TEN PRIORITY ACTIONS

FOR IMPROVING THE BUSINESS CLIMATE IN MALAWI

22 October 2004

Background

The private sector, represented by MCCCI, SOCAM, ECAMA and representatives from the eight prioritised sub-sectors in the Malawi Economic Growth Strategy, has come together to develop a ten point priority agenda for change in support of the Government's efforts to improve the climate for doing business in Malawi.

All stakeholders recognise that growth in the economy and impact on poverty can only come from through the development of the private sector. However, the private sector is constrained by a range of domestic and international factors highlighted by numerous studies and articulated as 28 constraints facing the private sector (see annex A). Many of these constraints and recommendations on how to tackle them were articulated in the Malawi Economic Growth Strategy that was developed through collaboration between public and private sectors.

This collaboration between public and private sectors has been improving in recent years, particularly over the last few months with supportive statements for change being made in the Government's manifesto, His Excellency the President of the Republic of Malawi's inauguration speech and subsequent meetings with the private sector.

The task of improving the investment climate is daunting and there have been many different prescriptions on where to start and how to progress. Private sector has in the past given a range of prescriptions for change that have not always been consistent between the different representative organisations, nor with a single set of priorities nor necessarily always coherently articulated in a way that GoM is able to implement. The private sector recognises that the lack of a coherent prioritised and shared private sector agenda has not assisted GoM in its difficult task of promoting investment.

Therefore, this document presents a coherent, prioritised and shared agenda for change that will start the process of improving the investment climate in Malawi for both domestic and international investors. It has been endorsed by the various stakeholder bodies that speak for the private sector and circulated widely for input and agreement. It represents a single private sector agenda, which we would request Government to consider, discuss and most importantly implement in the coming months as an indication of the seriousness with which GoM is seeking to improve the economy.

Three key points need to be made. Firstly, this document is based on the views of current investors in Malawi, be they small or large investors, indigenous or foreign. Its focus is on the climate for domestic investment and re-investment as international investors always see whether current investors are thriving, surviving or diving before deciding whether to invest rather than rely on what formal agencies say. If the current investors can be encouraged to show confidence by increasing their investment or reinvesting in Malawi, then we can also encourage international investors to seriously consider our country. The most likely source of investment in Malawi is by far the existing investors who already invest, be they Malawians or non-Malawians.

Secondly, we recognise that the current Government is facing a major task to bring the macro-economy back on track by tackling the budget deficit that is probably the single most important task over the coming 6-12 months. Therefore we have deliberately avoided measures that reduce GoM revenues in the short term or incur significant costs. Whilst there are necessary changes required to the way revenue is collected and the need for ongoing tight control of GoM expenditure, we offer an agenda for change that focuses on changes within the current means. In addition, the simple fact is that if we are to build medium- and long-term revenues for national development, these will have to come from developing the private sector if we are not to increase our reliance on our international development partners even further. Whilst the pressure to meet the budget gap in the short term is driving decision making, we must be very careful not to mortgage the future by further weakening the private sector base, particularly the formal tax paying businesses. The proposals made below are all intended to be revenue neutral in the short term. In the medium-term, the proposals will lead to additional government revenue, as they will improve the business climate and lead to additional investment, employment, and tax revenue.

Thirdly, it is encouraging to note that the Ministry of Finance is carrying out a study of tax rates in neighbouring countries. However, the headline rates of tax such as corporate and personal income tax rates, dividend tax rates and so on, often conceal important differences in the details of the tax regime. In addition, although the taxation regime is important, there are also many other factors that determine the attractiveness of an investment opportunity, not least the way in which investors are treated by governmental implementing agencies. The tax system is only one of a number of important factors that potential investors consider when deciding whether or not to invest or re-invest, often after they have weighed up all the other factors. Given that Malawi starts with several structural disadvantages, such as being land-locked, having a limited domestic market and very poor neighbours, compounded by weak infrastructure and our need to focus on export markets beyond our immediate locality (in the main) then we have a major task to persuade potential domestic and international investors of the merits of Malawi relative to countries with direct access to ports. It is not sufficient to be match what our neighbours have to offer – we have to be better and more attractive to offset the structural disadvantages we face.

The list below provides a starting point for GoM to improve the business climate and so secure its own revenues and national development. The items are not in priority order – they are all important. They also represent the start of a process for change that will see Malawi grow its way out of the poverty that afflicts so many of our people.

Ten Priority Actions:

1. Ensure that the Government's own deadlines for tax refunds are honoured

Many tax-compliant businesses are suffering from excessive delays in refunds of tax payments beyond the periods specified in the tax legislation. This is especially problematic in the case of surtax payments where in addition to excessive delays, the system does not allow for a refund claim to be even submitted until three consecutive months of net reclaims. The delays range up to a year in many cases, requiring businesses to borrow millions of Kwacha at excessive interest rates to finance investment and working capital. This is a form of borrowing that costs the lender not the borrower.

Furthermore, unlike many other countries, businesses cannot offset payments due from one form of taxation against refunds due from earlier payments of different taxes.

Therefore, the private sector requests that:

1. All tax refunds should be made within the existing time periods specified with no undue delay
2. Surtax should be moved to quarterly accounting for taxpaying businesses of good standing
3. Businesses should be allowed to offset tax due against refunds due on other taxes already paid, with safeguards for errors on both sides

2. Make investment incentives clear, transparent and non-discretionary

The Private Sector wholly supports the Minister of Finance's statement on the need to make investment incentives transparent and non-discretionary. In the Budget Speech, the Minister promised to develop criteria for granting tax incentives that will be gazetted and incorporated into the law. Alongside clear and transparent criteria that are well publicised, getting the incentives should be a matter of satisfying the criteria, not of discretion, whether by a Minister or a committee. In our view, the only question should be whether the investor has met the defined criteria and can prove it. This is an administrative not an executive decision making task.

Further, as the economy grows and becomes more complex, it becomes more impractical to retain Ministerial or Ministry discretion on such matters, particularly given the crucial role of the Ministry of Finance in managing the economy, not micro-managing investment. In the past, the focus of the Minister and the Ministry has correctly been on the management of the economy, which has unfortunately led to considerable delays in approving/rejecting investment incentive applications.

