

Government of Malawi



Ministry of Trade and Private Sector Development

Formulating a Strategy for Private Sector Development in Malawi - A Concept Paper

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Foreword

To be completed.

Table of contents

1.0	Introduction.....	3
2.0	Macroeconomic overview.....	3
3.0	The environment for doing business in Malawi	4
	3.1 Exogenous demand side constraints	6
	3.2 Exogenous supply side constraints	7
	3.3 Rates of return, and the economic damage of unduly high interest rates	7
	3.4 Low savings.....	9
4.0	An analysis of Malawi’s private sector – strengths and weaknesses	9
	4.1 Overview	9
	4.2 Value addition and productivity	11
	4.3 Capacity utilisation	12
	4.4 Internal and external infrastructure.....	12
5.0	The private sector as a driver of poverty reduction	13
6.0	The role of the public sector in supporting private sector development	13
	6.1 Public sector attitudes towards the private sector	14
7.0	The role of foreign capital - Foreign Direct Investment (FDI) and Official Development Assistance (ODA)	14
8.0	A Private Sector Development Strategy for Malawi	15
	8.1 Rationale and scope.....	15
	8.2 Lessons from the region (Zambia and Tanzania).....	17
	8.3 Coordination with existing developmental and sector strategies in Malawi	19
	8.4 The next steps.....	20
	Bibliography	22

1.0 Introduction

Investment is the key to alleviating poverty in the long run because it is the mechanism that creates and sustains productive jobs. International aid inflows, and the redistribution of income and provision of essential services by Government can help to ease the burden of poverty and act as a safety net, but without the means to earn an income, the poor will never be completely free from poverty.

Hence, if Malawi is to realise its bold development ambitions as set out in the Malawi Poverty Reduction Strategy and in the Economic Growth Strategy then a key objective of Government has to be creating the best possible environment for investment to take place. A sound and supportive investment climate unleashes the entrepreneurial talents of people, including the poor, leading to productivity improvements, diffusion of best practices and the creation of productive jobs.

However, at the present time, the private sector in Malawi is struggling to compete both domestically and internationally. A poor macro-economic environment, and in particular high interest rates that make credit too expensive for firms, has led to very low investment levels and declining competitiveness. The high transactions costs of doing business, particularly the high costs of transport, electricity, water and telecommunications all contribute to making Malawi a difficult place for the private sector to flourish.

The recent transformation of the Ministry of Commerce and Industry into the Ministry of Trade and Private Sector Development demonstrates the clear commitment of the Government of Malawi to support private enterprises and create the best possible enabling environment for private sector investment and development. The Presidential vision of transforming Malawi from a “predominantly consuming and importing country, into a predominantly producing and exporting one” conveys a similar message.

The purpose of this document is to encourage thinking on a strategy and action plan for the Ministry of Trade and Private Sector Development to deliver on private sector development in Malawi.

2.0 Macroeconomic overview

With a GDP per capita of just USD 167 in 2004 (approximately USD 640 in terms of purchasing power parity), Malawi remains one of the ten poorest countries in the world. There is a clear need for rapid and sustainable economic growth, and although 2004 saw an improved performance with economic growth reaching 4.6 percent (the highest rate for several years), this still falls below the 5-6 percent required to have an impact on poverty given that population growth is currently running at 2.1 percent (NSO 2005).

The underlying causes of Malawi’s low economic growth are well known: both investment and productivity growth are very weak. Gross fixed investment at just 8.1 percent of GDP (World Development Indicators 2005) is half the average for Sub-Saharan Africa and less and a quarter of that recorded in Mozambique. Gross fixed investment in the private sector is close to zero according to IMF estimates. Growth in labour force productivity is also virtually zero. Malawi currently invests double the dollar value of capital to yield an equivalent increase in output compared to the average in Sub-Saharan Africa.

Over recent years, Malawi has consistently run a large and unsustainable deficit on the current account in the order of USD 200-500 million per year. This dollar deficit has essentially been financed by balance of payments support from international donors. Malawi's exports are heavily dependent on a narrow range of primary commodities with tobacco accounting for nearly 70 percent of export earnings. This leaves Malawi highly vulnerable to demand shocks in the tobacco sector.

Poverty remains deep and widespread throughout the country and socio-economic indicators in Malawi compare badly, even with Sub-Saharan Africa (see Table 1 below).

Table 1: Selected social and demographic indicators in Malawi and other countries

	Malawi	Sub-Saharan Africa
Population below the poverty line	65	-
Per capita income (USD)	167	470
Illiteracy rate (percent of people aged 15 and above)	40	39
Life expectancy at birth (years)	39	47
Infant mortality (per 1,000 live births)	1,120	1,100
HIV/AIDS prevalence rate (percent, ages 15-49)	15	8.4

Source: Diagnostic Trade Integration Study (2004)

It is no surprise that as activity in Malawi's private sector has stagnated and wider economic performance has faltered, so have efforts to reduce poverty on a meaningful scale.

3.0 The environment for doing business in Malawi

As in many developing countries, the legal operating environment for private sector enterprises in Malawi is rather inhospitable. Firms face numerous hurdles in terms of red tape, regulations and requirements in carrying out the every-day business activities. Part of the reason behind these constraints is the legacy of preferential treatment to the large state-owned conglomerates that dominated the economy during the post-colonial regime. In addition, the State derives a very high proportion of its revenue from business. This burden of taxation falls heavily on a relatively narrow formal private sector.

Inappropriate regulation creates obstacles to the process of market development by raising the costs of business entry and growth. In particular, regulation and inadequate institutions for property rights and the rule of law create barriers to transition from the subsistence and very small scale economy to the modern more productive sector. Many entrepreneurs in Malawi remain trapped in the informal private sector due to the high costs of formalisation. Such firms therefore are not able to grow and benefit from economies of scale or access the additional benefits of formalisation such as bank finance and business development services.

The costs of starting a business in Malawi (both financial and in time), are not actually especially high compared to the average for Sub-Saharan Africa, as can be seen in Table 2 below. In terms of the number of procedures required to establish a business and the time taken, Malawi compares favourably with OECD countries. Similarly the zero minimum capital requirement ought to act as an incentive to small scale entrepreneurship. However the cost, as a percentage of per capita income, is high.

Table 2: Starting a business, 2005

	Malawi	Sub-Saharan Africa average	OECD average
Number of procedures	10	11	6
Time (days)	35	63	25
Cost (% of income per capita)	139.6	215.3	6.5
Minimum capital (% of income per capita)	0.0	297.2	28.9

Source: WB/IFC Doing Business database (2005)

Similarly, the steps, time and costs of complying with licensing and permit requirements for ongoing operations while comparing reasonably well with the region, highlight the additional challenges that the private sector faces in Malawi compared with developed countries.

