creates a link with the recipient country's labor markets. For example, FDI from South Africa to Zambia, motivated by a sudden rise in wages in South Africa, increases the demand for labor and, ultimately, wages in Zambia. International migration is another mechanism linking wages and labor markets across countries.

An evaluation of the extent of labor market integration involves measuring the speed with which wages in one country respond to shocks to the labor market in the rest of the region. The general rule for interpreting this measurement is that a faster adjustment indicates a more regionally integrated market. Such an evaluation shows that although South Africa has broadly integrated its labor market with others in the region, the depth of integration is still rather low. This reflects the fact that both trade and capital flows are far more restricted in the region than in places where there is greater cross-border labor market integration.

One such place is the U.S.–Mexican border, where a study showed that wages in Mexican border towns fully adjusted to wage shocks in the US in around one month. This is 3.6 times shorter than the time it takes for wages in the BNS to fully adjust to wage shocks to the South African labor market. As would be expected, adjustments to the shock would take even longer as we move further away from South Africa’s border. For example, it takes 5.5 months for Tanzanian wages and 11 months for wages in Mauritius to adjust to the same shock to South African wages.

Policy Recommendations

The key harmonization issues emerging from the diagnostics of the report concern import tariffs and nontariff barriers, competition policy, transport and other significant components of trade costs, provision of infrastructure, control of corruption and access to finance.

Harmonizing import tariffs and reducing nontariff barriers to trade

Although average tariff rates are now quite modest in the region, the structure of MFN tariff rates vary significantly within the
region, effective protection rates are quite high with a built-in anti export bias, many nontariff barriers remain in place within the FTA, and customs procedures have yet to be harmonized. As a result, the growth in regional and extra regional trade has slowed down in recent years. There is thus an unfinished agenda for tariff reforms that should include the harmonization of MFN tariffs among SADC members and reduction of effective protection rates.

**Developing and harmonizing competition policies**

As member countries liberalize intra regional trade and capital flows, care needs to be taken that first arrivals on the domestic scene from other parts of the region do not erect barriers to entry to domestic markets and domestic industries by design or otherwise. Combined with regionally harmonized trade policies, well crafted, effectively enforced, and regionally harmonized competition policies will help safeguard against such an outcome. At the moment South Africa is the only member country that has an internationally well regarded competition policy regime. However, even it needs further competition policy reforms.

**Reducing trade costs**

Perhaps the most prominent reason that intraregional and extra regional trade in the SADC are not growing is that trade costs also remain high for reasons that are not necessarily related to trade policy. Trade costs are high, particularly in Angola, DRC, Zambia, Botswana, and Zimbabwe (figure 4). High transport costs are often the main part of the problem, but problems with customs administration and regulatory costs of cross border transactions, and activities in general, are often major contributors.
In many countries, burdensome customs and trade regulations have added significantly to trade costs. In such countries there is a need to streamline clearance procedures as an important means of facilitating trade. Nearly everywhere there is a need to reduce transport costs by improving roads, railways and port services, although the specific means of achieving these differ from country to country.

**Improving power supply**

After freight transport and port facilities, power supply is the most important infrastructural obstacle to export diversification in many countries within the SADC. Power shortages are holding back manufacturing productivity and exports, particularly in Madagascar, Malawi, Angola, and Zambia. In each of these countries, start-ups can wait for months to be connected to the public grid while established businesses report significant losses of revenue due to frequent outages. The proximate cause of the shortages in all of these cases is years of underinvestment in the power sector. As a result, governments have sought to promote large investments in maintenance and additional generating and transmission capacity.

The root causes of the shortages also include the deliberate under pricing of electricity, the failure of poorly managed state-owned operators to collect payments, and the absence of a workable legal and regulatory framework for private sector investment. Instituting cost recovery tariffs, establishing efficient billing and collection, and limiting transmission and distribution losses are also among the measures that some governments in the region are being advised to take.

**Reducing start-up costs, particularly in resource-rich countries**

Although nearly all resource-poor countries have tried to lower business start-up costs, these costs as well as the time it takes to set up a company remain excessively high in all resource-rich countries. Governments should therefore carry out the administrative reforms needed to bring business start-up costs and set-up times down to international and regional norms.

**Promoting financial development and financial integration**

At the moment financial integration in the SADC is impeded by capital controls that are more stringent than in many other parts of the world, the lack of credit information in several member countries, and huge disparities in the quality of contract enforcement institutions among member countries. Improving availability of credit information, opening capital accounts, opening the banking industry to greater competition, and improving the quality of contract enforcement institutions are thus potentially important instruments for promoting financial development and financial integration in the region.

**Monitoring market integration**

In most SADC countries, government statistical agencies collect price data and household and labor force survey data with variable degrees of regularity and quality standards. Unfortunately, in many cases, the quality of data is so poor that they cannot be used to monitor the integration of regional goods markets or labor markets. And yet, well designed and disaggregated product price data are usually a more effective means of monitoring trade integration than are trade flows, and measures of labor
market integration provide an indirect but quite powerful and indispensable indicators of barriers to trade and investment flows. Much effort has been expended by policy makers of member countries in negotiating mechanisms for achieving integration. To monitor these, sufficient investment needs to be made on collecting the price and labor market data needed to monitor integration in all member countries.

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