2005 TAX REVIEW – PRIVATE SECTOR SUBMISSION

By

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&

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1 Introduction

This document provides the Minster of Finance and the Government of Malawi with a consensual and informed position from the perspective of the private sector of the Tax System and its Administration as a contribution to the Tax Reform process. Malawi Confederation of Chambers of Commerce and Industry (MCCCI), Economics Association of Malawi (ECAMA) and The Society of Accountants in Malawi (SOCAM), with input from the Bankers Association and facilitation from the National Action Group Forum Secretariat (NAG Secretariat) came together to provide one joint submission that broadly represents the views of their membership.[1]

This paper is based on an earlier document presented in February to the team from the US Treasury, but has since been modified to take greater account of the desire of GoM to maintain revenue neutrality as far as is possible and reasonable. It also formed the basis of the presentation to the IMF Tax Team in March 2005. This paper accommodates comments from our memberships on the drafts and further thinking on the issues based on feedback from the consultants, MoF and MRA officials. We believe that it represents a reasonable and balanced contribution to the debate on how to meet the needs of GoM for tax revenue, the needs of the people of this country to impact on poverty and the need to stimulate growth and development of the private sector as the source of our current and future prosperity.

Private sector argues that the key problem for the GoM in balancing its budget has been over-expenditure made worse by the loss of confidence by the donor community and the loss of their support through failure to meet the conditions set. This is how the deficit arose. The problem for GoM is therefore primarily one of expenditure management (and effectiveness of that expenditure) and not primarily of revenue raising.

In recent years it seems that the prevailing attitude has been to set expenditure budgets first and then find revenue from donors and the private sector to make up the gap. Imposing revenue increases on the private sector has been seen as an easy option to raise revenues. Over the last five years there has been a progressive and substantial increase in the amount of revenue gathered as a percentage of GDP, a disproportionate amount of which has come from the predominantly tax compliant formal business sector. Unless there is change of approach and emphasis, further increases in revenue raised will once again fall disproportionately on the tax compliant sector of the business community. This will further deplete their capital and further deter investment due to the low returns and the large share of net revenues already paid to government.

Unfortunately, whilst there is strong accountability to donors, this has not been the case in the past with taxpayers even though resources from businesses and individuals account for nearly half GoM revenues. However, the tax review announced by the Minister of Finance represents a welcome change and enabled the private sector to come together and offer some input from the perspective of what it is like to have to comply with the tax regime as it is. The private sector welcomes this and trusts that its contribution will be seen as constructive. In presenting these issues the private sector may appear to be too critical but it should be realised that without being direct on these issues they may never come to light.

It is realised that paying tax is never very popular and there will always be complaints, both legitimate and not legitimate. Individual or specific groups of taxpayers also tend to lobby for their own self-interests and seek special concessions. Because of this background, there is therefore a danger that as the private sector presents its contribution to the tax reform process decision makers in government may dismiss this as self interest lobbying instead of

[1] There has been considerable consultation based on previous submissions/ideas from members, circulating drafts/proposals and pre-budget consultations in Blantyre, Lilongwe and Mzuzu.

accepting that there are genuine problems to be addressed. In our process of wide consultation with private sector and dialogue with the consultants and GoM officials, we have tried to steer a middle path that balances the needs of the different stakeholders. The private sector would request government to give full and due consideration of the issues presented in this paper. So far the private sector is encouraged by the process and responses received from GoM officials and the consultants involved in the tax review process and hopes are high that the majority of the ideas will be taken into account.

The reality of operating a business in Malawi is very challenging. This has been acknowledged by the World Economic Global Forum's Global Competitiveness Report 2004/5 which ranks Malawi at 87th out of 102 countries on the Growth Competitiveness Index (down from 76th in 2003/4), 84th on the Business Competitiveness Index (down from 72nd in 2003/4) and of most concern, 100th on the macro-economic Environment Index, just three places from the bottom.[2] Of course this does not reflect the improvements that have been initiated by the new GoM over the last 9 months, but it does highlight that the business community is facing a harsh operating environment that had progressively and significantly worsened over recent years.

Complying fully with the legislation and regulations that make up the operating environment is also very challenging. 100% compliance with all legislation and regulation is impossible given the complexity, breadth and scope for interpretation of the rules, but this paper refers to "predominantly tax-compliant businesses" as meaning those that seek to and are in the majority of situations tax compliant. This contrasts with a section of the formal business community that is persistently non tax compliant either deliberately or through ignorance. These are not the informal sector and micro businesses from whom the potential for tax revenue is relatively small,[3] but the small, medium and occasionally large businesses that are formally established with fixed premises. At present the burden of taxes is falling disproportionately on the predominantly tax-compliant businesses as these seem to be the easiest way for MRA Officers to meet their targets. This needs to change and doing so could yield significant additional revenues for GoM.

Any tax system needs to have the confidence of taxpayers, if it is to avoid serious disruption and breakdown. Tax systems only work if the majority of taxpayers collect and remit taxes on behalf of governments and broadly comply, ***of their own will***. This enables the revenue authority to focus on those businesses and individuals that either choose to cheat or fail to comply through capacity weaknesses or lack of knowledge.

However, when a system is judged to be unfair, excessively burdensome or discriminatory in its rules or in the way it operates, progressively more and more of the previously compliant taxpayers stop co-operating and cease playing by the rules or choose not to invest further or liquidate their investments. Malawi has not reached the point where its tax system will collapse, but over the last five years taxpayer relations have deteriorated significantly due to the pressures on the MRA to collect revenue, which has often been implemented by MRA with little regard to the rules, precedents, agreed practices or acceptable methods. At the same time the rules are getting ever more burdensome and extracting a greater share of the available returns to tax compliant investors. Coupled with a deteriorating macro-economic performance through to mid 2004, with its impact on profits (triggered by government overspending and borrowing), businesses have faced a harsher operating environment, deteriorating relations with the MRA and lost a higher share of their earnings to government, with little to show in return.

[2] Reported in Daily Nation 14th April 2005.
[3] Though these are primarily not tax compliant, we would not direct compliance efforts onto this group for efficiency and poverty reasons.

It is time for Malawi to decisively change course and to establish the conditions for economic and business growth that will bring prosperity to businesses, people and government alike. As any business knows, balancing the books is crucial, as is ensuring that borrowings are manageable within the revenue surpluses available. Revenues can be pushed up so far and have probably reached the point in Malawi where further increases cannot be sustained just from the current sources. New sources of revenue are there, particularly the non-compliant business and NGO sectors. These are discussed in the following sections. But the quickest way for GoM to reduce its deficit is to cut costs, painful as that will be – Malawi simply cannot afford to keep increasing spending as it has done over the last five years.

In terms of its broad strategy, GoM must therefore:

1. Make more realistic projections for domestic revenues and donor inflows than in the past and base its expenditure budget on these, not set the expenditure budget first and find ways to bridge the gap as appears to have been the case in the past
2. Reduce the domestic debt as quickly as possible by cutting expenditure in real terms and as a percentage of GDP, paying down the debt with the savings to reduce interest payments and make more funds available to GoM in subsequent budgets
3. Make a decisive shift in compliance efforts by MRA towards the persistent and deliberate formal sector offenders – this will require stronger and perhaps independent capacity to be made available to the new leadership of MRA.
4. Support MRA to regain the trust of the majority tax compliant community by treating tax compliant businesses fairly, taking a more focused risk based approach and rewarding compliance.
5. Take the first steps to restructure taxation to remove the most obvious problems in the system – setting a new course and taking the first steps will be a significant boost for private sector confidence in the new government and encourage investment.