Table 3: Dealing with licences, 2005

	Malawi	Sub-Saharan Africa average	OECD average
Number of procedures	23	20	14
Time (days)	205	251	150
Cost (% of income per capita)	244.7	1,597.3	68.0

Source: WB/IFC Doing Business database (2005)

In terms of hiring and firing workers, Malawi again compares favourably with both other African economies and with OECD countries on all indicators except with respect to firing costs. Table 4 shows how in Malawi the cost of firing a worker is equal to 90 weeks of wages, compared to an average of 59.5 weeks in Sub-Saharan African and 40 weeks in OECD countries. The high cost of laying off workers is likely to act as a significant disincentive to the creation of jobs in the private sector as firms fear the costs of expanding their labour-force too rapidly.

Table 4: Hiring and firing workers, 2005

	Malawi	Sub-Saharan Africa average	OECD average
Difficulty of hiring index	22	48.1	29.5
Rigidity of hours index	20	63.2	50.0
Difficulty of firing index	20	47.8	27.3
Rigidity of employment index	21	53.1	35.7
Firing costs (weeks of wages)	90	53.4	32.6

Source: WB/IFC Doing Business database (2005)

With respect to registering property, the process in Malawi compares reasonably well to other countries (Table 5) although the time taken (118 days) is still very long.

Table 5: Registering property, 2005

	Malawi	Sub-Saharan Africa average	OECD average
Number of procedures	6	6	4
Time (days)	118	117	33
Cost (% of property per capita)	3.4	12.7	4.7

Source: WB/IFC Doing Business database (2005)

It is a widely held belief in Malawi that the legal system fails to provide the kind of service that the private sector needs to enforce contracts and settle civil disputes.

Unsurprisingly the data in Table 6 shows that while the number of procedures and the time required to enforce a contract is no worse than in other countries, the cost is much higher in Malawi, 136.5 percent of the debt, compared to an average of 41.6 percent in Sub-Saharan Africa and just 10.9 percent in OECD countries. When the cost of settling a dispute with a debtor is actually significantly higher than the value of the debt, then it is unsurprising that few companies choose to pursue settlement through the legal system. This situation is a major contributor to the high level of default on trade credit and non-payment of bills in Malawi.

Table 6: Enforcing contracts, 2005

	Malawi	Sub-Saharan Africa average	OECD average
Number of procedures	16	35	19
Time (days)	277	434	232
Cost (% of debt)	136.5	41.6	10.9

Source: WB/IFC Doing Business database (2005)

For growth in the private sector to take place, it is important that capital is able to flow freely within an economy and be transformed from non-productive and unprofitable investment into productive and profitable activities. The time required to close a business in Malawi is not high compared to other countries, however the cost is very high (30 percent of the estate) and recovery rate of just 12.3 cents in the dollar indicates that the process of transforming capital does not work efficiently.

Table 7: Closing a business, 2005

	Malawi	Sub-Saharan Africa average	OECD average
Time (years)	2.6	3.6	1.5
Cost (% of estate)	30	20	7.6
Recovery rate (cents in the dollar)	12.3	16.1	73.5

Source: WB/IFC Doing Business database (2005)

Table 8 demonstrates that entrepreneurs on average spend 782 hours per year dealing with the Malawi Revenue Authority, this represents almost 100 working days and imposes a significant cost on the private sector in terms of time forgone.

Table 8: Paying taxes, 2005

	Malawi	Sub-Saharan Africa average	OECD average
Payments (number)	33	41	16
Time (hours)	782	394	192
Total tax payable (% of gross profit)	56.5	58.1	46.1

Source: WB/IFC Doing Business database (2005)

3.1 Exogenous demand side constraints

Malawi is a small country with only limited domestic demand. Hence international trade is always going to be a key driver of growth in the private sector. While there are constraints and distortions limiting demand internationally (notably agricultural subsidies, technical barriers to trade and sanitary and phytosanitary requirements in developed country markets), the evidence would suggest, given Malawi's comparatively poor trade performance compared to other commodity dependent developing countries, that a lack of demand in the markets in which Malawi participates is not the primary constraint to export expansion. In fact Malawi enjoys

moderate current account surpluses with the United States and European Union, but has massive deficits with nearer neighbours, most notably South Africa, Zimbabwe and Mozambique.

3.2 Exogenous supply side constraints

As a landlocked country, Malawi faces additional challenges that need to be overcome in sending its products to international markets. This is an added, but not insurmountable obstacle. Switzerland is an example of a country which is equally far from the sea but does not lag behind its neighbours in terms of growth and development. Malawi's comparatively high domestic transportation costs imply that the high cost of transport frequently cited by export pessimists is not entirely due to the distance from Malawi to major ports. Malawi's inability to fully capitalise on trade opportunities such as AGOA, together with collapsing share of the domestic market in certain key products (e.g. textiles) implies that the binding constraints to private sector development lay on the supply side of the economy.

The supply side constraints to the development of not only the private sector in Malawi, but the wider economy in general are well-known and include high transport costs, the high cost and poor quality of utilities (electricity, water and telecommunications), weak skills base and the heavy tax burden on the narrow formal private sector.

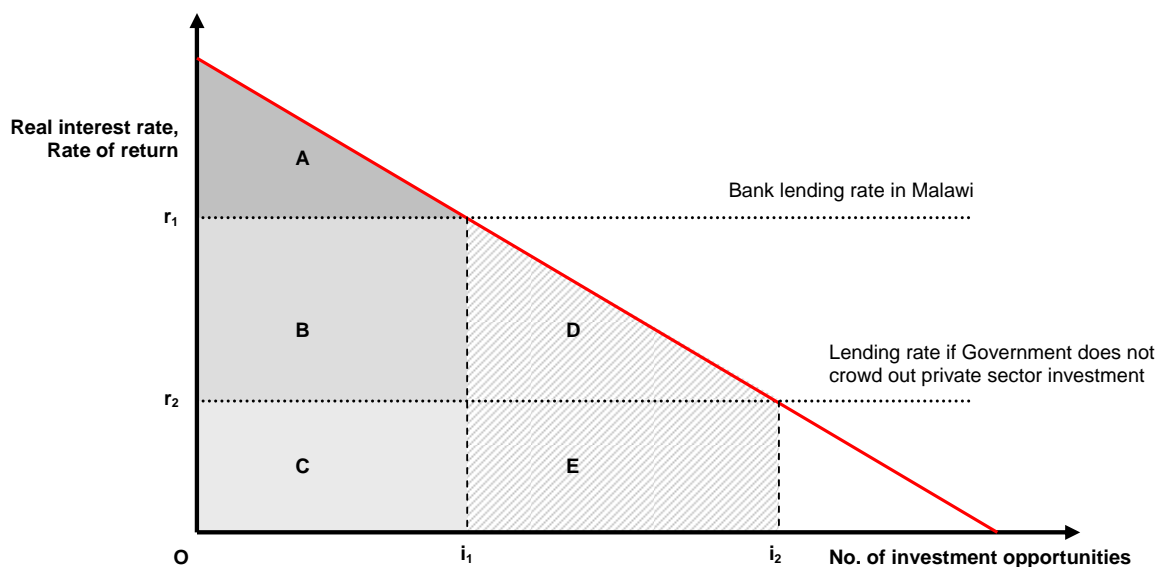
However, a stable macroeconomic environment is almost certainly a prerequisite for entrepreneurs to invest and carry out business with any confidence. Just about the most importance consideration for entrepreneurs in any business environment, is the interest rate. Closely followed behind is the rate of inflation, and for companies involved in international trade, the exchange rate.

