FINANCIAL VULNERABILITY IN **MALAWI:**

A REPORT FOR DEBT AND DEVELOPMENT COALITION IRELAND AND TRÓCAIRE

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Dr Sheila Killian
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FINANCIAL VULNERABILITY

Vulnerability is defined by Turner et al (2003) as 'the degree to which a system .... is likely to experience harm due to exposure to a hazard, either a perturbation or stress/stressor' Financial Vulnerability is a particular case of this, generally referring to a fragility or instability within an economy, which leaves the country open, to a dangerous degree, to serious adverse consequences in the event of some incident or situation which is outside the control of the government.

This report takes a focus less on the quantitative measurement of the contribution of individual factors such as debt, tax, inflation etc to vulnerability, and more on an exploration of the interrelatedness of these factors, and their impact on the lives and welfare of the Malawian people. In the manner of a perfect storm, it is this interplay rather than any single factor that results in the bleak prospects sketched out in this report. The IMF classifies Malawi as being in 'moderate risk' of debt distress (IMF 2013). However the myriad of financial vulnerabilities underpinning Malawi's economy combine to create a more serious situation than this suggests, in urgent need of national and and international action

Executive Summary

This report explores the financial vulnerability of Malawi and the extent to which this may be driven by debt and taxation. The report finds that the interplay of a range of economic factors including high sovereign debt, poor financial infrastructure, a tax system heavily dependent on consumption taxes, aid dependency, currency volatility and uneven foreign direct investment have led to a serious level of risk in the Malawian economy. This interplay creates a vulnerability which makes the challenge of addressing poverty and inequality all the more demanding.

The report reviews some relevant theory and empirical work in the area of financial vulnerability before describing the Malawian situation through a series of snapshots covering inequality, economic growth, aid dependency, external debt, the level of debt and credit within the Malawian economy, taxation, currency volatility and mining. It concludes with some proposals for actions which could be taken at a national level, and some proposals for actions which Ireland could take to alleviate or address some of the issues. The report specifically urges the Irish Government to:

1. **Use Ireland's influence within international bodies to push for debt relief for Malawi,** as an urgent measure to introduce a step-change to the economy and address the fact that external debt levels are creeping up steadily to an unsustainable level.

2. **Negotiate a Tax Treaty with Malawi (and perhaps some neighbouring countries on a multi-lateral basis) using the UN model as the template.** The treaty negotiation and agreement process is a long one, and Malawi's network is sparse. This makes it more difficult for them to attract foreign direct investment, reduces the transparency in their tax arrangements with multinational firms and leaves them open to harsh terms if treaties need to be agreed at short notice in order to facilitate a major investment. By negotiating a UN-model treaty with Malawi in the absence of a pressing investment need, Ireland can set a precedent for fairness in tax matters for Southern countries and strengthen the network and experience of Malawi's taxing authority.

3. **Add a focus for aid on measures to expand the banking system,** perhaps using mobile technology, to make it accessible and useful for the 80% of the population currently unbanked, and to implement a Financial Reforms programme to address the mobilization of domestic savings and better financial intermediation. While this may not be something to be delivered directly by Irish Aid, it could be undertaken under the leadership of Irish Aid and the Department of Enterprise, Jobs and Innovation as a coordination of private company and public sector initiatives.

4. **Offer practical assistance and support for a comprehensive review of investment incentives offered to multinational firms**, as called for by many Malawian CSOs, and support CSOs to input into that process.

5. **Use Ireland's influence within OECD, EU,**

World Bank and IMF to support Malawi in designing and strengthening their own tax systems and to continue to impose trade tariffs and customs duties where necessary. This could be done in combination with an expansion of the work of the Irish Revenue in Rwanda, to strengthen the domestic revenue-generating capacity of the Malawian tax authorities.

6. **Assist in drafting a wider range of tax treaties,** particularly focused where possible on following the UN model rather than the OECD. Again, the expertise and experience of the Irish Revenue could be useful here.