Whilst any agenda is difficult to prioritise, the following probably represent the priorities of the broader tax compliant private sector (not in priority order):

- Ensure the excessive amount of tax refunds currently due are paid within the statutory/ regulatory periods, particularly surtax and withholding taxes
- Separate the assessment and adjudication functions of the MRA as a means to restore confidence in the tax administration system
- Redirect compliance efforts to those that are clearly cheating at a significant scale with more adoption of risk based approaches towards broadly compliant firms and sectors
- More appropriate treatment of capital through more realistic capital allowances, shift to straight-line methods for taxation purposes, more appropriate time periods (shorter) and less exclusions (particularly non-manufacturing commercial property) that recognise the reality of the depreciated cost of capital in a high inflation economy
- Automatic indexation of allowances and thresholds (and fees charged for GoM services) with catching up where these have fallen in real terms
- Revise Capital Gains Tax to ensure inflationary changes in the value of investments are not taxed, and the rate of tax is revised to be appropriate to an investment not as if it were income.
- Significant review of Withholding Tax to reduce its scope, simplify its categories, introduce more appropriate rates in certain categories and increase thresholds to meaningful and efficient collection levels for both businesses and MRA to make efficiency savings. Exemption certificates need to be more widely available for the proven tax compliant. This would allow a more serious compliance effort once the rules are more appropriate.

- Urgently review the operation of surtax, with appropriate exemptions, zero rating and removal of anomalies. This would underpin more serious enforcement of the rules, particularly in the trading sector
- Automatic indexation of thresholds for PAYE, with an immediate up lift of the tax free allowance to MK 72,000 p.a. and bring down the highest rate from 40% towards harmonisation with the corporate tax rate to encourage enterprise, marginal efforts to earn more and better compliance.
- Remove the duty on spare parts for capital goods and extend the coverage of what capital items can be brought in duty free. Shift from a system of paying and then seeking remittance of duty and surtax as this is an unnecessary inefficiency.
- PSI needs to be applied on a more risk based approach targeting sectors of the economy which have highest rates of non-compliance, such as trading. Anomalies such as PSI on duty free materials and capital goods need to be resolved. Excessive delays by the contractors that hold up shipments need to be reduced and if necessary penalised if they are outside agreed reasonable times. There needs to be a deliberate requirement in the next contract to build MRA capacity because the longer PSI is out-contracted, the less capable MRA is of doing it and the more we become dependent on the contractors.
- Investment incentives need to be transparent and automatic, ideally built in as improved capital allowances available to all businesses whatever their size, instead of discretionary and often delayed without clear qualifying criteria.

2 TAX ADMINISTRATION

Good tax administration requires efficient and fair collection of taxes actually due from those individuals and organisations from whom they are due. Good tax administration not only delivers the revenues due to Government, but it also requires that those from whom the revenues are collected have confidence in the revenue authority and the fairness of the collection. Few individuals and organisations like to pay tax, but the principle of taxation is acceptable if the share of government of incomes accruing to people and businesses is seen to be reasonable and the way in which the taxation rules and regulations are seen to be fair.

The share of tax compliant individuals and businesses' income going to the government has gone up considerably and rapidly over the last few years, inevitably raising concerns about what is a reasonable share of income for the government. This is considered in the next section. However, perhaps of greater concern has been the way in which revenue has been collected.

The MRA has been able to significantly increase the amount of taxes collected over recent years for which it has been praised from some quarters. However, the price of this has been a severe breakdown in the previously relatively good relationships between taxpayer and revenue collector. Whilst MRA does not set the policy, the MRA and its officers have been re-interpreting well established conventions and overturning previously understood consensus positions, such as the treatment of marine insurance and the treatment of estate production for surtax. In effect, policies have been set or at least extended by the wide and often unsupportable interpretations made by the MRA. In addition to this, MRA has considerable powers to impose its interpretations as assessments, through the powers of seizure, fines, not releasing goods etc

A considerable amount of this has been done on an ad hoc basis, often by relatively inexperienced and relatively junior officers, but allowed and sanctioned from above. Much of this appears to have been driven by the incentive and target structure in the MRA, with officers openly disclosing that they have been sent out to collect funds as they "have not met their monthly target". Officers have also focused their collections by targeting those

companies that are predominantly tax compliant. It may seem strange to target the tax compliant, but it needs to be understood that given the complexity of the tax system and the scope for differing interpretations, it is always possible to make an assessment for more revenue. All companies and individuals make mistakes, but whereas these were corrected and any tax due collected, now there appears to be a readiness to resort to the quite punitive fines in place for 'first offences' and relatively minor and one off transgressions. At times it appears as if the fines are being used in some cases as a revenue collection method. Tax compliant businesses are thus being targeted for revenue collection, because they are the most visible and because they are already the main sources of revenue for MRA with information available on them.

2.1 Redirected Compliance Efforts and Stronger Capacity in MRA

The private sector welcomes the recent change in leadership at the MRA and recognises that there are still many competent and fair officials at all levels of the organisation. Our criticism is of the way it was being managed and incentivised to operate, not that it has a legitimate role in ensuring tax compliance. Sensible and fair interpretations are still possible and are made at the more senior levels within the organisation. Far from wanting to undermine MRA, the private sector wants to see MRA working efficiently and fairly. For this, it needs the resources and the capacity to do its job and these need to be provided by GoM.

For example, the sub-contracting of Pre-Shipment Inspection (PSI) to independent companies is essentially due to the lack of internal capacity within MRA. MRA could and should be made ready to take on PSI at the end of the next contract in two years, but unless this is actively built into the approach of the PSI contractor and to MRA's mandate, it will simply not happen (again). Putting it in the contract is an important step as indicated in the recently published request for tenders, but more important is enforcing this by having contractually enforceable conditions backed by sanctions for failure to implement.

The relatively weak investigations unit should also be strengthened, refocused from targeting the predominantly tax compliant to targeting the non-tax compliant and made more independent. If non-tax compliant businesses flourish, then those who are tax compliant are placed at a cost disadvantage in the market place.

MRA will also need considerable political will to ensure that those business people and individuals with connections are also required to pay the same taxes as the rest of the business community. This may even require extra-ordinary measures to ensure the independence and incorruptibility of the investigations and collections units. Fairness in tax administration requires the vast majority of those from whom tax is due to comply not just a select few – that is not happening in Malawi.

Much of the MRA's work should be the every day focus on basic follow-ups and education. It is not difficult to identify activities that should trigger a follow up, such as individuals who receive interest on Treasury Bills but may not have been submitting tax returns. Identifying those who are grossly abusing the surtax system is not difficult, yet the abuses continue unabated. Identifying areas of the economy where there is a culture of non-compliance would also yield considerable revenues relatively easily, such as getting the PAYE compliance of NGOs, Projects and even some Donors when paying national staff. Rather than seeking to squeeze extra from those that are predominantly tax compliant, it would be more efficient, effective and fair to target those that pay little of what is fairly due, without having to resort to ever more contorted re-interpretations of the rules and conventions, as appears to be happening at times.

This redirecting of investigatory work plus basic collection and education of the uninformed non-compliant could yield significant tax revenue, widen the tax base making it possible for

more reasonable levels of taxes and improve the fairness of the system with results within the first 12 months. Our rough estimate, based on common observance of the abuses, is that the MRA is collecting less than two thirds of the revenue due, with much of the unpaid revenue in the places we have suggested.

2.2 Refunds to be Paid within Due Periods

Many tax-compliant businesses are suffering from excessive delays in refunds of tax payments well 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 from six months to a year in most cases and commonly beyond one year. This requires businesses to borrow at high interest rates to 'lend' to government at no interest, with real values being eroded by inflation. Effectively this is a form of compulsory interest free lending.

It is understood that the Ministry of Finance recently increased the monthly allocation for refunds from MK 60 million to MK 100 million, but this has not been sufficient to clear the large backlog. However, it also appears that this inadequate 'budget' for refunds has been underspent despite the many legitimate claims to it. There is urgent need for the MoF and MRA to clarify how much the backlog is, how old these debts are and how much has been spent on refunds so far this year.

The extent of the outstanding refunds needs to be made explicit for the benefit of taxpayers, but also as GoM needs to know its net revenues not just its 'receipts'. Without this information, GoM cannot budget properly. Once the level of liability is established, then Ministry of Finance and MRA need to make and execute a plan for bringing this excess liability down to the levels that ensure GoM compliance with the legislation.

There needs to be more speedy assessment of claims in future to verify the liability and if the claims are not correct then they should be disallowed with the reasons clearly stated. If a claim is correct then it must be paid in the period within which it is due. This may require further strengthening of the MRA to be able to audit claims, but there should also be a greater risk-based selection of which businesses and claims to focus on. Legitimate, tax-compliant firms which generate refunds based on the nature of their business (exporters for example or those investing in capital equipment) should not be treated the same as traders with dubious compliance records.