High interest rates and inflation, together with a volatile exchange rate mean that otherwise profitable investment opportunities are not taken. High risk and/or non sustainable projects tend to be the only types of investment activities that yield a positive net present value. Both savings and investment is discouraged in such a climate.

3.3 Rates of return, and the economic damage of unduly high interest rates

Interest rates are currently comparatively high in Malawi, with the bank lending rate at 25 percent. The annual equivalent rate (including interest paid on interest) is 28 percent. Even in developed economies, very few private enterprises manage to earn a rate of return on capital employed in excess of 25 percent. Hence in Malawi, a large number of otherwise profitable investment opportunities are not taken unless internal funds are available.

Figure 1: Investment opportunities and rates of return



Source: Author's own

Consider the sloping line in Figure 1 above as an axis of ordered, available investment opportunities that yield a positive net present value. The current bank lending rate in Malawi is shown in the diagram at r_1 percent. At this rate, only i_1 investment opportunities will give a positive return to private investors once the costs of borrowing are taken into account. Investors therefore earn a total return equal to the shaded area 'A', and the banks earn a return equal to the shaded areas 'B' and 'C'. Knowing that the banks will take a larger share of the profits accruing to any investment acts as a considerable disincentive to any would-be investor.

One of the principle causes of high interest rates is the extent to which Government spends more than it raises in taxes and is then forced to borrow on domestic markets to cover the deficit. This drives up the bank lending rate as the Government uses up available credit that might otherwise be lent to the private sector, this is known as "crowding out". Consider the case where the Government does not over-borrow and the interest rate rests at a more natural level of r_2 . At this rate, many investment opportunities that were previously unprofitable because of the high bank lending rate of r_1 now become profitable. Hence at a bank lending rate of r_2 , i_2 investments are made. Investors now earn a much larger total return equal to areas 'A', 'B' and 'D'. The banks now earn a total return equal to areas 'C' and 'E'.

The banks may or may not experience a welfare gain if the interest rate falls from r^1 to r^2 , hence they may be reluctant to see change. However, other firms in the private sector will unambiguously benefit from a fall in interest rates. Society as a whole will experience a significant net welfare gain as shown by areas 'D' and 'E'.

Furthermore, unduly high interest rates are likely to force private firms into carrying excessive working capital as the costs of running short and being forced to borrow to cover operational expenses are very high. This results in further losses in efficiency.

High interest rates also have the effect of encouraging firms to undervalue future revenue streams. Firms may be discouraged from exporting where the time between cost outlays and revenue inflows is long and hence greater (costly) working capital is required. Similarly, those firms that do seek credit from banks are likely to only borrow to finance short-term investment opportunities.

Finally, high interest rates act as a de-facto barrier to entry into the market for new firms and entrepreneurs who do not already have access to capital. This results in lack of competition and acts as a considerably brake on economic and social mobility, not least for indigenous Malawian entrepreneurs.

3.4 Low savings

Malawi suffers from one of the lowest savings rates in the region, the limited supply of savings also contributes somewhat to the high cost of borrowing. A major reason for low savings in Malawi is due to the very high levels of poverty, households that are unable to meet basic subsistence needs are unlikely to enjoy the luxury of saving anything at all. However, it is also true that the taxation system discourages savings and does not help to foster a “savings culture” in Malawi. Equally, the high spread (currently averaging 24 percent – higher than any country in the region bar Zimbabwe) between deposit rates and lending rates in banks means that savers usually earn a negative return on their savings due to the negative real interest rates (inflation higher than nominal interest rates).

Table 9 shows how Malawi is the only country in the region which has experienced persistent negative national savings rates. This implies that Malawi is currently *consuming* rather than investing its (very limited) supply of capital.

Table 9: Net national savings, percentage of gross national income

Country	1990	1995	2000	2001	2002	2003
Ethiopia	7.31	14.49	4.49	8.96	9.74	12.47
Kenya	7.85	5.72	5.73	3.59	8.57	5.11
<i>Malawi</i>	<i>11.56</i>	<i>0.85</i>	<i>-3.78</i>	<i>-10.54</i>	<i>-6.03</i>	<i>-13.22</i>
Mozambique	1.70	5.57	3.79	9.82	22.41	5.17
South Africa	3.13	3.49	2.39	1.66	3.58	3.02
Tanzania	5.80	0.36	5.08	4.66	8.11	1.99
Uganda	2.68	10.70	7.69	7.76	8.43	10.32
Zambia	13.01	-2.74	-3.86	5.26	6.08	7.76
Zimbabwe	8.07	4.27	3.32	-2.35
Least developed countries average	..	8.31	11.42	11.77

Source: World Development Indicators (2005)

