LESSONS FROM MALAWI'S EXPERIENCE ATTEMPTING TO REFORM THE BUSINESS ENVIRONMENT

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Executive summary

Malawi is a least developed country and one of the poorest countries in Africa. A major determinant of low incomes is an underdeveloped private sector, weakened by years of underinvestment. Historically, the Malawi Government has tended to attached little importance to the role of the private sector as a driver of economic growth, firstly in the post-independence years preferring a state-led development policy with only limited legal space for the private sector. Then in the years following democratisation, the emphasis of national development policy was much more inclined towards the social sectors.

Since 2004, the government has made increased efforts to reform the investment climate and stimulate private sector driven economic growth as a means of raising incomes and reducing poverty. Early results have been promising, particularly in stabilising the macro-economy, reducing inflation and interest rates. Reforms are now increasingly focusing on institutional development and so-called “second generation” reforms that aim to improve the business enabling environment, as measured by the World Bank’s Doing Business indicators. Highlights include the establishment of a dedicated Commercial Division in the High Court, as well as the rationalisation of business licenses and the introduction of a risk based customs administration system.

However despite progress, the consensus for reform is not yet sufficiently deep and broad across the public sector and in a number of areas short term policy interventions do not always match the rhetoric. Bureaucratic resistance has slowed implementation of key reforms and government is often reluctant to place sufficient faith in private sector delivery of key products and services such as maize and fertilizer where success or failure has major political ramifications.

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1. Background to the private sector enabling environment in Malawi

Malawi is a landlocked least developed country in southern Africa. Poverty is both severe and widespread and the country compares poorly with the region on almost all social and economic performance indicators. Malawi has not been endowed with particularly conducive “starting conditions” for economic development. Geography has left the country far from seaports thus raising the costs of trade, Malawi has only limited exploitable natural resources, and the short rainy season leaves the population vulnerable to recurrent food insecurity. These developmental challenges, coupled with decades of economic mismanagement and a collapse in savings and investment have resulted in Malawi never really gaining sufficient momentum in economic growth to sustainably raise incomes.

For the first 30 years of Malawi’s post-independence history, the country was ruled by “Life President” H Kamuzu Banda. The dictatorial regime placed only minimal faith in the private sector as a means of driving economic development, and instead provided for a more statist approach that sought to establish parastatal enterprises (quasi state-owned enterprises) that at one point accounted for as much as 40 percent of GDP (Record 2007). A vast web of licensing requirements, coupled with massive parastatal market interventions and other controls left very little space for the private sector.

Malawi’s transition to democracy in 1994 promised a great deal, but delivery was disappointing. Many of the more cumbersome restrictions on private sector activity were lifted, such as limitations on informal trading and special crop permits, in what appeared to be a more liberal approach to private sector development. However, Malawi’s private sector struggled to adjust to a more liberalised trading environment, and weak economic management resulted in government over-borrowing, rising inflation and interest rates, and currency instability. Accusations of corruption led to the suspension of aid by donors in 2002/03, triggering further economic turmoil.

The new government of 2004 staked its political capital on managing a return to economic stability. Improved prudence in financial management has seen a reduction in domestic borrowing requirements and a gradual fall in nominal interest rates to 17.5 percent in August 2007, down from 40 percent in April 2004. Similarly, inflation of just over 7 percent in mid 2007 is the lowest for more than a decade. Malawi’s more responsible economic management has been rewarded by a return to PRGF support and debt relief under HIPC.
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Figure 1: Malawi’s GDP growth picks up as inflation and interest rates fall, 1998-2007

![Graph showing GDP growth, inflation, and interest rates from 1998 to 2007.](image)

Source: OECD 2007

However, Malawi’s private sector has yet to recover from years of disinvestment and contraction and further growth remains restricted by a generally poor business environment.

2. Diagnosing the investment climate constraints

As Malawi has made progress on reforming the macro-economy, emphasis has begun to shift towards “softer” reforms that aim to accelerate the rate of economic growth through a Private Sector Development reform programme.

The constraints to private sector development in Malawi are well-known having been studied via a multitude of diagnostic studies, reports and consultancies. The challenge has always been translating recommendations into policy actions that can have a meaningful impact on the investment climate.