Proposals on offsetting previously made by the private sector were essentially a function of the failure to give timely refunds. If refunds were made on a timely basis the need and desire for offsetting provisions would be significantly diminished. There is still a case for offsets and for rebalancing the rules on payments to be less unfair to the private sector, which are covered under other sections.

The real solution to this problem is for MRA and MoF to change the system so that, instead of MoF allocating a 'budget' or CCA for refunds, receipts are not remitted as revenue until immediate liabilities for refunds due had been cleared, in full. Some of the consultants for the tax reform process confirmed that such is the practice in most jurisdictions.

Therefore, the private sector requests that:

- The scale of the refunds claimed and the ageing of the claims in aggregate needs to be assessed and regularly published/made public.
- MoF and MRA need to state the period over which they will clear the current accumulated backlog.

- There should be a change in the system so that only net revenues are remitted from MRA to MoF after all immediate outstanding repayments have been made.
- MRA will need to have the capacity to audit and pay refunds within the stated legislative time limits.
- Audits should be on a more risk-based approach with businesses that have a poor compliance record receiving more attention and proper investigation

2.3 Fair System of Tax Adjudication

The confidence of the business community in the tax system depends on the capacity for fair adjudication in tax disputes between the revenue collector and tax payers. No matter how good the tax system is on paper, if it is being applied in a discriminatory, unpredictable or unfair manner, then investors will not be attracted to invest. Investors look as much or even more at the tax administration system than the tax regime on paper. Malawi used to have relatively good relationships between the revenue collection agencies and the business community. However, this has substantially broken down over the last 3-4 years in particular and confidence in the fairness of the tax administration is at a low point. Unless this is addressed, then Malawi is unlikely to see improved levels of domestic and international investment.

Taxation is a complex matter and there are situations that require interpretation as the legislation or regulations cannot cover all situations. This interpretation is done at all levels within MRA, including junior or inexperienced officers. This power of interpretation is very wide and at times, goes beyond the intention of the executive as expressed in legislation and regulations. Inevitably there are different interpretations and whilst these can sometimes be resolved through further investigation and dialogue, the more recent trend has been for businesses to be given assessments, increasingly without even discussion first, but backed with the threat of asset seizure.

In such situations, there is a procedure to appeal to a higher level within MRA, right up to the Commissioners and the Commissioner General. There is also an as yet unused provision for the appointment of special tax commissioners. This tax adjudication process has several obvious flaws.

First and most crucial is that the MRA is effectively investigator, prosecutor and judge in its own cases. This breaks all the basic principles of natural justice and is sufficient basis in its own right to change the system. It is very difficult for any organisation to find that its own officers were incorrect in their assessments compared to the view of an outside party. This has been made worse by the pressures for revenue collection on the MRA and because there are rewards for hitting revenue collection targets. The presumption that the business is wrong will always be the starting point for MRA until proven indisputably to be otherwise.

Secondly, MRA has significant powers of retention, detention and seizure. If it is in dispute with a party it can effectively hold the businesses assets and wait knowing that delays cost money for the tax payer and in most cases will be forced to cut its losses. This tends to be hardest on small and medium businesses, which have limited capacity to challenge such action.

Finally, although businesses can take the matter to court, the exceptionally high cost of the legal system in Malawi, the absence of dedicated commercial courts and the priority given to other types of cases mean that this is only an option for the largest businesses in major disputes. Effectively the vast majority of businesses, particularly small and medium have only the MRA as the adjudicator.

The establishment of the Office of a Tax Ombudsman with the powers of adjudication in tax cases that have exhausted the route of dialogue and negotiation would be one option. This would allow many businesses to access justice at a realistic cost. If this is not possible at this point in time, then there are other options that separate the prosecution of cases from the adjudication, such as the appointment of independent tax commissioners (as allowed for in current legislation), training a small number of Tax Magistrates or the implementation of the commercial courts with a tax adjudication mandate. Private sector is willing to consider any option that separates the powers of assessment from the power of adjudication.

It should not be seen that the independent adjudicator would have a huge caseload. The very fact of having an independent adjudicator would force MRA to improve the quality of its assessments to avoid the risk of lots of lost cases, for which it would bear the main cost and put pressure on private sector not to make frivolous appeals. This better balance between the MRA and the business would provide greater pressure on both parties to negotiate a solution rather than go to adjudication.

The independent adjudicating body 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 provide that there is pressure on both sides to settle early, whereas at present that pressure only falls on the business.

The way in which the tax system is implemented has been one of the biggest complaints of the business community and substantially undermined the legitimate tax-compliant business community. Therefore, transferring the powers of tax adjudication from the MRA, which can no longer be regarded as being a fair adjudicator, 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. Whilst there are important questions about where to house this function, it can no longer be in the MRA if there is to be a re-establishment of confidence in the tax administration system.

It is our belief that this transfer of the adjudication function should be funded out of the share of revenues that accrue to the MRA that it uses to fulfil this function as the transfer would remove one of the tasks that the MRA has to deal with. We also believe that development partners would be willing to assist in such a measure of good governance. A third suggestion on the funding, that came from within MoF, is that this could be funded out of the settlement with the costs being apportioned between the two parties according to how close to the final settlement their two submissions were. This approach will also encourage reasonableness in the competing submissions. This will not add cost to the government.

There may be some concern that this might result in reduced tax revenues. However, there are two strong counter arguments. Firstly, if assessments are incorrect and revenue is not due, then arguing to retain a system that levies incorrect tax assessments is saying that revenue collection should occur irrespective of the merits of the case – that cannot be an acceptable position and only serves to weaken further the confidence in the tax administration. Secondly, and related to the first, if the system is seen by investors to be unfair, then it will be a major factor in deterring investment that could generate revenue in the short, medium and long term. If Malawi is seen to have a fair system of tax administration, then this will in contrast act as a magnet for investors especially given the tax administration weaknesses in other jurisdictions. A fair adjudication mechanism will overcome many concerns about the overall attractiveness of the tax regime, if it is being, and being seen to be, applied fairly. Both businesses and the Government can only gain from this separation.

Therefore, the private sector requests that the Government makes a formal commitment to transfer the adjudication function and powers to another tax adjudication body, to be operational by December 2005, self-funded by the means indicated above.

2.4 Adopting Risk based Approaches

MRA also needs to take a more risk based approach to compliance with the emphasis on getting the larger amounts of revenue due but not collected, rather than seeking to extract incremental amounts from predominantly tax compliant taxpayers.

This risk-based approach is important as the tax system has several taxes that are based on the assumption that all businesses and transactions are suspect. Minimum Turnover Tax is an example of this, as it is self evident that a business cannot make profits every year, especially in a tough operating environment like Malawi. PSI also assumes all transactions are suspect.

The key problem is that MRA capacity is weak and these blanket measures are a substitute for proper auditing and investigation. The operation of such across the board measures also tends to hurt the tax compliant and often does not catch the determined evaders who use corrupt means to evade, thus defeating the purpose of a blanket approach and adding cost to the compliant.

Given limited capacity, resources and people, MRA needs to take a much more risk-based approach to its collection and enforcement efforts as a key principle. Of course a risk-based approach means that some apparently low risk transactions or businesses will pay less tax than they might have done, but the returns for more attention on the higher risk transactions and businesses will more than compensate for this.

3 BUSINESS TAXATION

This section looks at the operation of corporate level taxes.

3.1 Overview on Corporate Tax

The concern for overall revenue neutrality is understood and this makes it very difficult to make the important restructuring of the tax system. However, one idea under consideration is that of having a small temporary increase in Corporation Tax, probably 1% and no more than 2% to offset other changes such as the abolition of dividend tax, the downward harmonisation of Fringe Benefit Tax and a significant reduction in the top rate of personal income tax from 40%, ideally harmonised with the corporate tax rate.

This is an area where the consensus from private sector is not clear. The concern is that a temporary increase in corporation tax would become permanent and the offsetting benefits might be eroded by changes in thresholds or even increases in the rates in subsequent years. Private sector has born the brunt of significant tax increases over recent years and the signal of increasing the most visible corporate tax rate might be perceived wrongly. It should also be noted that generally corporation tax rates in the region, are reducing not increasing. We currently have no firm view on the desirability of this, but would be willing to put specific suggestions to the private sector that are within the means of the government. The only basis on which such an idea would be sellable to the private sector is if there were definite offsetting adjustments in the areas of dividend tax, FBT and the top rate of income tax.