Therefore, the private sector requests that:

1. The Ministry of Finance publishes and regularly updates transparent investment incentives with clear criteria for entitlement as currently in place or as enacted from time to time.
2. That the approval of incentives becomes only a matter of fact as to whether the criteria have been met, not a matter of discretion whether by a single Minister, by Ministers collectively or a committee. This should become an

administrative procedure not a matter requiring executive decision-making. This depends on making sure the criteria are explicit, clear and transparent.

3. Any incentives granted should be published in the Malawi Government Gazette.
4. Ideally, incentives should be built into the tax system as is the case with current capital and investment allowances which are offset against the capital verified to have been invested and are then accessible by all tax-compliant investors that meet the criteria. This will be of particular benefit to smaller investors who are not able to invest the resources in applying and following up applications in the current system.

3. Extend the deadline for businesses to calculate and pay provisional tax.

Businesses have 14 days from the end of their financial year to calculate their overall tax bill for the year and to pay 90% of the estimated amount of tax due for that year as provisional tax (including quarterly payments already made) or face significant penalties for under payment. Whilst there are complementary issues of cashflow and realisation of profits, it is not realistic to expect businesses to be able to calculate their tax bill so soon after the year end, which is always one of the busiest times of the year for management. Calculating tax requires businesses to have an accurate summary of all costs (including accruals for invoices not yet received and consolidating reports from branches/subsidiaries/business units), to have an accurate total for revenues, taking into account surtax and withholding taxes, and finally calculations for depreciation, capital allowances and other taxation issues such as net payments made (provisional tax and withholding taxes) and carried forward reliefs etc. As a comparison, the requirement is same as if government as a whole or single ministries or even departments within ministries or agencies were required to calculate expenditures within 10% of the final audited total within 14 days of the budget year end. Businesses then have to do the same for revenues and then make the necessary tax calculations.

The impact is particularly unfair on small and medium businesses very few of which have in-house accounting or taxation expertise. Even businesses with in-house accounting functions find it a major challenge to calculate this figure to within 10%. In both cases, managers have to rely on incomplete data that is neither internally nor externally audited at that point. This can often lead to businesses overestimating their liability for tax to avoid the risk of penalties, which can then result in overpayment of corporation tax that cannot then easily be reclaimed when the final figures have to be submitted within 6 months of the year end. Many businesses simply incur fines.

This is not about reducing the overall liability for corporation tax paid provisionally, rather for operating realistic timescales for payment of the provisional tax part of a business' tax liability.

Therefore, the private sector requests that:

1. Quarterly provisional tax payments periods should be extended from 14 to 30 days of the quarter to which they relate, with no penalties applied (as at present) and that the final provisional tax payment of 90% of the liabilities is made within 60 days of the year end with the same penalties as at present.

4. Establish the office of Tax Ombudsman

The private sector would support the establishment of the office of a Tax Ombudsman as stated in the UDF manifesto. At present, due to the piecemeal nature of new tax legislation and regulation, there is a lack of clarity in the tax system which gives rise to differing interpretation and potentially discretion. The MRA is often placed in the unenviable position of having to interpret unclear tax rules and this interpretation does vary from officer to officer. Businesses have the right of appeal through each layer of the MRA, right up to the Commissioner General, but this places the MRA in the roles of both prosecution and judge. Any system of justice requires a separation between those prosecuting and defending their positions and those who adjudicate. The manifesto was therefore correct to highlight the need for an independent Tax Ombudsman with the necessary powers to adjudicate.

This would also remove some of the current delays in the system where appeals can be delayed even whilst the MRA has impounded or seized goods, forcing businesses to pay irrespective of the merits of their appeal because the losses from not having the goods or equipment would be greater than settling. The Tax Ombudsman must have the power to force the MRA and businesses to pay the costs incurred by the other for the delay in settlement of taxes due or for losses incurred due to unfair seizure or impounding of goods/capital. This will ensure that there is pressure on both sides to settle early rather than at present, where the MRA can just sit and wait at the businesses' cost.

The way in which the tax system is being implemented over recent years has been one of the biggest complaints of the business community and undermined the legitimate tax-compliant business community. Therefore, the establishment of a Tax Ombudsman Office with the power to adjudicate and enforce decisions would be a major step forward in promoting investment and reassuring legitimate taxpaying businesses of the restoration of balance in the administration of the tax system.

It is our belief that this manifesto commitment should be funded out of the share of revenues that accrue to the MRA as it would remove one of the tasks that the MRA has to deal with, that is adjudication in disputed tax cases. We also believe that development partners would be willing to assist in such a measure of good governance.

Therefore, the private sector requests that:

1. GoM makes a formal commitment to the establishment of an Office of the Tax Ombudsman to be operational within 12 months of the commitment, funded out of current MRA revenue share.

5. Revitalise MIPA

MIPA once served a valuable function as a one-stop shop for domestic and international investors and re-investors. However, changes to the reporting and operation of MIPA, the delay in carrying out the merger with MEPC, and the under-funding of MIPA have undermined its effectiveness and morale within the organisation. Without an effective and strong MIPA, investors have little voice when seeking services from government and its agencies, yet investment by its nature requires the input and co-operation of many ministries, departments and agencies. Investors have neither the time, resources nor the knowledge to know who to deal with, what their legitimate rights are and how to overcome obstacles or lack of progress.

It is proposed that the Government take urgent steps to re-engineer and revitalize MIPA, which would increase its ability to effectively co-ordinate the different arms of government in support of domestic and international investors to resolve problems that they face in creating jobs, export earnings and in creating revenue streams for the nation. This might involve moving responsibility for the Agency back to the Office of President of Cabinet where it was original and/or establishing regular audiences with the President to brief him on progress. A strong private sector majority on the board would be an important step

Therefore, the private sector requests that:

1. The GoM undertake an urgent review of how to revitalise MIPA to begin implementing the changes with an appropriate budget at the start of the next fiscal year.
2. The review specifies how to strengthen accountability of MIPA to the private sector and to government as well as how it can undertake its cross cutting role effectively.
3. A service charter is established with powers for MIPA to enforce standards of service to investors from governmental agencies, departments and ministries.

6. Improvements in key service utilities: electricity, telecoms and water

Businesses rely on the provision of key utility services in order to produce and sell their own goods and services. There is some concern about the cost of utilities, particularly the maximum demand tariff for electricity, however the major concern is the unreliability and poor quality of services and the unresponsiveness of these utilities to complaints.