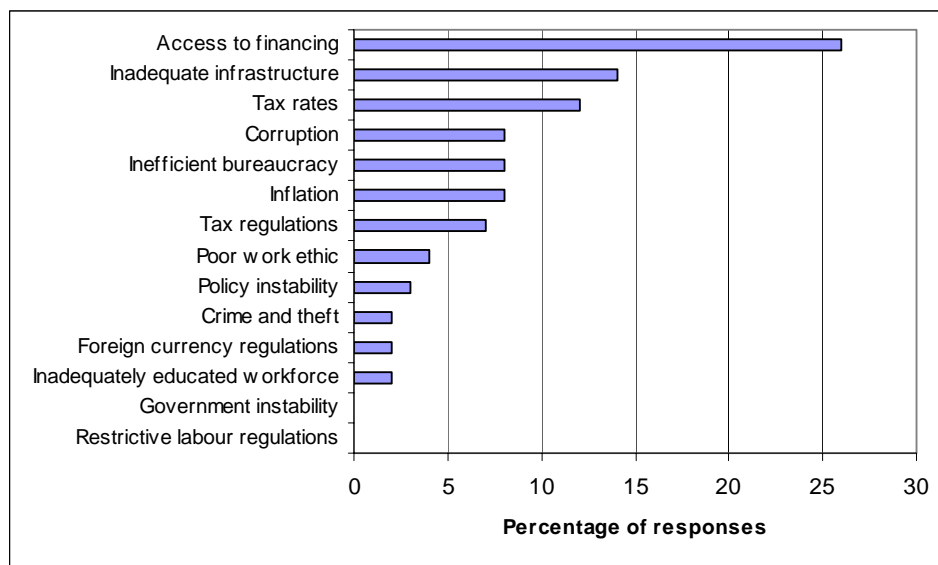
Almost all of the developing countries in the world that are experiencing high growth, have high domestic savings rates. Unless Government is able to create a healthy savings market for Malawians, lack of credit will always be a major and long term constraint to the development of the economy.

4.0 An analysis of Malawi’s private sector – strengths and weaknesses

4.1 Overview

Malawi’s competitiveness domestically, regionally and internationally varies by sector. Figure 2 lists the most problematic factors affecting the enabling environment for business in Malawi according to a survey of the private sector in 2004. “Access to financing” was by far the most significant constraint, followed by “inadequate infrastructure”, and “tax rates”.

Figure 2: Principle factors affecting the business enabling environment in Malawi



Source: World Economic Forum, Executive Opinion Survey (2004)

On most performance indicators for the manufacturing sector, Malawi has fallen behind its peers during the 1980s and 1990s. Manufacturing value added (MVA) is now just USD 25 per capita, down from USD 34 in 1980 (see Table 10).

Table 10: Developmental indicators for the manufacturing sector, selected African countries, 1980, 1990 and 2000

		Ethiopia	Kenya	Malawi	South Africa	Zimbabwe
MVA per capita (USD)	1980	13	33	34	729	181
	1990	12	37	33	661	176
	2000	21	34	25	591	130
Manufactured exports per capita (USD)	1980	1	39	15	139	67
	1990	1	22	6	288	55
	2000	-	19	6	384	58
Share of MVA in GDP (percent)	1980	6.8	9.6	14.4	21.5	22.7
	1990	7.3	10.1	17.4	21.5	20.5
	2000	6.2	10.3	11.1	19.4	16.0
Share of manufactured goods in total exports (percent)	1980	10.2	52.7	35.1	19.4	37.8
	1990	17.0	51.3	13.1	25.7	38.6
	2000	12.4	37.7	19.1	63.8	38.4

Source: UNIDO Industrial Development Report (2004)

Similarly manufactured exports per capita are now less than half the level recorded in 1980, and the share of MVA in GDP has dropped to just 11.1 percent. The share of manufactured goods in total exports of 19.1 percent, while recovering somewhat from a trough in 1990, lags well behind most of Malawi's peers (UNIDO 2004).

Table 11 shows that the bulk of the private sector in Malawi (as in most developing countries) consists of sole proprietors. The large number of small firms in African developing countries should not, however, be seen automatically as a sign of underdevelopment. Rather it is the case that firms are confined to subsistence and activities that generate very low returns that are often uneconomic. Additionally, the

high costs imposed by the state on the formal private sector firms acts as a disincentive for firms to formalise. This imposes a significant economic cost if firms remain below optimal size.

Table 11: Percentage share of enterprises by employment size band in total employment in enterprises with 50 or fewer employees, selected African countries

Number of workers (including working proprietors)	Botswana	Kenya	Lesotho	Malawi	South Africa	Swaziland	Zimbabwe
	1992	1991	1991	1992	1991	1991	1991
1	65.0	55.1	79.5	59.5	46.6	68.8	69.6
2-5	28.1	42.7	18.0	38.4	50.1	28.4	26.9
6-10	5.1	1.9	1.6	1.3	2.8	1.4	2.3
11-19	1.0	0.2	0.5	0.5	0.4	0.9	0.7
20-50	0.9	0.1	0.4	0.3	0.1	0.5	0.5

Source: Liedholm and Mead (1993)

4.2 Value addition and productivity

The formal manufacturing sector in Malawi consists of seven main sub-sectors (see Table 12 below). The food and agro-processing sector (which includes sugar and processed tobacco exports) shows most promise in terms of value addition (estimated to be in the range of 30-35 percent). Most of Malawi's manufacturing industries are using relatively simple technology and rely on imports for their intermediate inputs. In terms of value addition in other products, the picture is somewhat mixed.

Table 12: Value addition in manufacturing by sector (percent)

Sector	1994	1996	1998	2000
Agro-processing (includes Food)	35	35	30	33
Textiles, clothing, leather	7	5	7	5
Wood products, publishing	14	16	19	15
Chemicals, plastics, rubber	24	23	23	19
Non-metallic mineral products	4	3	3	4
Metal products, machinery	14	15	15	20
Other manufactures	3	3	3	4
Total (MK in 1994 prices)	1323.7	1389.3	1423.1	1405.6

Source: CSO (from World Bank 2004)

In 2000, manufacturing value added per capita in Malawi was USD 25, this compares with USD 591 per capita in South Africa, USD 130 in Zimbabwe, and USD 34 in Kenya (UNIDO 2004).

For agricultural produce, over-reliance on rain-fed agriculture has resulted in fluctuations in production and a very short growing season. Because of the high risks in agricultural production, poor access to and the high cost of credit, investment and re-investment has been poor, with traditional methods of production still prevalent and productivity stagnant. The short growing season and reliance on rainfall also means that the bulk of Malawi's trade is highly seasonal.

During the ten years from 1994 to 2003, national productivity growth averaged just 0.84 percent per annum (World Development Indicators 2005).

4.3 Capacity utilisation

The low and declining level of manufacturing activity is reflected in low capacity utilisation across almost all sub-sectors in Malawi (Table 13 below). Major sub-sectors such as food processing, beverages, and textiles are operating below 50 percent capacity.

Table 13: Capacity utilisation in manufacturing sector (percent)

Sub-sector	1997	1998	1999	2000
Food processing	65	54.6	47.5	50
Beverages	60	55	60	43
Textiles	53.5	50.5	46	46
Wood products	63.3	68.3	67.5	85
Paper and packaging	60	65	62.5	61.5
Chemicals	90.9	74.2	78.9	74.3
Metal fabrication	12.7	23.1	21.5	30
Mineral products	42	55	62	63

Source: APRU Baseline Surveys (from World Bank 2004)

The most likely cause of these low capacity utilisation figures is the continued effect that the high transactions costs of doing business in Malawi have in terms of weakening effective demand. While supply capacity exists; the high transportation costs (for both exporting finished goods and importing raw and intermediate goods), high interest rates (high cost of working capital) and the high cost and unreliability of utilities all reduce the incentives for production.