Hence, Malawi’s 2006 Investment Climate Assessment did not reveal anything new or groundbreaking when the results were released (nor did anyone expect otherwise). The survey confirmed that macroeconomic instability is the biggest perceived constraint to private sector performance, followed by access to finance, problems in the supply of electricity, the availability of skilled workers, crime, and then corruption (in that order).

More interestingly, evidence from the ICA revealed just how much Malawi’s private sector had contracted in recent years. The manufacturing sector was found to account for just 11 percent of GDP, down from a high of 32 percent in 1992. In addition the manufacturing sector was also found to be remarkably inward looking for a small, landlocked country with only 14 percent of manufactured output exported (RPED 2006).

Like many other low-income developing countries in Africa, Malawi has been disappointed that the country has not attracted large-scale foreign direct investment to take advantage of abundant low-cost labour. Annual FDI inflows have rarely risen
above the US$ 50-100 million range. Evidence from the ICA confirmed that Malawi possess a comparative advantage in the region in terms of low-cost labour. However when considering total factor productivity, that is taking into account the relative costs and returns to both labour and capital together, Malawi’s cost advantage evaporates. Similarly, while Malawi’s unskilled labour is lower cost than in almost all regional competitor countries, skilled, professional and managerial wages are higher than in a number of countries including Uganda and Madagascar, and on a par with more developed Kenya (RPED 2006).

The Doing Business indicators have also played a role in changing perspectives on the need to reform in Malawi. Analyses such as ICAs can often have only limited impact beyond the technocrats of central government, while the Doing Business indicators tend to be easier for the public to grasp, giving a clearer indication of Malawi’s comparative performance with other countries in the region.

Table 1: Malawi is ranked 110 out of 175 countries according to the Doing Business indicators

<table>
<thead>
<tr>
<th>Rank</th>
<th>South Africa</th>
<th>Mauritius</th>
<th>Namibia</th>
<th>Botswana</th>
<th>Swaziland</th>
<th>Seychelles</th>
<th>Zambia</th>
<th>Malawi</th>
<th>Lesotho</th>
<th>Mozambique</th>
<th>Tanzania</th>
<th>Comoros</th>
<th>Madagascar</th>
<th>Zimbabwe</th>
<th>Angola</th>
<th>Congo, DR</th>
</tr>
</thead>
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<tr>
<td>Overall</td>
<td>29</td>
<td>32</td>
<td>42</td>
<td>48</td>
<td>76</td>
<td>84</td>
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<td>156</td>
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Of course the challenge to move from diagnostics to action is perhaps the hardest part of the reform process that any country will face. Indeed, in many ways conducting the analytical work is much easier than securing buy-in around specific reform items among stakeholders, yet it is this hard-to-do consensus building that is frequently neglected. Then, when nothing much happens, governments are lambasted for “lack of political will”.

In Malawi’s case, the general results of the ICA, together with analyses of Malawi’s performance among peers according to the Doing Business survey were filtered through a series of technical working groups. Recognising the need to focus the reform effort, technical working groups were set up around the five Doing Business indicators where Malawi’s performance was relatively worse, and therefore offered the greatest scope for improvement. The groups were small enough to move quickly (generally 5-7 persons) and consisted of thematic specialists with a bias towards private sector membership. Each group started by analysing the breakdown for Malawi’s score in any given Doing Business indicator, and then worked towards a matrix listing bottlenecks with proposed solutions. The matrices produced by the technical working groups were then further

2 Getting credit, trading across borders, dealing with licences, paying taxes and closing a business.
prioritised until “quick wins” were arrived at. From Malawi’s previous attempts at reform such as under the Integrated Framework process, it has been difficult to start a reform process when the menu of required actions is so immense (for example Malawi’s DTIS Action Matrix ran to 40 pages). Hence, a “lesson learned” was the need to start with bite-sized pieces of reform that could be tackled before gaining momentum and moving on to the next stage.

As the work of the working groups reached its conclusion, it became clear that some reforms were more procedural and administrative in nature and so did not require significant costs, while other diagnosed reforms had much more significant capacity building and resource implications.