The private sector would support the current process for the privatisation of MTL as soon as possible as well as the commercialisation and public-private partnerships being considered for ESCOM and the Water Boards. The under-investment in capacity and quality over the years is now beginning to feed directly into inconsistent and poor quality services to users of these monopolies, particularly power but also water and telecoms. Without urgent and major improvements, then private sector growth will not be attained because the utilities simply cannot provide the necessary services to sustain it.

Therefore, the private sector requests that:

1. The privatisation and commercialisation process is completed rapidly to ensure the utilities can sustain the growth in the economy
2. Service charters are established that set out clearly, and in writing, the quality and level of service that business (and domestic) customers can expect. Public/private utilities would be required to report against key indicators (as used to happen) and state how they intend to improve their services.
3. The performance of MTL, ESCOM and Water Boards is transparently monitored and regularly reported.

7. Remove requirement for exporters to convert 40% of Forex on receipt

In May 2001, the foreign exchange surrender requirement for exporters to immediately convert 60% of the Forex denominated earnings into kwachas was reduced to 40%. The private sector proposes the elimination of the mandatory surrender requirement entirely so that businesses which legitimately earn FX can use their own foreign-denominated funds at a time that suits the needs of the individual business. Due to the cyclical nature of agricultural production cycles (agriculture represents over 80% of exports by value) converting into kwachas on receipt is likely to be out of synchronisation with the need for expenditure for the businesses. Given the timing of past devaluations and of the likelihood of these in the future, then this has added a business cost whilst providing only a temporary respite for the kwacha. Arguably, given that most crop sales occur in a limited period, post harvest, this may have induced a cyclical pressure on the kwacha giving apparent stability in the May to October period and greater weaknesses in the November to April period.

The irony of foreign exchange is that the more a government seeks to control it, the more individuals and private sector will seek ways to overcome the controls (both legitimate and not legitimate). Once a business can bring in and take out its foreign exchange, there is every incentive to bring more forex in rather than seek to avoid bringing it in if it cannot be used as required by the business. The 40% rule effectively penalises exporters, the very people on whom Malawi depends for a substantial proportion of its foreign exchange. Malawi is one of only a handful of countries in the world that require mandatory conversion of forex by exporters on receipt of funds. This makes Malawi a significantly less attractive place to invest for export oriented production and sales.

8. Improved transparency of government spending

At the heart of Malawi's current economic difficulties is the control of public expenditure and the resulting budget deficit. These have been directly responsible for the high real interest rates that make domestic borrowing for investment unrealistic. This has hit both domestic investors, particularly smaller indigenous firms who cannot borrow internationally, and capital intensive businesses, particularly manufacturing, the hardest. With the withdrawal of the development partner support, the burden of funding the increasing budget deficit has fallen even more heavily on the formal tax paying sector. The percentage of revenue a proportion of GDP has increased dramatically from 17.1% of GDP in fiscal year 2001/02 to close to 21.8% projected for 2003/4 according to the IMF, representing a 27% rise in revenues on an increasing trend These increases cannot be sustained and are now resulting in more business closures and disinvestments by the formal sector. Efforts to widen the tax net have been undertaken, but the softest target for short term collection is always those who already pay most of the taxes. This has resulted in significant complaints about the way the tax system is being administered, resulting in our support for the GoM's desire for a Tax Ombudsman.

Further increases in revenue collection will become increasingly difficult from the formal private sector, without risking serious disinvestments. Achieving the revenue targets which represent a further MK 12 billion over last year (or 17%) is optimistic. Therefore the attention must focus on keeping within or even below the expenditure budget of MK 89 billion, which will result in a deficit of MK 12 billion.

To ensure greater budget discipline as the central plank of economic policy, the performance of the Government on revenue collection and expenditure should be published quarterly in full. This should also account for accruals for costs incurred but not paid (for example GoM debt to the utility companies remain a major concern) and for refunds due against revenue collected.

Therefore, the private sector requests that:

1. The Government publishes a comprehensive statement of its revenues and expenditure. We would suggest that the Government undertake to publish this within 30 days of the end of each quarter and an audited version within six

months of its budgetary year end, mirroring the same requirement on businesses.
2. The Government published the allocation of the various levies collected, particularly those relating to fuel.

9. Capital goods and spare parts (except for motor vehicles) to be duty free and zero-rated for surtax

In principal, many capital goods that represent the basic items for capital expenditure are exempt from duty or subject to duty of 5%. However, there are three related problems. First of all, spare parts for all these duty free items (machinery, irrigation equipment and other replacement capital items) are dutiable, thus discouraging maintenance and replacement until absolutely necessary. Secondly, although capital goods meant to manufacture for export oriented goods are supposed to be imported duty free, in practice duty is charged and remitted on application, but after some delay and using the Finance Minister's discretion. The investor therefore has to make an application in advance and be able to secure a refund (see 1 above). This represents a serious impediment to doing business. Thirdly, surtax is charged on machinery and other capital goods yet it is reclaimable immediately though not usually repaid promptly. Paying duty and surtax which is then reclaimed simply adds extra cost for the importer and the MRA to administer, the bulk of which falls on the business as they also have to carry the cashflow cost that is exacerbated due to the lack of prompt refunds. None of this supports the building of the productive base of the economy from which revenues for GoM can be generated from PAYE and corporate taxes. It also discriminates against the smallest businesses making small investments that it is not worth the cost of pursuing the refunds or which the small investors are not aware how to reclaim. In addition, these taxes hurt Malawi's tourism industries. For legitimate tour operators and car hire companies, an allowance should be made for the allowance of vehicles free of duties.