3.2 Minimum Turnover Tax

Minimum turnover tax applies when a tax loss has been determined or the computed tax on income is less than the amount payable as minimum tax. This tax acts as a surrogate for a vigorous audit and investigation that should be triggered by the continued declaration of losses by a taxpayer. It also encourages some businesses to declare turnover at a level equivalent to the minimum tax only.

Our strong feeling is therefore that minimum tax should be removed and penalties for deliberately understating profits should be applied rigorously.

However, if the minimum tax rates are to be retained, “turnover” must be defined to exclude tax-exempt income such as dividends, capital gains on disposal of listed assets, non-trading receipts such as grants and donations. There is also a case for reviewing the bands, as these tend to be weighted in a way that disadvantages smaller companies due to failure to index these adequately.

3.3 Fringe Benefits Tax (FBT)

Through an omission in legislative drafting, an agreed reduction in the rate of fringe benefits tax was never enacted. A fringe benefit is defined as “any provision by or on behalf of the employer to an employee of any asset, service or benefit-in-kind if such provision includes an element of personal benefit to the employee”. Fringe benefits tax is payable at 35% and is assessable on the employer.

There is no justification for charging FBT at rates in excess of the general corporate tax rate of 30% as the tax is paid and assessed on the business. Accordingly, the rate of tax on fringe benefits should be reduced to the corporate tax rate currently applicable as was originally intended.

3.4 Dividend Tax

Our preference would be for Dividend Tax to be abolished as soon as possible, perhaps as part of an offsetting increase in corporate tax. Effectively, this discourages investment and the emergence of larger firms with separate shareholders and managers.

If Dividend Tax remains, then there should be a review of how it operates and as a minimum the rate should be reduced from 10% to 5% and group relief should be introduced with the proviso that this should only be available to businesses where beneficial ownership of not less than 75%, is held by the same shareholders.

3.5 Treatment of Assessed Losses

At present, losses can be carried forward indefinitely. It is being proposed that loss carry-forwards be limited, to a period of no more than seven years, and that at the same time the option carrying back losses to three previous tax years be introduced.

Under this proposal, any assessed loss relating to the prior year that is agreed and is brought forward into the current period would be set off against the taxable profit of the taxpayer until fully relieved, provided that this will not be carried forward from year to year beyond a consecutive period of seven years from the date first established.

The loss carry-back would enable a taxpayer to set off existing tax losses against prior years' taxable profit or against taxable profits relating to a period not exceeding three penultimate years. Any unrelieved losses would be carried forward and available for set off against future taxable profit to the limit described above. It will however be important to exempt investments in mining and plantations such as tea, coffee and timber from the restriction to carry forward losses beyond seven years as such investments have long gestation periods.

There needs to be the introduction of group relief for companies which have an 80% common ownership.

3.6 Definition of Income

It is recommended that the definition of "income" (Section 11 of the Taxation Act) should be reviewed to clearly exclude:

- capital gains, and
- tax-exempt income.

This is an important technical issue.

4 ALLOWABLE DEDUCTIONS TO DETERMINE TAXABLE INCOME

There are many areas where deductions are arguably justified, but this risks adding complexity to the system. We have therefore focused on a narrow range of what seem to be the most important ones.

4.1 General Deduction Formula

All expenses incurred during the year of assessment wholly and exclusively and necessarily in the production of income or for purposes of a taxpayer's trade are deductible from assessable income to determine the taxpayer's taxable income.

It is recommended to insert the word "assessable" immediately before the word "income" at the end of Section 28(1).

4.2 Social Investment and Social Welfare Expenditure

Businesses fill some of the gaps in the provision of social infrastructure and social welfare. This includes houses, boreholes, clinics, schools, roads/maintenance, footbridges, funeral expenses, HIV/AIDS testing and counselling, nurse and teacher salaries and so on.

However, the current treatment of such expenditure is variable and subject to interpretation. In practice, much of the infrastructure spending is not allowable. In a recent case, a major company had its expenditure on their workplace HIV/AIDS programme disallowed and was given an assessment of several hundred million Kwacha thankfully reversed by senior MRA officials.

GoM already has a clear policy on some of these matters, for example, in the National HIV/AIDS Policy, section 3.7 of the Appendix notes that, "tax legislation shall be revised to provide incentives for employers who provide comprehensive HIV/AIDS programmes in their organizations."[4] This has not yet been fully recognised in the tax system or administration.

[4] http://www.unaids.org/html/pub/topics/human-rights/malawi_national_policy_en_pdf.pdf, p. 33.

Given the constrained level of Government budgets and the scale of the problems facing the nation, it would benefit all parties if business expenditure on all social infrastructure and social welfare expenditure which benefited employees and communities were more explicitly recognised as allowable for tax purposes and even encouraged with additional incentives in some areas. Essentially GoM would see more infrastructure and social welfare at only 30% of its actual cost, assuming an unchanged corporate tax rate. That has to be a good deal for this country and should be implemented as soon as affordable. Such a public-private partnership approach has proved beneficial in some countries such as Brazil.

4.3 Pension Fund Contributions, Life Insurance Premiums and Annuities

Pension funds provide one of the few sources of investment capital in this country. The Government's National Economic Empowerment Policy notes that Malawians tend not to save and invest in the domestic economy. One reason for this is the unfavourable tax treatment of savings. We would therefore recommend changes to encourage saving, including by increasing the tax free threshold on contributions to pension funds.

Currently, there is a tax exemption for the first K3,000 per annum contributed to an approved pension fund. This allowance has become derisory due to inflation, and fails to encourage a savings mindset or to provide funds for re-investment by pension providers. The same is true of employee and employer contributions to approved pension funds. All of these allowances have simply been eroded by failure to index at the rate of inflation and have undermined what were accepted and laudable goals of the tax system.

Life insurance premiums to an approved insurance company should be allowed as a deduction up to a defined limit.

Section 40 (Taxation Act) allows a deduction of an annuity, allowance or pension paid during the year of assessment:

- to a former employee, on the grounds of ill-health, infirmity or old age; or
- to any person who is/was dependent for his maintenance upon the former employee…provided that the amount allowed shall not exceed in respect of dependent persons the sum of K1,200

These allowances are important for encouraging savings and provision of welfare to employees. Every time they are not up rated at the rate of inflation, they become more and more eroded. Therefore, these allowances should be up rated annually at least in line with inflation and as soon as GoM revenues permit, they should be increased at above the inflation rate to recover the lost ground over recent years. At the current levels they have become meaningless in practical terms.

5 CAPITAL ALLOWANCES/DEPRECIATION

Investment in fixed capital is the basis for growing the supply side of the economy which has been severely lagging in Malawi. Even the manufacturing sector, which has more favourable treatment has been declining steady from 17.0% of GDP in 1994 to 11.5% 2002 with the decline continuing, as evidenced in high profile closures over the last 3-4 years.

A major problem in Malawi has been the treatment of capital investment for taxation. Due to relatively high inflation over the recent past, the relatively long depreciation periods for many

capital items, predominant use of declining balance and significant exclusions, then the heavily capital intensive industries have been significantly penalised in this economy. All of these factors mean that a business does not ultimately get anything near to the cost of its original investment allowed for taxation purposes.

The main contributing factor to the poor performance of manufacturing, or other businesses with heavy capital investment, in this country, is the unfavourable treatment for tax purposes of capital investment. Investment is the bedrock of any economy and the basis on which revenue streams for businesses and therefore government are created. More realistic treatment of capital would encourage and reward those willing to invest in a difficult operating environment for businesses, particularly but not just manufacturing and processing. Without this, Malawi will continue to shift towards a trading economy where fixed capital investment is minimum and it is easier to evade taxation.