4.4 Internal and external infrastructure

Recent research from the Ministry of Transport and Public Works (MoTPW) has suggested that for Malawian exports, some 55 percent of the costs of production (CIF) are taken up by transportation costs (applied throughout the value chain). The equivalent figure for the average LDC is 17 percent, and for the average OECD country just 8 percent. This indicates just how much transport costs affect Malawi's competitiveness.

The road transport infrastructure and network in Malawi has improved significantly over recent years. However there still remain a number of bottlenecks. Inadequate resources for maintenance means that new and rehabilitated roads deteriorate rapidly (limited enforcement of maximum vehicle loads at weighbridges also contributes to road deterioration). Domestic road transport costs remain high, partially due to the high cost of capital and poor road maintenance (that contributes to higher than average wear and tear on vehicles). A distinct lack of competition in the road haulage sector, and major coordination problems during the peak tobacco selling season also add to costs.

The table below demonstrates that since 2000, Malawi has depended disproportionately on relatively high-cost road transport for internal trade. Traffic has been diverted away from lower-cost rail transport due to the dramatic fall in the quality of the rail infrastructure.

Table 14: Domestic freight traffic by transport mode (000 tons)

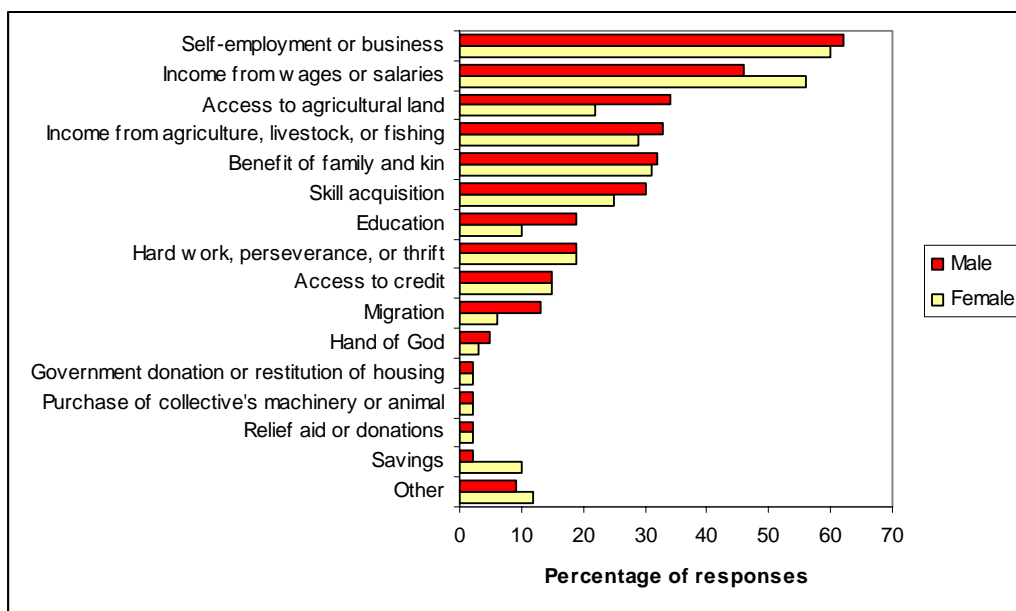
Mode	1998	1999	2000	2001	2002
Rail	167.0	196.8	249.7	172.5	183.5
Road	96.0	177.0	201.0	229.1	279.1
Lake	14.0	11.0	10.0	5.0	8.5
Air	2.0	2.0	1.0	0.7	0.6
Total	279.0	386.8	461.7	407.3	471.7
% change	-	38.6	19.4	-11.8	15.8

Source: Tera International (2004)

5.0 The private sector as a driver of poverty reduction

The role of entrepreneurs and the private sector is critical for poverty reduction. International aid and the redistribution of income by Government can help to alleviate poverty in the short run by sharing out national income more equally, however the only way for Malawians to see sustained increases in incomes and reductions in the level of poverty is by generating new and productive employment opportunities outside of the public sector. Evidence from the Voices of the Poor study across a number of developing countries (including Malawi) shows that “self employment or business” and “income from wages and salaries” are the most significant factors leading to upward mobility by quite a large margin (see Figure 3 below).

Figure 3: Factors leading to upward mobility in developing countries



Source: Narayan and others (2000)

6.0 The role of the public sector in supporting private sector development

A useful analogy is to consider the role of the Ministry of Trade and Private Sector Development as being similar to one of any private enterprise in serving its clients, except the Ministry should view its clients as the private sector at large. Any successful entrepreneur will report that the two key rules of running a successful business are ‘understanding the needs of your customers’, and ‘providing a quality service to customers’. The same principles can be applied to Government. Therefore, ministerial activities in PSD should aim to fall in line with the following two broad principles:

1. Understanding the needs of the private sector; and

2. Providing a high quality and well targeted service to the private sector.

It should also be understood that Government cannot be both the public and private sectors at the same time, nor should it try to be. The aim is to create the best possible enabling environment for businesses to grow of their own accord.

6.1 Public sector attitudes towards the private sector

Sustainable long term development is only going to take place in Malawi if the public sector and society at large understands that the private sector is the only long term driver of increased living standards. Government can redistribute and increase the welfare of some, but only at the expense of others. Only with sustained increases in output and productivity, can the welfare of all be improved. The private sector needs to be considered at the centre of Government policymaking.

For too many, the private sector is just considered to concern the business interests of a narrow segment of society. It should be the role of the Ministry of Trade and Private Sector Development to consider the impact of all Government policies on the private sector, and lobby to ensure that all Government policy gives full and fair consideration to any impact on the private sector, and to demonstrate to the nation in general how private sector development can drive poverty reduction throughout Malawi.

7.0 The role of foreign capital - Foreign Direct Investment (FDI) and Official Development Assistance (ODA)

As a continent, Africa attracts a very small share of global FDI. Of that total, Malawi's share is tiny. The Government has attempted to increase inflows of FDI into Malawi by making improvements in the legal environment for foreign investment by signing Investment Promotion and Protection Agreements (IPPAs), Bilateral Investment Treaties (BITs) and by making efforts at the regional level through COMESA and SADC. However, the reality is that on paper Malawi already has a very hospitable and liberalised investment environment. Such efforts are at best only likely to be of marginal impact.