Therefore, the private sector requests that:

1. That duty on agreed categories of spare parts for productive revenue generating investments is reduced to zero (we understand that there are revenue implications at point of entry, but that there is a need to consider certain categories that increase productive output, jobs and forex as special cases, for example spare parts for irrigation equipment).
2. That surtax on capital equipment and spare parts in certain agreed categories is removed to avoid the cost of administration for government and producer.
3. *All certified industrial capital goods must be imported duty free without the investor having to apply for remission.*

10. More public oversight of appointment of board members to statutory corporations

Statutory corporations, bodies and governmental agencies play a significant role in the operation of the economy and support to businesses. In line with the statements of the President, there is a need for appointment to such bodies to be purely on the grounds of competence and relevant experience. Many of the problems of statutory corporations, bodies and agencies stem from poor governance exercised by inappropriately experienced individuals not appointed on merit. Appointments of such board members should be done in consultation with management of the statutory corporation and a relevant business association in that sector. It is in the interests of all stakeholders that appointments are made on merit to ensure that these agencies, bodies and corporations operate in the interests of the GoM, the businesses that they support and the people of Malawi.

Therefore, the private sector requests that:

1. There be a clear and unambiguous system for public appointments to statutory corporations, bodies and governmental agencies (including business promotion missions at Malawi Embassies) to ensure their proper functioning beyond partisan control; and
2. Occasionally (perhaps annually) there be an inter-agency business conference (perhaps for one morning) for all relevant agencies and stakeholders to focus minds on the business environment and to revitalise business consciousness and business-friendly attitudes.

Way Forward

On all the above issues, private sector would like to work with GoM and implementing agencies to clarify points of detail and jointly develop proposals for the way forward. We wish to support GoM efforts to improve the climate for investment and doing business in Malawi so that we can build a thriving nation.

We see this as the beginning of a further deepening of the dialogue process between government and the private sector and would seek to discuss how the above can be implemented in partnership.

Signed:

ECAMA	MCCCI
SOCAM	Tea Association of Malawi
Tobacco Exporters Association of Malawi	Cotton Development Association
Chamber of Mines	Trade Policy National Working Group
Garment and Textile Association of Malawi	Malawi Tourism Association

Cross-cutting constraints on the Private Sector

Identified from public-private dialogue
in the development of the
Growth Strategy for Malawi

NAG Forum Secretariat

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CROSS CUTTING CONSTRAINTS ON BUSINESS GROWTH

According to the World Bank's Malawi Country Economic Memorandum (2003), the country has the potential to grow at an annual rate of 5.2% over the medium term. This annual growth is projected to come from agriculture (5%), manufacturing (6.5%) and services (5%). However, there are many **Cross cutting constraints** on private sector growth identified from consultation activities involving Private Sector and other key stakeholders that would need to be addressed first. These are the **macro-environmental** issues that constrain individual firms from achieving higher sales and profits through investment and trading activities.

The constraints fall into six broad areas:
1. Weak **macro-economic** conditions
2. High burden of **business taxation**
3. Weaknesses in the **legal and regulatory framework**
4. Weaknesses in the **infrastructure** that supports the economy
5. Weak **dialogue and co-operation** between private and public sectors
6. Weaknesses in the **Human Resource** base and skills

Of these, weak **macro-economic conditions** and **business taxation** are the biggest areas of constraints to Private Sector investment and trade, though weaknesses in the **legal and regulatory framework** also make Malawi a difficult place to do business in both absolute and relative terms. Weaknesses in the **infrastructure** add extra costs, particularly transportation and utilities, making Malawi an unnecessarily expensive place to operate a business and in turn contribute to high prices. Failure by the Private and Public Sectors to engage in **constructive dialogue** with each other and to **co-operate** effectively in the past have limited growth opportunities and resulted in lost investment and trade. There has also been a general failure to effectively engage the private sector in the dialogue between GoM and IMF to ensure the implications of structural adjustment on businesses are fully understood. Finally, weaknesses in the **human resource base** and weak skills development contribute to poor overall productivity in the economy. These areas are broken down and analysed below.

Weak Macro-economic Conditions

Poor macro-economic conditions and instability are seen in **high real interest rates**, relatively **high inflation**, **unpredictable exchange rates** and **weak domestic demand**. These factors impact very negatively on the business community and directly deter trade and investment, contributing to the low or negative growth rates across most sub-sectors of the economy. Whilst the overall macro-economic climate remains so negative, it is unlikely that substantial private sector investment will be made, which in turn makes significant growth unlikely. The recent poor macro-economic conditions are also an important contributing factor to disinvestments over the last few years, as seen in the number of high profile business closures.

<u>Achieving macro-economic conditions that are conducive to investment and growth has to be the top priority for GoM in order to promote private sector development.</u>

1. **Cost and access to finance** – With commercial Kwacha borrowing rates at over 45% and real interest rates in excess of 30%, there are few business opportunities that can yield sufficient returns to meet the cost of finance. There are therefore few businesses borrowing in Kwacha to invest. Only businesses that have to meet short term financing needs are borrowing in Kwacha. There are some export oriented and international businesses that borrow in hard currency, but this carries an additional cost especially as the risk premium for Malawi is relatively high and such loans are also vulnerable to devaluation effects. Effectively the **vast majority of Malawian businesses are not able**

to access finance for investment and those businesses that have borrowed for past investment or are forced to borrow for immediate working capital needs pay a high and unsustainable price. The underlying problem is that much of the available domestic capital is being diverted to fund GoM's budget deficit through Treasury Bills forcing up interest rates. The cost of servicing this debt accounts for 24.7% of GoM expenditure and 4.5% of GDP at December 2002. Whilst the budget deficit persists at high and unsustainable levels, access to finance by, and the cost of finance to businesses will be problematic. Cutting the budget deficit is the most critical issue that GoM must address right now.

2. **Relatively High Inflation** – High inflation rates have been a problem for businesses in the recent past making pricing decisions more difficult and uncertain, because costs are constantly moving and unpredictable. The recent slowdown in inflation towards single figures is welcome, though this is a combination of greater availability of cheaper maize and weak economic activity. The volatility of inflation rates is a disincentive to investment as it makes returns more uncertain than they already are, especially for businesses that do not earn hard currency.

3. **Exchange rate instability** - Fluctuations in exchange rates make costing and pricing decisions more difficult and add unexpected costs that cannot always be passed on. Malawi is highly import dependent and devaluations feed directly and quickly into business costs. This is offset to some extent for those businesses that are exporting, but not wholly and not at all for non-exporting businesses. The unexpected appreciation of the currency in 2001 was also very damaging to particular export oriented sub-sectors such as tea due to the different timing of inputs relative to sales.