The private sector would like to advocate for a tax regime with more favourable capital allowances that would spur economic growth in the country. The Private Sector would be willing to see the abolition of certain discretionary investment incentive allowances **if** the saving on these were consolidated into more favourable capital allowances that were available to all. Discretionary allowances tend to favour the larger and foreign investors who have the interest and the resources to pursue them. Capital allowances are more accessible to all businesses, more automatic and cheaper to administer for businesses and government.

Allowances are also favoured as they are universal and do not require inefficient, time-consuming and unpredictable discretionary process of application and granting. This makes them more likely to benefit small and medium businesses who either do not know how to apply for special incentives or do not have the capacity to do so. Receipt of the allowances also occurs after the investment has been made and audited accounts presented, further encouraging compliance.

5.1 Exclusion of Commercial (non-manufacturing related) Buildings

Currently, commercial premises do not give rise to capital allowances for tax purposes. This is ***very unusual*** internationally and constrains the development of all types of commercial property investment and improvements. At present, the only buildings/premises that qualify for capital allowances are those directly used for manufacturing or for warehousing manufacturing-related products. Even investment in offices or other non-manufacturing related premises for a manufacturing businesses would not qualify.

This exclusion has no economic logic. Businesses' investment in their commercial premises that is shown to be necessary to doing business, and thereby creating revenue for GoM as well as the business, should qualify for capital and other related allowances. The low level of building activity in Malawi is evident compared to many other developing countries, much of which can be attributed to the treatment of investment in commercial premises.

The absence of this basic treatment of buildings for capital allowances may also partly explain the poor state of repair of many of our commercial premises. In addition, it is not possible to reclaim surtax on building materials used for non-manufacturing related premises. Encouraging investment in premises would stimulate economic activity, particularly as construction is relatively labour intensive.

Paragraph 8(3) - Second Schedule as read in support of Section 33 must be amended to include "buildings used for commercial purposes" as assets qualifying for capital allowances.

The exclusions from what can qualify for capital allowances need to be reviewed more generally.

5.2 Greater Use of Straight-Line Depreciation and More Realistic Periods, especially on Information Technology

Whilst some items of capital investment are treated on a straight-line basis for taxation purposes, most are still based on the much less favourable reducing balance basis. The latter significantly reduces the taxation benefit, particularly on capital items depreciated over more than three years.

The periods over which these allowances can be claimed are also overly long relative to the economic and even physical life of many of the capital items.

This is exemplified by the treatment of Information Technology. The removal in the past of duty on imported equipment (virtually all IT equipment is imported) was very welcome, but if Malawi is to be competitive, it must ensure that businesses are regularly updating their equipment and are able to claim sensible capital allowances. At present, IT hardware is depreciated at a rate of 20% per annum on a reducing balance basis over five years. This assumes that businesses replace their computers and related equipment only once in five years, which is patently not correct and nor should they be encouraged to hang onto increasingly obsolete equipment by the taxation system.

Instead, we recommend that computers and related equipment should be allowed for taxation at a straight-line rate of 33.33% to encourage businesses to reinvest in their equipment rather than waiting for obsolescence or failing to reclaim the full taxation credit for their investment.

The cost of software that is purchased and used in the business for processing data should also be treated as wholly tax deductible with the proviso that where the cost is significant (a threshold to be set), it should be capitalised and written off over the period of the licence or usage, whichever is preferred.

5.3 Treatment of Investment Allowances

Investment allowances are currently provided and deducted from the cost of the asset to arrive at the tax written down value on which subsequent claims of annual allowances is based. It is recommended that the investment allowance should be granted as an outright incentive, that is, not as a deduction from the capital cost of the asset.

More favourable investment allowance rates would encourage investment in revenue generating fixed assets. Businesses do not invest if there is no income stream associated with the investment and this would improve the revenues for businesses and government if a more generous set of allowances were in place.

6 CAPITAL GAINS TAX (CGT)

Taxing capital gains in a manner and at a rate similar to trading or employment income is inappropriate, as this acts as a disincentive to investment in a country that badly needs such investment. Accordingly, it is recommended that if it is intended to continue charging tax on capital gains, it should be taxable under a separate tax heading or subsection, instead of being incorporated in Section 11. All provisions relating to the taxation of capital gains should be consolidated into one part of the Act if not in a separate Act all together.

The failure to publish an inflation factors index for the purpose of preventing the value of an investment being effectively taxed has made the operation of CGT extremely unfair to the investor. Essentially they are being taxed on the inflationary gains not the capital gains. This was not the intention of the tax and it should not become this by lack of appropriate action by the MRA to publish a simple index annually.

Whilst failing to index might be seen as a means to increasing revenue, it is a very short term view as it is already deterring investments and is also encouraging tax avoidance/ evasion activities. The rate of CGT at 30% is too high to encourage compliance, with no threshold allowances, is also penal for a tax on investment and high relative to our neighbours and internationally where 15% is more normal.

Further, on the way the CGT is currently operating, we would question how much revenue is raised by CGT as it currently stands. Therefore, there needs to be considerable reform for CGT to operate fairly and effectively. Our recommendations are as follows:

6.1 Tax rate

A separate tax rate for determining tax on capital gains must be introduced. In countries within the Southern African region, capital gains are generally taxable at a rate not exceeding 15%, instead of 30% on companies or as high as 40% on individuals. It is also well known that high rates discourage compliance. This is why CGT needs to be taken out of Section 11 and a more appropriate rate, not exceeding 15% introduced.

6.2 Inflation factors/Indexation

Inflation use rates were last provided by the Commissioner of Taxes in a Government Gazette Notice No 67 dated December 31, 1998, and became effective January 1, 1999. It has thus been more than five years since inflation rates have been reviewed in a period that has been characterised by high inflation rates. As a result, CGT has become very unfair in its operation deterring investors from new investments and leading to considerable tax avoidance and evasion.

Therefore there is an urgent need to publish indices for the intervening period for both equity and revenue raising reasons.

The responsibility for reviewing should be vested in the hands of independent assessors in order to ensure impartiality, reasonableness and commitment to publish every year. The best organisation would be the Reserve Bank of Malawi with publication within a statutorily defined time of the period to which it relates.

6.3 Rollover relief

Rollover relief is a means by which liability to capital gains tax is deferred to reflect that investors may change the particular assets in which they are investing. The essential feature of roll-over relief is that a gain which would otherwise have arisen on the occurrence of a taxable event for capital gains tax purposes is deferred, or rolled over, until there is a subsequent disposal of the final asset concerned.

A provision for rollover relief should be incorporated setting out specific requirements in order to qualify for tax relief.

Guidelines necessary for conversion of one asset to another should be put in place to ensure that proceeds of disposal of the first property that are intended to be reinvested in the second property should be treated as tax exempt.

7 WITHHOLDING TAXES (WHT)

Withholding taxes are taken as an advance against the final income or corporate tax liability of the individual or corporate entity. They account for a major proportion of revenue received by the MRA, but cannot be treated as net revenue until the extent of any overpayment has been taken account of.

Rates appear to be set on the assumption that the individuals or even the businesses will not ultimately submit a tax return or account for the final tax due. For a tax compliant business, the rate of 20%, which is the most common rate, assumes that the business will earn a net profit before tax of 66.66%. The rate appears to have been set as if it were an equivalent of income tax levied on a self-employed person, for which this would be a partial payment of the net income tax due.

However, for a tax compliant business, this is far too high a rate and significantly impacts on cashflow to the benefit of government and at the expense of the business.

Of course there is considerable tax evasion, particularly by self-employed individuals, from day labourers to consultants. However, applying withholding tax as if all individuals and businesses were cheating is damaging to tax compliant businesses. In addition to the high rates that impact on cashflow, the problem of refunds and overpayments also arises again. Effectively, many businesses that have withholding tax deducted at 20% find that they are in a tax credit position at the end of the year, but are unable to get it repaid by the MRA thereby increasing their overall effective tax rates.

The problem depends on the nature of the business, but has been a considerable problem for both professional services income and agricultural income where the rates applied are punitive. Collection of withholding taxes on casual/contracted labour, smallholder crops and many other transactions has also become punitive and unfair due to the failure to index these thresholds. The use of individual transactions as the basis for deducting withholding tax led to the situation where smallholders were not even getting the benefit of the low tax-free threshold, as they were being deducted on every transaction. The MRA and MoF have rightly responded to this by in practice allowing administrative arrangements to exempt the first MK 36,000 of income equivalent to the current tax free allowance. However there are still many situations were the deduction of withholding tax is unfair and hits the poor hard. In particular, the failure to index the thresholds has led to more and more transactions to be caught by withholding tax.