More than anything, foreign investors need an underlying business reason to make an investment. Furthermore, if domestic businesses are struggling to invest and make profits, then foreign businesses are highly unlikely to have any confidence investing in such an environment. For developing countries, FDI is rarely a *driver* of growth, it is much more likely to be an *accelerator* of growth. If Malawi is going to attract a meaningful supply of FDI, then it needs first and foremost to create the conditions for dynamic domestic private sector growth to take place.

Table 15: Total net financial flows (ODA and FDI), USD million

	1985	1990	1999	2000	2001	2002	2003
ODA	113	503	435	446	404	377	498
FDI	1	23	-19	26	19	6	23
Total	114	526	416	472	423	383	521

Source: World Development Indicators (2005)

Table 15 above demonstrates that ODA inflows have consistently dwarfed FDI inflows into Malawi. Foreign investors have largely shunned Malawi for many reasons including macroeconomic instability, weak governance, corruption, lack of rule of law and fiscal mismanagement.

For a number of reasons, pessimism has come to constitute one of the greatest obstacles to trade and private sector development playing a key role in economic growth and poverty reduction in Malawi. However, international economic relations can play a strong role in helping Malawi break out of the vicious circle that causes generalised poverty to persist. The following key points suggest ground for optimism:

- Access to foreign savings (through FDI) can play a catalytic role in helping poor countries to break out of the cycle of low incomes, low savings, low investment and low productivity;
- Exporting to international markets enables land and labour resources, hitherto underutilised owing to the weak effective demand associated with mass poverty, to be productively mobilised;
- Increased access to available modern technologies enables latecomers to achieve significant productivity increases without continually having to reinvent;
- Increased FDI can increase investment and provide technology and managerial skills; and,
- Increased international migration enables poor people in poor countries to find employment abroad even if opportunities are limited in their own country. International remittances are becoming one of the principle sources of foreign exchange for many LDCs. International remittances now account for approximately 70 percent of world FDI flows and are significantly larger than international ODA flows. Remittances also have a strong impact on poverty as they tend to go direct to poor households in developing countries.

8.0 A Private Sector Development Strategy for Malawi

8.1 Rationale and scope

Any attempt to improve the private sector enabling environment will do well to give full consideration to the following two principles:

- Sound private sector development is, first and foremost, a function of sound policy, including the necessary basic institutional underpinnings. An effective state, as well as functioning communities, is needed for a truly beneficial investment climate; and,
- Special public interventions to help private firms seem to have weak or mixed results. Overall, it appears that, as for the case of aid effectiveness in general, special support to the private sector is most successful when policy and institutional development is substantially on the right track, but, otherwise, it is typically ineffective (Klein and Hadjimichael 2003).

The aim of the Malawi Private Sector Development Strategy is to build a partnership between public and private sectors that seeks to address the constraints to enterprise development in Malawi, and put private sector development at the heart of the socio-economic development of the country. This strategic effort can be seen as a major step towards implementing the vision of His Excellency, the State President that Malawi should become a producing rather than consuming country, one which exports rather than imports.

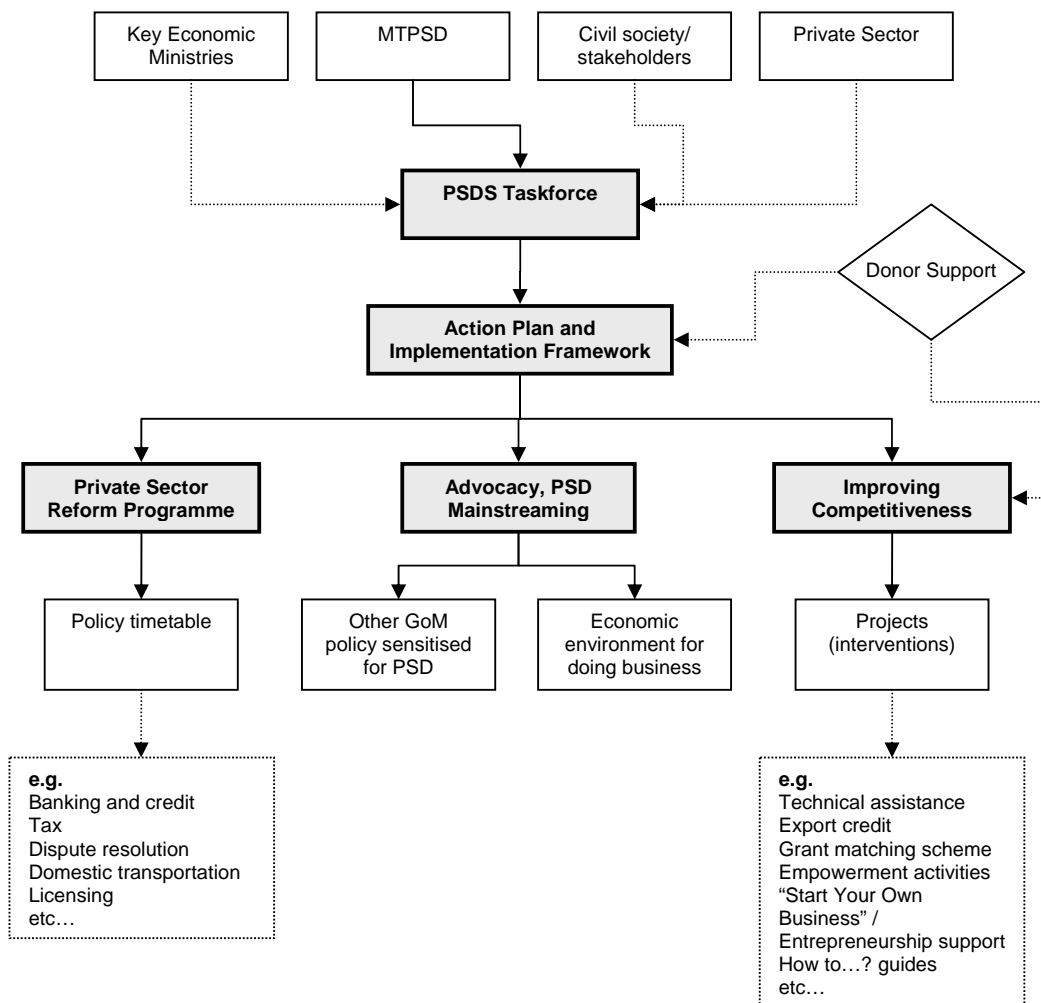
Provisionally, the strategy will consist of three main components:

- a) A private sector reform programme;
- b) Advocacy and private sector development mainstreaming activities; and,

- c) Interventions aimed at improving the competitiveness of Malawi's private sector (a private sector development programme).