4. **Weak domestic demand** – with 85% of the population living in rural areas, mostly on subsistence incomes and limited growth in urban incomes, the domestic market is small and not contributing to growth for consumer related goods and services. The low and negative per capita growth of the last three years has shrunk average real incomes and further reduced opportunities for trade and investment.

The Taxation of Business

The overall **burden of tax**, the **administration of the tax system** and the **implementation and scope of Surtax** have increased the pressure on the Private Sector and made it more difficult to do business in Malawi. The main pressure is coming from GoM's need to increase **collection of revenues**, to meet its budget deficit. The Private Sector is paying the price for GoM's budget deficit, through high interest rates and more aggressive revenue collection, which is falling increasingly heavily on the 'taxpaying' formal sector rather than on those businesses that are deliberately evading tax or operating in the informal sector.

5. **Burden of Taxation on Businesses** - The burden of taxation on businesses is increasing as GoM seeks to bridge its budget deficit. **Corporate Tax** rates are broadly competitive in the region, however, increases in **Personal Tax** rates and the failure to index threshold rates to inflation has raised the costs of employment significantly, as employees seek to maintain real disposable incomes. The current maximum rate at 40% encourages evasion. The starting threshold rate of K.3,000 per month[1] is far too low as this is barely a subsistence wage in urban areas bringing too many people into the tax system for minimal revenue. **Withholding Tax** is unclear in scope and application, which makes it hard to comply and avoid penalties. It has made it more difficult for service businesses to operate and grow. **Provisional Tax** is difficult to comply with as it requires the ability to make

[1] This is less than three times the per capita consumption poverty base line ($0.35/day), which would not sustain the basic needs of a family of four or more.

complex calculations of liability based on incomplete data and uncertain taxation rules/application. **Minimum Turnover Tax** hits start-up businesses and new investments at the time when their cashflows are weakest. There are many other **Charges** and **Levies** that adversely affect all businesses or some sub-sectors in particular, such as **Pre-shipment Inspections** and the **Fuel Levy**. Legitimate businesses in Malawi now have to be tax experts and to devote considerable resources to managing tax to avoid undue penalties. Smaller businesses are particularly disproportionately affected and can rarely afford the specialist help required. Yet the non-taxpaying formal/informal sector for who many of the taxes and stiff penalties are designed continue to evade the system as the cost of compliance is so high relative to the cost of evasion. The taxation of businesses is now burdensome, overly complex and costly for legitimate businesses and MRA to manage.

6. **Burden of Compliance on Legitimate Businesses –** Formal sector taxpaying businesses understand the need for GoM to raise revenue. However, the pressure on the MRA to raise more revenue is being felt by the dwindling number of formal sector businesses that are complying with the rules. Simple and genuine errors are being increasingly punished as if they were deliberate evasion. This pressure has tended to be on legitimate businesses that are paying taxes, but are increasingly being targeted to pay more, sometimes through arbitrary rule-making. Scrutiny and investigation by MRA officers in itself is sometimes used as a means to extract revenue as it is less costly in resources to pay the alleged underpayments and penalties than to challenge it through the courts. The greater the pressure on legitimate businesses the greater the temptation to evade collection or to bribe officials to waive the tax. It is commonly believed that there are a large number of businesses that **evade tax** though lack of scrutiny or, when they are scrutinised, by paying off officials. This evasion by a section of the business community is being paid for by those that are broadly complying with the requirements and by GoM in lost revenue.

7. **Implementation and Scope of Surtax –** The use of Value Added Taxes is a common method for raising revenues by Governments around the world and there is no objection in principle to the extension of Surtax in Malawi. However, there are several major problems with the design of Surtax and the way it is being implemented.[2] **First** of all the rate at 20% is high in absolute and relative terms compared to competing nations. At this level it positively encourages evasion, which is happening on a wide scale, as the benefit of evasion is high. **Second**, legitimate businesses have not been given enough time and support to implement a major change like this. The impact for smaller locally owned businesses is particularly harsh as they have limited technical capacity to deal with the change and the complexity of Surtax whilst undertaking their normal business activities. **Third**, the rules are not clear enough with much confusion on what products and services are covered and not covered. More areas of exemption are also required for basic household purchases.[3] **Fourth**, the extent of non-reclaimable inputs is too wide and damaging to suppliers of such items and those that buy them. The original list was meant to be reduced but has not been. Office furniture, hotel accommodation, supply of premises for any functions and cleaning services seem to be particularly odd inclusions if they are demonstrably for business purposes. **Fifth**, the cashflow burden falls entirely on businesses especially the asymmetric rules on reclaims.[4] **Sixth**, the coverage of Surtax appears to be too extensive. Donor agencies are not exempt, nor are sectors that are predominantly export oriented. Surtax on supplies to companies in export processing

[2] Many of the recommendations of the original working group were not implemented yet these would have overcome many of the current difficulties.
[3] The situation on bread and bread making ingredients is one example.
[4] Three consecutive months before a reclaim can be made and then 3-6 months for actual repayment based on the experience of manufacturing businesses.

zones has been introduced, which seems to be counter to the purpose of EPZs.[5] It also makes Malawian suppliers of goods to EPZ companies more expensive relative to duty free imported goods. Over 95% of tea and all tobacco is exported yet there is no block exemption or negotiated status for those growing, processing and selling these products. Surtax is being paid and there is a long reclaim process, resulting in cashflow costs and unnecessary costs for businesses and government to administer the reclaim process. Effectively local exporters must pay surtax first if no bond is lodged and then claim it back. The excessive reclaim times impacts on cashflows and have halted follow up shipments in some cases. **Seventh**, the penalties for Surtax are very harsh, especially for smaller businesses and the circumstances in which they are applied are no longer as flexible. Late submission of a return by one day, even if the return were for a reclaim would apparently result in a fixed penalty of K20,000.

Weaknesses in the Legal and Regulatory Environment

The regulatory environment is there to support, monitor and regulate business activity. There are legitimate Public Sector functions such as **regulating behaviour** as well as **encouraging investment and exports**. Many regulatory and administrative procedures run by the public sector are costly and inefficient. The **processes and incentives for investment are weak** as are **most services provided by the Public Sector**. It is also clear that Government is **not consistently pro-business in its policies** and some officials in the public sector operate in ways that damage trade and investment by **failing to implement the policies correctly**. The **commercial legal system** is not working sufficiently well to support the operation of the private sector. GoM has generally not been able to deliver **international trade agreements** or enforce existing agreements that work to the interest of businesses and Malawi.