In December 2006, a final shortlist of three “quick wins” was agreed upon for immediate action. At the same time work began on the design for a US$ 18.7 million “Business Environment Strengthening Technical Assistance Project (BESTAP)”, to be jointly funded by the World Bank and EC which aims to address the more resource heavy issues over a five year period3.

The three “quick wins” were: (i) establishment of the Commercial Division of the High Court of Malawi as a means of reducing the time taken and cost required to settle commercial disputes and to close a business; (ii) introduction of a risk based customs administrative system at Malawi’s border posts as a means of speeding up border transit times; and (iii) introduction of a Single Business Licence as a means of rationalising multiple licences and reducing costs.

3. Building consensus around the need for reform

As in many aid-dependent African countries, Malawi’s national development policy throughout the late 1990s was governed by a Poverty Reduction Strategy. Also as in similar countries, Malawi’s PRSP had a very limited emphasis on private sector development, or even trade. New national leadership in 2004, together with the notional expiry of the Malawi PRSP in 2005 provided for a fresh opportunity to look at the direction of national development policy. The 2006 Malawi Growth and Development Strategy provided for a key departure from previous policy. While the PRSP emphasised “economic development through poverty reduction”, the MGDS sees the causality reversed with a much clearer emphasis on achieving economic growth first, and as a means of achieving poverty reduction. In addition, the document provides a much clear indication than any previous national policy documents that it is the private sector which is the “engine of growth”.

Secondly as Malawi has made progress on restoring macro-economic stability and thus laying the basic foundations for private investment, focus has begun to shift towards what have been termed “second generation” reforms that aim to accelerate economic growth.

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3 BESTAP was approved by the board of the World Bank on 24 May 2007.
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Malawi’s Registrar of Companies
Approximately US$ 1 million of the US$ 18.7 million Business Environment Strengthening Technical Assistance Programme has been allocated to computerising the current system. The aim is to reduce the time taken to start a business from the present 37 days to less than 10.

Increased momentum for reforming the investment climate has also come about from the role that business environment indicators (such as Doing Business) now play in determining country aid allocations. Given the need to maintain fiscal prudence, finance ministries in developing countries can often be reluctant to reduce red tape and restrictions on the private sector for fear of short term revenue loss. Support for Malawi’s PSD reform programme has, however, been vocal at the higher levels of the Ministry of Finance, due to that fact that indicators for starting a business (cost and number of days required) are benchmarks on the US Millennium Challenge Account. Moving from “threshold” to “compact” status could see as much US$ 200 million in grant funding provided to Malawi and thus securing “green” indicators is a high-level policy priority. Similarly, cost of doing business indicators feature in the World Bank Country Policy and Institutional Assessment (CPIA) which determines the IDA lending envelope available to Malawi.

However, in other areas while the rhetoric towards the private sector has improved, the reluctance to hand over responsibility for administering the annual fertilizer subsidy to the private sector betrays a telling distrust within government. The success (or failure) of the subsidy will probably be the major issue which will determine the re-election prospects of the current administration. Hence, while Malawi has made progress in improving public private dialogue, much more can still be done.

4. The “quick wins” – two out of three so far…

Malawi’s performance on achieving the three “quick wins” so far has been mixed. The process of establishing dedicated commercial courts has been ongoing for some time, but the PSD reform programme proved instrumental in bringing the process to conclusion. A major obstacle that had held up the process for several years was the lack of physical space for the Commercial Division. The extra momentum brought about by the PSD reform programme, together with newfound and wider appreciation of the importance of the need to settle commercial disputes quickly and efficiently were key parts in allowing government and donors to agree on a formula whereby donors would cover the first two years of rent for the courts, with the treasury agreeing to take over afterwards. Rules of procedures have now been gazetted and two judges appointed full time to the Commercial Division. The Division is now in full operations and has already dispensed with more than thirty cases.
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As a landlocked country Malawi’s transport costs erode trade competitiveness and the country is almost at the very bottom of the Doing Business league table for “trading across borders”. Border posts have generally not functioned well for a number of reasons, including the need to maximise trade taxes given the country’s narrow revenue base. The PSD reform initiative managed to achieve a successful coalition with the customs authorities in introducing a risk based system that provides a private sector incentive towards customs compliance. Importers are risk profiled and firms judged to be customs compliant are issued with one-year certificates which entitle them to only random rather than compulsory physical examinations at border posts. Malawi’s customs authorities were already working towards the phase-out of costly pre-shipment inspections which had previously been contracted out. Faced with the enormous task of bringing in post-shipment inspections, it made sense to try and couple the changes with the introduction of a system that improves efficiency for the private sector and reduces average transit times.