The failure to index has resulted in huge inefficiencies in the system that add considerable cost to businesses and to the MRA. It was interesting that the MRA were also happy to exempt smallholder crop transactions up to MK 36,000 as this was resulting in a lot of paperwork for small amounts of tax and also leading to farmers presenting themselves at MRA offices to claim refunds (particularly the small tobacco farmers).

An example will illustrate this inefficiency. If a business pays a contractor MK 500 then it has to deduct 20% WHT of MK 100 – this could be 4% WHT in the case of an electrical contractor, representing MK 20. For this a certificate has to be produced, record kept and certificate and payment rendered to MRA. MRA then has to record, pay in and allocate the WHT to the correct taxpayer account. The cost to each of the business, the contractor and

the MRA must exceed the amount of revenue remitted. If businesses incur more costs to administer this system, then government will also see reduced corporate tax revenue, so it loses twice!!

It should also be noted that the range of transactions for which withholding tax is due are many and subject to considerable interpretation. This is an area where it is very easy to make a mistake, yet the punishments for errors are significant and increasingly being applied to genuine 'first' mistakes or differences of interpretation. If the MRA wants to find fault with even a predominantly tax compliant business, then WHT is an easy area to do this in.

It would also be beneficial for withholding taxes to be more restricted on all agricultural crops to encourage production and to encourage the development of the majority rural population. This would also contribute to food security, which has been a persistent drag on the overall economy and Government budget.

Administratively, it is difficult to apply withholding tax on bank interest income and tends to fall on small savers who cannot adjust their affairs to avoid it. Therefore, it should be eliminated as soon as affordable and for the sake of consistency and fairness withholding tax should also be eliminated on government securities.

What has saved many businesses for now has been the poor level of compliance with withholding taxes and the poor follow up by MRA in most cases. If MRA were more active in this area it could increase cash revenues considerably though it would also create significant net liabilities due to the high rates and low thresholds. WHT certificates also provide a very good basis for following up on self-employed individuals and businesses to determine if they are making correct tax declarations at the end of each year.

There is a significant and pressing need to:

1. Verify how much of the revenue that MRA and MoF receive in Withholding Tax is net revenue and not just a cashflow advance that will need to be repaid and to make provision for this repayment.
2. Simplify the application of withholding taxes and reduce the categories to which it applies
3. Significantly increase the thresholds to reflect past under-indexation and index these automatically from now on
4. Provide for the wider availability of withholding tax exemption certificates (WHTECs) for those businesses that are remitting provisional and corporate taxes, PAYE and submitting accounts within the required time limits.
5. Ensure that repayments are made once verified accounts have been submitted and examined within an acceptable period by MRA
6. Incorporate the annual tax-free allowance threshold for smallholder crops to formalise the arrangement already being operated

8 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, net of quarterly payments already made, or face significant penalties for under payment. Whilst there are complementary issues of cashflow and realisation of profits, it is simply not realistic to expect businesses to be able to calculate their tax bill so soon after the year-end.

The impact is particularly unfair on small and medium businesses as very few 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 a 10% margin of error. 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 provisional 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 six months of the year-end. Many businesses simply incur fines.

Therefore, the private sector requests that 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).

In addition, the final provisional tax payment of 90% of the liabilities is made within 60 days of the year-end, not 14 days, with the same penalties as at present. This would be the simplest method to redress the balance.

This is not about reducing the overall liability for corporation tax, paid provisionally, rather it is for operating realistic timescales for payment of the provisional tax part of a business' tax liability in a manner that encourages compliance and accuracy. In this respect it is revenue neutral though deferring some of the revenue would result in an additional cashflow cost for GoM, which is not unreasonable given that the burden of cost mostly falls on the businesses.

9 PERSONAL TAXATION

There are two main problems with personal taxation – first of all the failure to index allowances and thresholds. Secondly, the marginal rate of personal tax is too high to encourage compliance and is too punitive for the individuals, especially given the extension of surtax on most products and services, dulling the incentive to declare earnings and to seek incremental earnings.

Once again, there has been a problem of indexation. Failure to index by its nature is a revenue raising measure, albeit less obviously so to the public than raising tax rates. The failure to index for the last two budgets and the progressive erosion of many thresholds, has increased effective tax rates on income meaning more income is subject to tax and at higher marginal rates.

A taxpayer will become liable to tax when his or her annual income exceeds around $320 per annum (which will be even less when the currency is devalued/depreciates further). The Millennium Development Goals define an international poverty line of $1 per person per day, that is $365 p.a. Therefore Malawi is taxing its people who are below the poverty line without even accounting for the fact that one wage earner has several dependents who depend on this income as well.

Previously we suggested that the tax free threshold, currently at MK 36,000 p.a., should be increased to K240,000 per annum. This suggestion took into account that the average wage earner in formal employment probably supports about five other people. Whilst that is a poverty focused goal and reflects the current level in some countries, such as Zimbabwe, we realise this is not attainable in the immediate future.

Therefore we would recommend that the threshold at which income tax becomes payable for the lowest paid workers is raised immediately to at least MK 72,000 and that it is indexed at least at the rate of inflation in subsequent years with further increases in the thresholds when these can be afforded. Although this increase looks considerable, the failure to index properly in the past has increased effective taxes on the lowest paid and this is not fair given the levels of poverty in this country. It would also encourage more employment of workers and reduce administration costs, particularly for businesses with many lower paid workers.

The actual tax take for government from this category is likely to be relatively low, given that the tax rate at this level is low, but the benefit to a person on less than $2/day would be high.

We have already made suggestions about the possibility of harmonising the top rate of tax with the corporate tax rate. This makes sense especially for self-employed business people. But it also ensures that the relatively high marginal tax rate does not act as a disincentive to both compliance and incremental earning. It may not be possible to reduce the rate significantly in the coming budget but perhaps the first step could be taken towards a harmonised rate with a more realistic threshold (which has also not been indexed for the last two years). The imposition of the 40% rate and the wider application of surtax has meant that government has taken an increasing share of higher incomes, hitting the tax compliant individual very hard.

Whilst there would be some loses of revenue implicit in the above, there may be some compensating increased declaration of income and more marginal earnings. MRA should also be encouraged to ensure that PAYE is applied amongst NGOs, Projects and Donor Agencies who are not operating PAYE correctly for their national employees. This is done in several ways such as paying via allowances which these organisations claim are not taxable (when in fact they are) or paying employees gross and letting them declare the earnings at the end of the year as self-employed contractors or simply fail to deduct and remit. This is common with many misconceptions about PAYE and allowances in the NGO/Project/Donor sector.

It should also be noted that many of these organisations are also failing to operate surtax, withholding taxes and other elements of taxation correctly. As the NGO sector represents a considerable portion of the economy, the revenue potential is considerable for relatively limited tax payer education and compliance efforts by MRA.

Applying PAYE more rigorously to the non-compliant private sector would also help level the competitive playing field as well as increase revenues. Failure to account for employee taxes correctly, creates an employment-cost advantage for the non-private sector over the private sector when competing to attract employees to the private sector.

There is also a case for MRA to start conducting serious investigations in the tax affairs of individuals who show signs of prosperity but without clear sources of income.

10 INVESTMENT INCENTIVES

There are a number of investment incentives available pursuant to the Investment Promotion Act and the Export Processing Zone Acts. In addition, the Minister for Finance has the discretion to exempt any person or business from any tax or other payment under the Public Finance Management Act.

Incentives are one way in which government can ameliorate the overall unattractiveness of the Malawi tax system to investors. However, in practice these have tended to act in favour of larger and/or foreign investors. Many of these also find it very difficult to get the incentives that are available on paper due to the slowness of the process. Many domestic firms have failed to appreciate that incentives are available and if they have, then they have failed to secure them either because the process has been too long or too demanding on resources. In addition, much of the economy is excluded from the operation of these allowances, particularly the traditional agro-processing industries. The incentives also failed to attract significant inward investment with around $50m a year attracted compared to South Africa which attracted over $5.8 billion in the last year (over 1,00 times more).