8. Costly regulatory and administrative procedures – There are still many cumbersome procedures when interacting with the Public Sector and generally weak administration of many procedures, which leaves room for corruption. The importation process is particularly costly to businesses that seek capital equipment and key inputs. Reserve Bank of Malawi is undertaking a review of the importation procedures with a view to simplify them. This would represent a big step forward and needs to be completed with urgency as it puts Malawian businesses at a cost disadvantage and loses significant revenue for government. Linked to this is the requirement for export earning businesses to immediately convert 40% of forex revenues. This can result in them being vulnerable to devaluation if this is higher than their immediate expenditure needs. Foreign exchange earners are being required by some banks to convert one hard currency into another through converting to Kwacha and then repurchasing the other hard currency, in breach of RBM rules. This adds around 6-8% to the costs of inputs and effectively transfers manufacturers profits to the banks for no added value. Pre Shipment Inspection fees of 1% on imports in excess of $2,000 represent an additional tax on legitimate importers and the MRA is apparently in breach of WTO rules by taking the higher of the custom's value on the invoice or the inspector's valuation. This penalises companies that negotiate better deals and fails to catch the businesses that understate values and then bribe officials if caught out. Input costs for businesses in Malawi are exacerbated by the MRA requirement that goods entering Malawi do so under a transit bond, which is only offered to freight and forwarding association members. This means that manufacturers are forced to pay a total of about US$480 per truckload in order to comply with this requirement.[6] A better way would be to categorise importers to exempt those that have a good track record in tax compliance.

[5] Prior to this extension, supplies to EPZ companies were exempt through the use of form ST14.
[6] Transit bond of $150 plus $10/tonne for 28 tonne load.

9. **Weak Public Services and Inefficient Delivery Systems** – The overall perception of businesses is that the quality of public services has declined and that the public service delivery system is not efficient. There are many complaints by businesses of inefficiency, unnecessary delays and poor services by the public sector and many of these provide opportunities for graft by minor officials. Whilst there have been reforms in the 1980s and 1990s that removed many unnecessary licensing and other regulatory activities, where businesses require action by the public sector, the performance has rarely been to an acceptable standard. Communications in the Public Sector are too slow and unreliable with Ministries regularly 'off line' or not contactable by telephone and an over reliance on the post for communicating information, even though it is uncertain and very slow. The dialogue and co-operation between the public and private sectors over social service delivery, has not been sufficient, with the private sector feeling that it has been left to pick up the bill for gaps in provision rather than achieved through dialogue and co-operation. Inefficiency in public services undermines the efficiency of the Private Sector.

10. **Weak investment incentives and investor package** – Investment is more international than ever and Malawi must compete for inward and domestic investment against other countries. The incentives for any investment in Malawi are relatively weak compared to incentives available in other regional countries and result in limited new domestic and inward investment and re-investment in Malawi. The current investment incentives tend to favour certain sectors like manufacturing and agriculture and are not designed with other important sectors and sub-sectors in mind. Domestic investors who are looking to reinvest are not generally aware of the incentives available to them, which to some extent favour new, international and greenfield[7] investments. This puts existing businesses, especially smaller ones, at a disadvantage if they want to re-invest to modernise. Whilst EPZ rules are generally competitive, there is scope for more flexible operation to provide investors with more reasons to choose Malawi or for existing investors to grow. The lack of clear and fixed incentives in a comprehensive package is also a problem as enquiring investors may not be willing to engage in protracted negotiations or to contact several organisations to get a better offer when determining which countries to shortlist for detailed investigation. Other countries offer more attractive fixed incentives at the outset and a more comprehensive investor package. Improved investment incentives and a clearer package would result in some <u>future</u> revenues foregone but many new **revenue streams gained**.

11. **Weak process for investment and implementation of incentives** - The procedure for investors has been improved through the MIPA one stop shop, but is not always within the target ten-day period especially when this involves allocation of land and is not sufficiently transparent. The approval of incentives and allocation of land is slow and uncertain for some sub-sectors, such as Tourism. Several major investors have been lost over the years simply due to delays in approval. There is no mechanism to ensure that all GoM bodies implement any agreed incentives. The level of support for the smooth operation of EPZs is inadequate and prevents EPZ companies accessing the full benefits to which they are entitled. Ultimately this will deter more investors and limit the growth of existing investors.

12. **Incentives once granted are not guaranteed -** Even when incentives are given, other arms of government, including MRA and Ministry of Finance, can over ride them. This has been happening on a regular basis, particularly in Tourism. In addition, the recent suspension of duty waivers has caused confusion amongst potential and actual investors without generating significant incremental revenue as it has deterred potential investors or simply delays investment. The former results in lost revenue altogether and the latter just

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[7] Greenfield refers to developments on new sites that have not previously been used for business/industry, rather than re-development of previously developed but now vacant ('brownfield') sites that are more costly to develop as clearance of buildings etc. may be required. Policy may wish to favour utilisation of vacant developed sites rather than use greenfield land.

delays the point at which GoM starts to receive revenues from Corporate, Payroll and Surtax payments.

13. **Inadequately pro-business policies and weak implementation of policies -** Malawi needs to become known as a country that is very pro-business if it is to reverse the decline of the private sector and stimulate significant investment. At present, the legal and regulatory environment appears designed to maximise short-term revenues from business, irrespective of the medium or long-term damage. **Attitudes in some parts of the Public Sector** are negative or at best ambivalent to business rather than supportive. **Consistency of policy** is also important as policy reversals are very damaging for investment prospects as is the efficient implementation of pro-business policies that do exist. There are insufficient industry and sub-sector specialists in line Ministries that know and understand key industries/sub-sectors and can advise colleagues on the business friendly actions and policies.

14. **Inefficient and Ineffective Commercial Legal Systems -** It has become very expensive and slow to pursue commercial cases. The courts give priority to political cases and there is a loss of confidence that issues such as theft by employees will be vigorously pursued. This has resulted in businesses dismissing such employees without reporting it. The charges made by lawyers are mostly fixed by statute/regulation and result in limited competition and relatively poor service. There are no dedicated commercial courts or procedures or small claims court where minor cases can be settled quickly and cheaply.