The strategy will aim to suggest a timetable for policy reforms to improve the environment for doing business in Malawi, to mainstream PSD as a major developmental issue across Government, and to take specific steps to improve the competitiveness of the Malawi economy through interventions such as improving business and entrepreneurship support services. See Figure 4 below for a diagram of the proposed approach.

Figure 4: Schematic diagram of the proposed Malawi Private Sector Development Strategy



Source: Author's own

Unlike other strategy documents in Malawi, it is proposed that the Private Sector Development Strategy will not focus on specific sectors. Instead interventions will aim to provide general support to entrepreneurship and the private sector through reforms and support measures that improve the enabling environment for all private sector enterprises. The focus will be on thematic areas that affect the business operating environment such as banking and credit; tax policy; skills, productivity and technology; dispute resolution; domestic transportation; and licensing.

Box 1: Framework approach to PSD interventions

Institutional Framework

- Sound and stable macro-economic policies are an essential basis for development, but they are not sufficient to encourage business growth.
- The lead Ministry covering private sector development needs to be strong and influential, and its role clearly identified may help to provide a legal basis for reforming the policy environment, and monitoring the implementation of reforms.

Policy Machinery

- Consultation with the private sector, and with all levels of Government, is essential to design and monitor effective policies and regulations.
- Policies should be more concerned with helping the private sector to help itself, that is by removing obstacles, rather than in providing financial or business support measures.
- Government needs a central point for regulatory reform to monitor new and existing legislation, to promote change, and to act as an advocate both within and outside government.
- Mandatory policy/regulation impact assessment procedures are necessary.

Policy Formulation

- Fiscal policies should be directed at reducing barriers to formal sector activity (thus reducing the size of the informal sector). Compliance costs of the tax system can be lowered by simplification and the adoption of user-friendly unitary tax authorities.
- The (real and informal) costs of business registration and licensing need to be brought down drastically, and uncoupled from revenue raising.
- Poor people will never be able to participate fully in opportunities to raise capital until they can obtain clear legal title to property.
- Banking and other financial institutions should be regulated in ways that minimise costs and promote competition.
- Systems for exit from business through bankruptcy or liquidation need to be modernized.
- Alternative dispute resolution mechanisms are particularly needed where relatively low cost legal services are unavailable.
- Rationalisation of customs procedures is necessary so as to facilitate trade, and thereby private sector development.
- Policies on business support services need to be redirected towards facilitating private provision, and providing information and easing compliance with regulations.

Source: Adapted from Bannock 2002

8.2 Lessons from the region (Zambia and Tanzania)

During October-November 2005, a team of stakeholders from the Ministry of Trade and Private Sector Development, the Malawi Investment Promotion Agency and the Malawi Confederation of Chambers of Commerce and Industry conducted PSD familiarisation visits to Zambia and Tanzania. The purpose of the visits was to learn lessons and gain from the experience from counterparts in the region.

Zambia is considered to be of interest principally because the “Private Sector Development Reform Programme” was completed in 2004 and serves as a useful model for Malawi. The Zambian programme was developed in partnership with the World Bank following an Investment Climate Assessment (ICA). Tanzania is of

relevance because three private sector development initiatives are currently underway: the Business Environment Strengthening in Tanzania (BEST) Programme, which has been implemented for two years; the Private Sector Competitiveness Programme, which is about to begin implementation; and a Private Sector Development Strategy, which is currently being developed.

Zambia's Private Sector Development Reform Program appears to be a well designed program where many aspects can be applied to Malawi. However, it is of concern to note that even with a well-developed program, with strong support in the Ministry of Commerce, Trade and Industry at the highest level (PS and the Minister), with support at the Cabinet and Presidential level, with strong support in the private sector and among a majority of donors, and with a highly efficient coordination unit – very little of substance in terms of actual reforms has been achieved yet. It may well just be the case that it is too early to tell, but this underlines the difficulty in achieving reform of the enabling environment in which the private sector operates in an African context.

Specifically, the following main “lessons” can be drawn from the Zambian experience for reference to Malawi:

- Since PSD constraints inevitably cut across government, there is a clear need for PSD to be seen as more than just a Ministry of Trade and Private Sector Development issue, it has to be an issue across government;
- There is a need to think of a novel implementation framework to avoid past failures in implementation;
- Support needs to be gathered across government, the private sector and donors;
- The rural and informal private sectors should not be neglected, and grassroots / district level support needs to be gained.
- Donors need to be disciplined to ensure that PSD initiatives are harmonised, avoid duplication and send out the same message;
- Government needs to be committed (and bound) to improving the macro-economic enabling environment for the private sector; and perhaps most importantly,
- Commitment at the highest level is essential.

With respect to the case of Tanzania, while there are a number of interventions on PSD in the country, the net effect does appear to be well coordinated and, most importantly, Tanzania can point to actual on-the-ground reforms that have been implemented and are delivering results. Nevertheless, Tanzania's Socialist past means that the reform challenge is larger than in Malawi and there are more “quick wins” that can be implemented as part of the ongoing transition. Most impressively, right across Government the same language is being spoken in terms of the challenges to PSD that need to be addressed.

The following main “lessons” can be drawn from the Tanzanian experience:

- As with the case of Zambia, commitment at the highest level is essential given the cross-cutting nature of a PSD reform agenda;
- Attitudes across Government need to be harmonised around the importance of PSD as a driver of growth and development, and the need to reform the private sector enabling environment and reduce the costs of doing business;
- PSD reforms can be easily married to economic empowerment activities;
- A strong investment centre / investment promotion agency needs to be at the centre of a PSD reform agenda;