Most incentives are still at the discretion of the Minister of Finance, who has to review and sign these off. Even in a relatively small economy like Malawi, this is no longer appropriate for many reasons. First of all it adds another task to what must be one of the busiest roles in government. Secondly, the Minister of Finance has more important tasks to manage, particularly the overall management of the economy, and approving incentives acts as a distraction. Thirdly, where there is discretion there will always be suspicions, whether reasonable or not, that there is favouritism to one or other firm that either has connections or strong lobbying capacity. Fourthly, as soon as a firm gets an incentive, it creates an uneven playing field in that sector, again opening the Minister to criticism.

Discretionary incentives are also inefficient as they require special effort and costs for the business to pursue, and cost money and time for MRA and MoF to administer.

Whilst there is a pressing and strong need to make Malawi a more attractive place for investors, investment incentives are not very efficient, fair or particularly effective at doing this. If there were a shift from discretionary incentives to improved capital allowances available to all businesses through their accounts, then this would be generally welcomed. The exact nature of which incentives go would need to be discussed and for those who already have the incentives or are already in the pipeline, then these would have to be given a reasonable opportunity to be completed.

However, it there is not to be a shift then the following improvements to the operation of the allowances should be considered.

10.1 Export Processing Zones

Export Processing Zones (EPZs) are generally viewed by the business community as an imperfect vehicle for investment incentives, for a variety of reasons. Currently, under section 8 of the Act, the Minister may declare a factory or area of land to be an EPZ. There is an EPZ Appraisal Committee defined by the Act, which acts in an advisory capacity to the Minister. In light of delays in receiving Ministerial approval, it is recommended that the Committee itself have the final say in designating EPZs.

The EPZ Act provides for import duty relief, but this has come into conflict with the old Surtax Act which does not allow domestic businesses to sell to EPZ businesses at a zero rate of surtax. The result of this is that EPZ businesses are now paying surtax on domestic purchases and claiming refunds from the MRA. This situation was never envisaged in the EPZ Act and needs to be remedied so that these EPZ companies can be buying domestically without having to pay and reclaim surtax. In practice, this means that there is often a considerable waiting period to receive refunds. We suggest that the Surtax Act be amended to allow for sales to EPZ businesses to be made at a zero rate of surtax.

10.2 Public Finance Management Act

The power available to the Minister of Finance to provide an exemption to any taxpayer for any purpose gives rise to much suspicion on the part of current and would-be investors about the fiscal regimes that domestic competitors are in fact facing.

This problem could easily be overcome if the Act were amended, so that the Minster could only exercise his power by notice in the Malawi Gazette. In this way, transparency would be introduced into what has been a murky area.

It is also noted that the continued demands on Ministers time for assessing such matters is an inappropriate demand on busy Ministers, particularly in the case of the Minister of Finance.

If there is to be retention of such powers, it needs to be delegated to an appropriate body that will make a decision based on clear and transparent criteria.

10.3 Publication of Investment Incentive Criteria

If discretionary incentives are retained and not incorporated into automatic allowances, then there needs to be clear qualifying criteria, a faster decision making process and greater transparency.

One of the ten issues presented to government by the private sector is that investment incentives need to have clear qualifying criteria that are published and that Ministerial discretion needs to be removed, with the investment committee making decisions against the published criteria. MoF promised to publish the criteria but has not done so yet. This needs to be done urgently for those incentives that remain.

Decisions of the committee need to be published and strict timescales operated to. Most international investors will not be prepared to wait over a year, as is common now, to get a decision, which often comes after the investor has either taken the risk and invested or given up. Whilst this may not be a deliberate policy to make the incentives difficult to get, it has the same effect and makes the incentives very uncertain, something that investors dislike strongly.

11 Importation Duties and PSI

Import duties are currently a major source of revenue for government. It is however a fact that Malawi has over the years progressively moved towards a more liberalised duty system and will be required to move even further towards zero duties under its various trade commitments and reduce its reliance on import duties as source of revenue.

Pre-Shipment Inspection (PSI) is widely disliked because of the considerable costs and delays that it adds to imports and exports. Whilst the PSI implementing companies like to claim considerable amounts of revenue from operating PSI which bear more detailed inspection of their claims, there are major costs to the economy that have to be offset against these claims.

It is however recognised that MRA is ill equipped at present to move away from this, even though Malawi has formally committed to its abolition through signing up to the World Custom Union. In essence our suggestions are limited in scope to improve the systems and reduce its cost for legitimate businesses and for government, both of which are paying a high price for PSI. There should also be a firm contractual commitment against which payment is dependent to build capacity in the MRA to deliver risk based PSI at the end of the forthcoming contract. These measures are discussed below:

11.1 Importation of Capital goods and spare parts

In principle, many capital goods that represent the basic items for capital expenditure are exempt from duty or subject to duty of 5%. However, there are four 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 routine maintenance and replacement. Secondly, although capital goods to manufacture 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. This represents a serious impediment to doing business and should be granted automatically for qualifying imports.

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. Fourthly, the meaning of capital goods could be sensibly extended under Section 84, to cover other elements of an installation. At present, not all capital goods regarded as such by businesses are included. The section needs re-looking at.

The 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 small/medium businesses making small investments who either feel that it is not worth the cost of pursuing the refunds or are not aware how to reclaim. In addition, these taxes particularly 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 duty on agreed categories of spare parts for productive revenue generating investments is reduced to zero (It is understood 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).
- That surtax on capital equipment and spare parts in certain agreed categories is removed to avoid the cost of administration for government and producer.
- All certified industrial capital goods must be imported duty free or with 5% duty without the investor having to apply for remission.
- The contents of what qualifies under the relevant sections as capital goods should be extended

11.2 Pre-shipment inspection of goods

As indicated PSI is important for revenue collection for government, but is not being implemented in a satisfactory manner making it overly costly and a drag on efficient trade in an out of the country.

The extra costs for businesses are considerable and occur through delays (demurrage, interest, management time etc.) and knock on effects on production and ultimately sales and profits are very hard to quantify, but there are frequent and justifiable complaints from businesses. The fees earned by the PSI company are then externalised, leading to a loss of a considerable amount of forex. The cost of PSI at 0.9% of the value of the imports is very high and adds to the cost of goods in the economy, as does the related cost of 1.6% for MBS to assess the quality of the goods. The latter is often done alongside the more stringent checks of the larger companies that know their products better and have the right facilities for checking the goods. After all they have the greatest interest in getting the right quality and quantity of goods.

Pre-shipment inspection is based on an assumption that importers undervalue dutiable imports to evade duty that is due. Some importers do deliberately undervalue imports and these should be caught and prosecuted as appropriate. This is a particular problem in the trading sector and should be particularly monitored, ideally by MRA but if not then contracted to a specialist agency.

PSI is applied on all shipments over $2,000, yet the risks of compliance are greater in some areas than others, with trading businesses and goods being the most risky. PSI is being implemented indiscriminately including on the importation of duty free goods (machinery and

raw materials), adding cost and no value. A more risk based approach is offered by PSI companies which they claim can be tailored to the needs of each government. We would strongly suggest that GoM seeks a risk-based approach (which is becoming more common in developing countries) that focuses on a more limited set of transactions from at risk sectors, such as trading in consumable goods (still a major part of Malawi's imports) with spot checks on businesses and sectors that have good compliance records. This would reduce the negative impacts experienced by many manufacturing and processing businesses as well as enable more focus of time and effort on those transactions that are more likely to have been undervalued.

MRA currently takes the higher of the invoiced amount or the PSI valuation. This is an inconsistent and unfair practice. A fairer application of PSI would be to take the PSI value even if this were lower than the declared value, assuming that MRA/GoM would not accept the declared value.

It should be born in mind that the World Trade Organisation has given countries that still operate PSI up to 2008 to build capacity and eliminate the practice. This is the right time for GoM to build capacity within MRA by engaging an independent firm to train MRA staff to complement what the current PSI service provider may be obliged to do. It may not be prudent to rely solely on the current service provider as it may be in their interest to see that MRA takes time to build that capacity.