15. **Unfavourable Trade Agreements and Weak Negotiating Capacity –** Malawi has consistently failed to get trade agreements that work to its best interests or failed to enforce good agreements in the face of difficulties from trading partners. In contrast other countries have used trade agreements to break out of poverty. For example, Mauritius negotiated a massive preferential quota for speciality sugar with Europe[8] that has enabled it to become a major player in the world sugar industry, despite having no competitive advantage in sugar compared to Malawi. This quota provided Mauritius with the revenues to diversify into other added value activities. Trade negotiation is one of the activities that makes or break industries at a stroke as experienced by the major closures in the garment industry from January 2000. Weak capacity and failure to fully involve private sector people has resulted in poor agreements and lost investment for Malawi.

16. **Uncompetitiveness of Markets** – many domestic markets are still not competitive enough, partly due to limited competition but also the high cost of imported inputs resulting in the high cost of goods and services. Problems with storage and distribution gaps further add costs for businesses. There are some sub-sectors with too few players that results in limited competitiveness, some of these are dominated by Public Enterprises. However, the limited number of businesses in some sub-sectors is also a function of limited demand. Therefore, there needs to be care in balancing the needs of consumers and businesses when seeking to stimulate domestic trade. The extension of Surtax has also impacted directly on prices and created dual markets in some cases, at the expense of those following the rules, putting legitimate businesses at a price disadvantage.

17. **Inefficient Parastatals** – The privatisation process has put over 50 Public Enterprises into the private sector, however GoM still has considerable interests in many businesses directly or indirectly through investments it controls or influences[9], particularly in the utilities, transport and services area. Some of these perform some social function, but

[8] Over 400,000 tonnes vs. Malawi's 20,834 tonnes quota for speciality sugars – the industry is seeking to improve this but needs government's full support and commitment to the negotiation process.
[9] This includes MDC with interests in 11 companies, Press Trust and ADMARC with interests in 16 companies according to the World Bank CEM 2003

many do not and the rationale for public sector part or full ownership is unclear, especially as many have been poorly managed and built up considerable losses that take resources from the social functions and poverty reduction activities. Such heavy public ownership and influence can have the effect of taking potential investment opportunities away from Private Sector and crowding out or deterring Private Sector investment. Of great significance is that many of these Public Enterprises put considerable pressure on GoM finances to cover their losses, when they could be turned into viable revenue paying businesses in private hands able to generate higher revenues. This is a major contributor to the budget deficit and urgently needs action to improve management through commercialisation or privatisation to reduce the drain.

18. High Insecurity – Insecurity and theft add unproductive costs to doing business in Malawi. The burden of insecurity falls particularly heavily on smaller businesses as they are often not able to protect their property or replace it if it is stolen or destroyed. When vandalism is done then the cost is also loss of production. The perception of many in the Private Sector is that the Police give too little focus to the protection of people and business/domestic property. Security adds significant costs through anti-theft measures, increased insurance costs and unrecoverable losses ultimately deterring investment and trade.

Weak Infrastructure

The infrastructure to support businesses is weak in Malawi, particularly in relation to **transport** and **utilities**. This weakness contributes to the high costs of doing business that are then passed on to other businesses and consumers. It also impacts on Malawi's ability to export and compete internationally:

19. Weak transport infrastructure – Malawi's landlocked status is a major disadvantage to businesses as it increases the costs to importers and exporters relative to regional competitors. The weakness of the transport infrastructure includes **poor access to ports**, **limited air links** and **freight capacity**, **limited rail capacity** and **poor condition of roads** particularly those serving manufacturing, mining, tourism and rural producing areas compounds this problem and add costs. Limited options and competition increase the opportunities for high prices to be charged by transport providers. The **National Roads Authority** has brought about some improvement in the overall position within Malawi and giving concessions for rail and lake services holds some prospect for more investment and improvement of services. In relation to Air transport, there needs to be greater access to alternative carriers for passengers and freight to drive down costs. The privatisation of **Air Malawi** and opening up air routes to other carriers is vital to connecting Malawi to key markets. The regime for landing fees and aviation fuel is relatively uncompetitive and deters potential carriers[10] from using Malawi as does the poor Airport infrastructure. There are ongoing problems with neighbouring countries that affect the smooth flow of goods across borders, compounded by delays at Malawi's border posts that delay and add cost. Major interruptions to key transport routes such as the Nacala Corridor rail link are a serious disruption and cost to businesses.

20. High cost of transportation – this is partly a function of the poor infrastructure, but also the requirement to use local transporters and the high cost of overland transport into Malawi. The later is partly due to the demands for imports of fertiliser and maize at key times of the year and compounded by third country rules that limit the competitiveness of the domestic/international transport industry. The costs of domestic transporters are also

[10] These are the highest in the region and amongst the highest in the world so that external carriers purchase fuel in the country of origin and where possible bypass Malawi.

unnecessarily high due to the relatively high costs of parts and of fuel partly due to the high fuel levy as well as damage from the poor road conditions.

21. Unreliable and expensive Utilities – Electricity, Water and Communications are unreliable, despite some improvements and still relatively expensive compared to competitor countries. The recent problems with electricity have been and continue to be a disaster for many businesses[11] in lost production, lost productivity and extra costs. Reliability of power has been demonstrated as a necessary pre-condition for growth. ESCOM's **Maximum Demand Tariff** is distorting, despite the recent change, as it penalises those that are doing the most business. It is also making it less viable to irrigate crops where this requires electricity even though irrigation is a GoM priority. Supply fluctuations involve protecting electrical equipment from surges and providing back up for outages at a cost. Unreliability of supply also results in production losses and is particularly damaging for manufacturers with processes that cannot be stopped and restarted. The cost of back up generation is high in capital used and generation licences are an extra cost that unfairly penalise those needing certainty of supply such as continuous manufacturing processes. Getting new telephone lines in some urban areas is difficult or impossible due to inefficiencies and limited capacity. The cost of international calls is high in relative and absolute terms, inhibiting international trade. Communication is vital to business and therefore urgent investment in more digital capacity is crucial to support growth. Mobile phone call charges are significantly more expensive in Malawi than most regional competitors, limiting growth of communications and adding further costs to businesses and government, given the difficulty of accessing fixed line communications.