The third quick win concerned the reform of business licences and was the one that many expected to be easiest given that it required policy changes within only one institution – the ministry responsible for private sector development. Malawi’s business licensing regime is a hang-over from the 1970s with multiple overlapping licences and a discriminatory fee structure based on a vague interpretations of ethnicity. Large recent fee increases have cause widespread discontent in the private sector and proposals were made under the PSD reform programme to rationalise eight licences into one and reduce fees to purely administrative costs. Despite clear commitments at the ministerial level to implement these reforms, actual on-the-ground changes have yet to take place. Early bureaucratic opposition to the reforms centred around the need to maximise government revenue at a time while the budget was under pressure. After the Minister of Finance himself indicated that revenue loss was of no concern, resistance focused on the need to protect indigenous businesses through discriminatory fees. In reality it is highly unlikely that such a blunt and restrictive policy of differential licensing based on ethnicity is likely to result in real empowerment of the poor. Finally there were concerns raised among officials responsible for administering the licence that the rationalisation of multiple licences would result in “disorderly trade”, would be “confusing to the public”, and lastly was being forced upon Malawi by the World Bank.

At the present time any changes to the business licensing regime have still yet to be gazetted and it is the opinion of the author that the last remaining obstacle to reform is a reluctance to surrender rent-seeking opportunities by those officials responsible for collecting the licence fee.
5. Early results and lessons from the process

Thus far Malawi’s PSD reform programme has resulted in both successes and failures. On the macro-economic front the progress has been impressive. Much improved fiscal discipline on the part of the public sector has brought real benefits to the private sector in the form of lower interest rates and inflation. Such improvements, coupled with (at least on the surface what appears to be) improved political governance are the key drivers behind Malawi’s modest recovery in private sector confidence and investment. Promising signs during the last year with major new manufacturing and mining investments point to a cautiously optimistic future, as does a closer reading of the ICA dataset (see Record and Davies 2007 for more).

It is difficult to disentangle the active effects of Malawi’s PSD reform programme on the business environment from the more passive effects of a better macro environment and better fiscal governance. Certainly the process of diagnosing and beginning to implement PSD reforms has played a part in mainstreaming private sector development issues to some extent. As discussed above the three micro reforms (quick wins) have had a mixed but broadly positive effect thus far.

The following are early “lessons learned” from Malawi’s ongoing experience in trying to improve the investment climate:

- Diagnostics are the easy part. It is more important to distil problems into bite-sized policy measures that can be easily digested by policymakers. Basic cost-benefit analysis on potential reforms is important to ensure that finite stores of momentum are not lost on the more politically difficult reforms.

- Reformers (reform champions) and processes already underway can be strengthened by putting them into a PSD framework.

- The Doing Business indicators are a very useful (and ready to use) M&E tool. They are already linked to the MCA and CPIA and thus can help win friends to a PSD reform process in finance ministries. However there is a significant “ownership risk” if contentious reforms are then too closely associated with the World Bank and IFC.

- A resident PSD interest among donor country staff makes a big difference. Small countries such as Malawi are often served by regional donor staff or regional programmes. The “fly-in model” can be antagonistic, suffers from a rigid timetable and makes it more difficult for donor and government staff to build the sort of personal relationships that can help a lot in pushing through reforms.

- In small countries there is not enough space for multiple PSD/business environment programmes. Malawi faces a problem of inconsistent depth of donor interest in private sector development and growth issues. Donor engagement is generally dependent on the personal commitment and interest of in-country staff/economists/country managers.
Finally in a country with severe health, education and food security challenges such as Malawi, it can be difficult to convince donors to commit to supporting a private sector development reform process. Donors tend to find it easier to pump resources into the social sectors where the links between inputs and outputs are clearer (number of schools constructed, nurses trained etc...). In contrast, supporting PSD reforms requires a greater leap of faith in order to get results, but in the long run is the only way that a given developing country can generate internal resources to fund social development.
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References