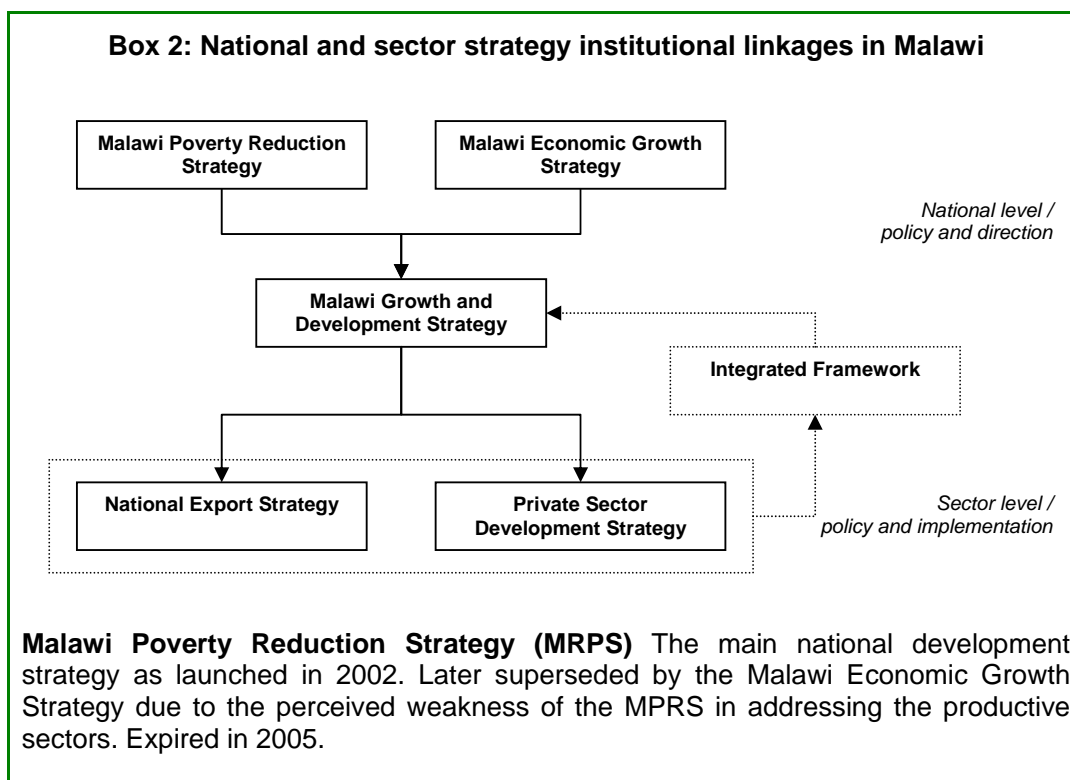
- Reforms need to be made to ensure that the informal or extra-legal economy can be accommodated within the formal sector economy; and,
- The Ministry of Finance needs to be fully committed to the removal of nuisance taxes and other impediments to entrepreneurial development (such as business licensing).

Detailed reports on the visits to Zambia and Tanzania are available.

8.3 Coordination with existing developmental and sector strategies in Malawi

The Private Sector Development Strategy will aim to work in concert with other policy initiatives at the national level (such as the Malawi Poverty Reduction Strategy, the Economic Growth Strategy and the new medium term Growth and Development Strategy currently being written), as well as other relevant strategies at the sector level (such as the National Export Strategy). As such, it is envisaged the Private Sector Development Strategy will not have sector-specific plans (e.g. for cotton, tobacco, tea etc.), rather it will focus much more at the enabling environment for all private sector enterprises, large and small, domestic and international oriented, formal and informal, rural and urban.

It is envisaged that the Private Sector Development Strategy will work in tandem with the National Export Strategy. The formulation of both strategies has been spearheaded by the Ministry of Trade and Private Sector Development. However, while the National Export Strategy aims to focus on strengthening the value chain of existing export sectors and developing new export products, the Private Sector Development strategy should work to provide support across all product and service sectors with a greater focus on improving the regulatory environment for production, rather than focusing directly on tradable goods and services.



Malawi Economic Growth Strategy (MEGS) Launched in 2004 as a compliment to the MRPS, but focusing more on the productive sectors of the economy as opposed to the social sectors emphasis of the MRPS.

Malawi Growth and Development Strategy (MEDS)* The new national comprehensive development strategy current under preparation and due to be completed by end 2005. The new strategy technically replaces the expiring MRPS, but aims to merge both the social sectors focus of the MRPS with the productive sectors focus of the MEGS.

Integrated Framework (IF) A multi-donor initiative designed primarily to integrate trade and private sector development issues into national development strategies. The Diagnostic Trade Integration Study (DTIS) was completed in 2004.

National Export Strategy (NES) A new sector level strategy under development led by the Ministry of Trade and Private Sector Development focusing on highlighting export issues as development issues, improving value addition of existing export products and developing new products with high export potential.

Private Sector Development Strategy (PSDS) A new sector level strategy aiming to improve the enabling environment for private sector development in Malawi through policy reforms, interventions and advocacy across Government to mainstream private sector development as the principle driver of long term economic growth and poverty reduction. Formulation is also being led by the Ministry of Trade and Private Sector Development. The domestic sectors focus of the PSDS is designed to partner the external sector focus of the National Export Strategy.

Source: Author's own

8.4 The next steps

It is proposed that during the period November 2005-July 2006 (nine months inclusive), the development of a detailed action plan for private sector development and reform will take place.

- a) Project inception and formation of "Private Sector Development Strategy / Inter-Agency Taskforce". Drafting of the action plan and implementation framework will be conducted by under the supervision of a "PSDS Taskforce". This high-level team will comprise of approximately 12 persons/institutions and will act as a regular consultation forum during the drafting process. The taskforce will be chaired by the Office of the President and the Cabinet and will be supported by consultants.
- b) Initial research, collection of documents and preliminary consultations / review of analytical studies. During this phase, background research will be conducted on the state of the private sector in Malawi (much has already been done on this); previous, current and future PSD interventions and projects in Malawi; and existing PSD interventions and projects in the region from which Malawi can learn.
- c) Investment Climate Assessment (ICA) of Malawi. A major national survey of the "investment climate" of Malawi is to be undertaken during October 2005-January 2006 supported by the World Bank. The ICA is a in-depth survey of approximately 350 manufacturing enterprises in Malawi. The aim of the survey is to assess and validate the constraints to private sector investment in

Malawi, and to benchmark Malawi's investment climate with respect to other comparable developing countries. It is expected that this survey will generate significant quantitative data and policy recommendations for the strategy design.

- d) Working meetings of the PSDS Taskforce. The Taskforce will meet four to five times as a group for a series of two-day retreats where, with the support of consultants, the group will work to formulate an action plan and implementation framework.
- e) Preliminary consultations with Government, the NAG, civil society, donors and private sector stakeholders. The PSDS Taskforce will present its initial concept / draft matrix for the PSD Strategy to Government, the NAG, donors and selected members of civil society and the private sector to gauge initial reactions and opinions.
- f) Preparation of detailed strategy document and action plan. Following on from stakeholder consultations, revised versions of the action plan / matrix will be prepared, along with a detailed action plan for implementation.
- g) PSD consultation and dissemination forum. The full strategy design will be presented to stakeholders and the wider audience in Government, civil society, the private sector and to donors for validation and adoption.
- h) Revision and preparation of final PSD action plan / matrix and implementation framework. After all consultations have been completed, feedback and comments will be incorporated into a final version of the strategy design which takes into account the concerns of all stakeholders.

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