22. Weak Information Technology Capacity - Malawi has relatively poor connectivity to information technology and high data demanding communications. There are not enough IT graduates to meet the needs of the Private or Public Sectors, resulting in generally costly and weak IT services.

Private, Public and Donor Co-operation and Dialogue

There has been very weak co-operation between the Private and Public Sectors due to a lack of understanding and mutual suspicion on both sides as well as a failure to fully appreciate the necessary interdependence for mutual success. There are important areas of potential co-operation between Donors, Private and Public Sectors, on policy development and implementation as well as developing smallholders.

23. Weak dialogue between Private and Public Sectors – Consultation processes have generally been very weak, with the Public Sector going through the motions, whilst the Private Sector has become unwilling to invest enough time, energy and resources to fully engage. When there has been consultation, there has been a failure to really listen and appreciate the perspective of the other side resulting in misunderstandings, false perceptions and frustration. Due to failings on both sides, the development of the **Malawi Poverty Reduction Strategy** failed to properly engage the Private Sector as the main source of growth, resulting in a weak integration of Private Sector issues into the MPRS. In the recent past, the Chamber of Commerce has generally failed to win the trust and confidence of the Private Sector and to perform as an effective mouthpiece for the Private Sector perspective. There are signs that this is being reversed, but it has meant that the Private Sector has tended to work as a series of independent and relatively weak sub-sector lobbies with limited real influence on policy. There are no sub-sector specialists in the key ministries, who can build a full understanding of these key sub-sectors and act as a co-ordinating point.

[11] And the Public Sector

24. **Weak inter and intra sectoral linkages -** With 85% of the population engaged in mixed subsistence and cash crop agriculture, access to key inputs and technical support is important to improving yields, quality and returns in cash crops and subsistence crops. Organising inputs and extension services has provided a major challenge to MoAI and is a very difficult task to deliver across the whole country on limited resources. This has led to major gaps in services affecting smallholder yields and quality of both cash and subsistence crops. Low smallholder productivity[12] has resulted in low incomes and limited resources for re-investment in productivity improving inputs, particularly as the terms of trade have generally moved against agricultural commodities. Yet there are ways to rapidly improve productivity relatively quickly for low investment.[13] Initiatives in tobacco, sugar, cotton and tea suggest that a more co-operative relationship between smallholders and larger processors/marketing firms can be symbiotic. Larger firms provide inputs and technical support, in return for access to the crop and the ability to offset the input costs against remittances to smallholders. Whilst smallholders have to pay for market prices for inputs, they are now getting consistent access to inputs on credit and technical support resulting in higher profits. Smallholders also have a guaranteed buyer that provides certainty and remits payment on time. Such schemes show the potential to have a big impact on rural incomes and productivity with benefits to the macro economy through increased exports, higher GDP and higher demand in the economy. There are fewer linkages in manufacturing and other sectors, with generally weak private: private and public: private dialogue and co-operation.

25. **Weak Donor dialogue with Private Sector** – Past dialogue between donors and the private sector has been weak and over reliant on representative bodies that have historically had weak capacity. There is a need for the impacts of multilateral donor decisions on the prospects for the Private Sector to be more fully discussed and understood by all stakeholders. Donors need to be more willing to listen to the criticisms made and not simply dismiss them as the same old story when determining policies and actions that impact on businesses.

Weaknesses in the Human Resource base

The development of the Human Resource base in Malawi is a key part of the MPRS. The current resource base is relatively weak characterised by low skill, low productivity and low wages. This partly reflects weaknesses in the education system ***inadequate specialised skills development*** but also the devastating ***impact of HIV/AIDS*** and ***poor management practices*** in the private sector more generally.

26. **Inadequate Specialised Skills Development and Staff Retention** – the development of the human resource base in Malawi has been relatively poor with a generally low standard of attainment by many school leavers and even graduates. Curricula are not clearly linked to the needs of organisations and the number of linkages and practical experience placements have reduced. Vocational training has not delivered a substantial enough number of vocational graduates and those that have graduated have generally not achieved sufficient levels of skills to provide support for businesses. Businesses have had to fill the skills gap through internal or external training at their own costs, or have simply tried to cope without investing enough in staff training. The incentives for training are relatively poor and need to be extended to create more of a learning culture. The supply of

[12] Sugar is an exception, with the Kasinthula Smallholder Scheme producing world-class production levels, significantly higher than estate yields.
[13] Examples would include seed treatment in cotton that simplify the management of the crop and protect against pests in the first 12 weeks.

training has generally been poor with over reliance on inappropriate curricula, poor quality of trainers and poor management of training programmes. There is also considerable loss of trained and skilled staff from Government and Private Sector to Donors and some well-funded NGOs though the offer of packages above the going market rates in terms of salaries and benefits.[14] This causes considerable disruption to GoM and businesses as well as the lost investment in training and skills development.

27. High Cost and Impact of HIV/AIDS and Preventable Diseases – Businesses and the Public Sector are beginning to recognise the cost of HIV/AIDS from losing skilled and trained staff, who tend to be disproportionately affected, to prolonged illness and ultimately death. The potential for losing trained staff to HIV/AIDS is discouraging investment in key staff or requiring investment in more staff to ensure at least one is available. HIV/AIDS is also impairing Public Sector's capacity to deliver services and to function. Much more could be done by GoM and the Private Sector working together to build on initiatives from within and outside Malawi. The cost of malaria, TB and other respiratory illnesses is high in terms of lost productivity, based on WHO data.

28. Weaknesses in the Private Sector – There are management failings within the Private Sector. Some managers in the Private Sector have been too ready to cut corners, support graft, engage in anti-competitive behaviours and take short-term perspectives in their businesses. There has been a failure to develop the attitudes of employees to increase individual initiative, responsibility, performance and culture of service to customers. This is partly a consequence of the environment, but also a failure by management at all levels as there are examples of businesses that have substantially changed employee attitudes and performance by a change of management. This must become the norm if Malawi's Private Sector is to compete effectively domestically and in world markets as a change in the climate for doing business and greater competition from new investment would expose those failings. There needs to be a greater focus on quality and innovation in the private sector.

[14] Whilst some organisations can no longer pay employees tax free, there are still too many with pre-existing agreements that enable donors and NGOs to out bid private sector