12 SURTAX / VAT

There are many concerns about the operation of Surtax (soon to be VAT). Whilst this is an important revenue raising measure, the promised review of the operation of surtax has never materialised with only a limited set of proposals coming from government on which private sector was consulted. A much broader and comprehensive review is required to make it work.

It should also be noted that compliance is very poor and, due to this and the high rate of surtax, compliant businesses are at a significant cost disadvantage in the marketplace against firms that sell with or without surtax. There are even traders who boast in private that they are declaring only 10-20% of their turnover for surtax and corporate tax purposes, suggesting considerable revenues could be yielded from this sector.

This dual pricing approach is rampant and it is a mystery why the MRA officers seem unable to prosecute the many offenders in the trading sector. This ought to be the focus of education and compliance efforts and the latter ought to be able to increase revenues very quickly. There is considerable regional and international experience on how to improve collections in such non-compliant sectors and Malawi should make use of that experience. It might be helpful to consider more independent tax collection methods targeting these sectors.

GoM should announce a full review of surtax as there are many aspects that need revision. A few limited suggestions are made which will not significantly impact on revenues.

12.1 Small businesses

The current threshold of K2 million would seem to require many small businesses, who are unlikely to be significant taxpayers, to register for surtax. Complying with surtax collection is a significant administrative burden for small businesses. At K2 million, any business selling more than K166,666.66 of goods per month would have to register. We suggest that the

threshold for registration for surtax should be progressively increased through over-indexing compared to the rate of inflation.

In addition, some small businesses with good compliance records should also be allowed to calculate their surtax liability on a cash, rather than on an accruals, basis. This would recognize the cash flow problems that non-payment of liabilities poses in Malawi. This would also avoid the risks that can be associated with the cash basis if operated by larger businesses.

12.2 Transportation and Primary Producers

In order to reduce operating costs of transportation which is one of the highest rates in the world, it is recommended that domestic transport should be zero-rated to equalise the position with international transport services. The impact on the transport industry also needs to be considered as they need to be able to reclaim surtax on their inputs, otherwise this will compound the problem of already high transportation costs.

Primary producers should be zero-rated and not exempted.

12.3 Real Estate/Property

We concur with the authors of a World Bank paper on taxation who note that:

- "The common practice is that residential buildings and rent are exempted, but office buildings are fully taxed. Exempting residential building and residential rent is commonly practiced on the basis of both technical and equity grounds. Technically, it is hard to impute rent values for owner occupation: extensive information and subjective valuation are required. But, if residential building is VAT-exempt, residential rent also needs to be exempted to eliminate any discrimination against renting and in favour of owner occupation. The treatment of real estate sales is non-uniform across countries with a VAT, even within the EU. (Table 1, due to Conrad (1990), shows the practice in selected countries in the European Community.) Generally, resale of residential housing is VAT-exempt."[5]

We would also propose that surtax not be chargeable on the resale of property, which is very unusual and unfair. This recent introduction is likely to have a considerable impact on property values and sales.

12.4 Payment dates

We note in the 2004/05 budget speech that there was an intention to change the surtax payment date from the 30th to the 25th of the month. We understand that this is seeking to ensure that payments are made before the last day of all months even though in most months this could be up to five days before the month end. Some businesses remit their surtax on the first working day after the month end and claim they could not remit it at the weekend or on a public holiday. Rather than put an even greater cash flow burden on the private sector by requiring the 25th (and presumably even the 23rd if the 25th is a Sunday), the simple solution would be to require payment "on the last working day of the month in which it is due". This would seem to be the fairest solution and therefore late payment after the month end would be penalised in the normal way.

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[5] http://www1.worldbank.org/publicsector/tax/PracticalIssues/papers/Value%20added%20taxation/Value%20Added%20Taxation.doc, p. 32

12.5 Allowance for bad debts and Deadline for Appeals

Bad debts that are proven to be irrecoverable should be allowed, within a realistic period of, say, one year, not the three years as proposed by others. The latter would mean that the inflation loss in value of the surtax and the cashflow financing cost would be huge. If a debt is not paid within a year, then the chances of recovery are very slim. If it is recovered then the requirement would be on the business to remit the surtax in the month following.

Registrants should be allowed to lodge an appeal in respect of errors within six years rather than six months, which is far too short.

12.6 Irrecoverable inputs need reviewing

Not all legitimate business expenditure by surtax registered businesses gives rise to input tax credits. Irrecoverable inputs currently include hotel accommodation, repairs to non commercial vehicles (pick-ups, vans), costs of security and so on. The list is long and unreasonable. There is an urgent need to have this reviewed, as was promised at the time of introduction.

It is recommended that business costs of this and similar nature that are incurred in the production and sale of taxable goods and services should be eligible for surtax relief. A proper review of the list of excluded items is required and these should be properly gazetted.

12.7 Taxpayers in regular credit situations

A few companies in Malawi export almost all of their production. They are thus regularly in credit with the MRA with regard to surtax. The very high cost of finance, with high interest rates and considerable delays in refunds commonly extending over 12 months make these credits a significant charge on the profitability of these companies that are the main providers of Malawi's growth prospects, revenue and forex earnings.

Many countries have special programmes to deal with refunds to exporters. Clearly, these must be carefully designed to prevent fraud and abuse. We would suggest that such a programme be implemented, available to those companies with an excellent record of tax compliance. Audits could be made to records and purchases periodically to allow the MRA to satisfy itself that all claimed credits are legitimate and penalties applied for non-compliance.

12.8 Equal treatment

A number of anomalies arise from importation of intermediate and finished goods, in ways that disadvantage local manufacturers of similar goods. The importation of wheat flour is a good example, where local production is subject to surtax whilst imported flour is not. This encourages imports and discourages local manufacturing and has resulted in the severe restriction of production compared say to Zambia, where wheat milling is thriving. There are many other anomalies, such as baby food which can be imported surtax free but local manufacturing is subject to surtax.

GoM needs to take a positive view to at least not disadvantage local manufacturers. Where intermediate or finished goods are imported there is a need to ensure that any surtax or duty exemptions do not disadvantage similar products produced in Malawi. A general review and call for specific examples is required.

13 ESTATE DUTY

Like CGT, another non-performing tax is Estate Duty payable on the value of the estate that transfers on the death of the person. The limit is so low that many Malawians could find their estates subject to it, so it seems it is not to being implemented, perhaps due to the recognition that it would be both costly to cover all estates and because it would be grossly unfair. It would be far better to set a more realistic limit and then focus collection on the limited number of estates that exceed this amount. With any new tax like this (new in the sense of being implemented), then it makes sense to apply it at a relatively low rate to get it established, especially as much of the value of the estate may have come from taxed income over the lifetime of the person.

Estate Duty is a significant potential revenue enhancing area. However in order for it to achieve the intended purpose it has to come within the jurisdiction of MRA and operated as suggested above.

14 REVENUE ENHANCING MEASURES

We have some additional specific suggestions that would raise revenues.

Just as inflation coupled with a general failure to index allowances and thresholds has increased revenues, the failure to index a range of user fees and charges has resulted in lost revenues and in some cases meaningless charges. We give some examples below:

Charges for services can be reviewed upwards to realistic levels as follows:

- business registration fees for non-corporate establishments (brief-case businesses) could be increased from K200 to K5,000 and indexed thereafter;
- filing fees of statutory documents with the Registrar General, could be increased from K10 to K500 per document;
- search fees at the Registrar General could be increased from K10 to K500 per document (It is understood that Department of Lands charge K500); and
- road licence fees for private motor vehicles could be increased with inflation but with more generous consideration given to the cost of commercial vehicles due to the particularly high cost of transport in Malawi.

15 CONCLUSION

This paper has raised a number of issues that require the intervention of government and/or the Malawi Revenue Authority. The aim has been to bring to light those tax related issues that are hindering private sector growth and suggest ways of dealing with them. The paper has tried to suggest solutions that are to a greater extent revenue neutral and those that though appear to reduce revenue in the short term are revenue enhancing in the medium to long term.

There is a unique opportunity this time round for the government to completely revamp the whole tax system to make it simpler to operate and at the same time ensure that private sector investment is encouraged whilst ensuring that government revenue is enhanced in the medium to the long term. It is hoped that this opportunity will not be missed.