7. **Support the introduction of wideranging international reform on tax transparency including: full, publicly accessible country-by-country financial reporting by multi-national companies and the automatic exchange of information on tax matters between tax jurisdictions in a way that supports participation from countries like Malawi.**

The situation in Malawi is very grave, but far from hopeless. Urgent action needs to be taken on a multilateral basis, and Ireland should play its part in supporting Malawi to achieve greater financial justice.

1. Financial Vulnerabilities in Malawi

Introduction

This report explores how debt and taxes impact on the financial vulnerability of Malawi, reviewing both international theory in the field and a wide range of recent studies and data sets to examine how the various categories of debt, tax policy and tax practice impact on the country. In looking at debt, the scope extends beyond external sovereign debt levels to include internal domestic, corporate and personal debt. Similarly the work on taxation goes beyond an assessment of the country's own domestic tax system to consider the impact of the international system, and the potential adverse effect of policy incoherence in the North. The aim is to expose the main drivers of vulnerability, paving the way to the development of more nuanced policy recommendations at both a local and an international level which, if implemented, would contribute to greater stability in Malawi's economy.

The report is laid out as follows. The next section reviews academic work on financial vulnerability, particularly of sub-Saharan Africa, and the impact here of tax and debt. The following section goes deeper into the situation in Malawi, describing the context and economy and this is followed by a series of financial snapshots which combine to illustrate the extent of financial vulnerability and the key areas of strength and weakness within the country's financial system. The final section summarises and draws conclusions about the causes and triggers of vulnerability within the country, and concludes with a series of policy proposals at a national and international level.

2. Financial Vulnerability, Debt and Taxes

It is intuitive that external debt, because of the cost of servicing the related interest, should have a dampening impact on growth levels among poor countries. Counter to this runs the idea that some external debt can be used constructively to stimulate a moribund economy, and so increase growth. These contradictory impacts perhaps explain the mixed results obtained in earlier research in the field. (Fosu et al. 1996) however, in a wide-ranging empirical work, demonstrated the dampening impact of external debt on growth, particularly in sub-Saharan Africa. They suggest that debt dampens growth not only because of the servicing cost of interest, but because the presence of debt "apparently adversely impacts the nature, and hence productivity of investment undertaken." (Fosu, 1996:93) This is a really interesting finding, because it goes beyond the simple idea that borrowed money will be invested productively in the economy, to the benefit of the population at large. The basic contention is that if debt is high, governments will be forced to choose investment projects that pay off with a high degree of certainty

IRISH AID IN MALAWI

Irish Aid has been working with Malawi as a key partner country since 2007, with earlier work there stretching back to 2002. The main focus of their work is on agriculture, food and nutrition with a secondary thread of work on governance. More detail is available at (Irish Aid 2010)

DEBT RELIEF IN MALAWI

Malawi was not included among the original countries eligible for the Highly Indebted Poor Countries (HIPC) debt relief scheme in 1996, but was eventually included in 1999. African CSO, Afrodad, indicate Malawi's debt service ratio was 12.4% of exports at that time (Afrodad 2014). In 2004, after implementing the policy conditions attached to the scheme, Malawi's HIPC debt relief was finally approved. In 2006, Malawi received additional debt cancellation through the top-up scheme, the Multi-lateral Debt Relief Initiative (MDRI). In total Malawi received US$ 1.62 billion debt relief through the HIPC scheme and US$ 1.58 through the MDRI scheme, amounting to a total of US$ 3.2 billion. On being approved for debt relief, Afrodad point out that Malawi had to pay US$ 90 million in payment of arrears to creditors before receiving it. They indicate that the overall debt cancellation resulted in the decrease of total external debt stock from 104% of GDP in 2005 to about 14.2% in end-2006.

Malawi Debt Relief received in nominal terms (IMF 2013):

HIPC	**US$1.628bn**
MDRI	**US$1.587bn**
Total	**US$3.215bn**

in the relatively short term, in order to meet the interest costs. The study tracks this effect across a swathe of sub-Saharan Africa, using two decades of data from the World Bank.

Subsequent work on debt levels including that of (Azam, Fosu et al. 2002) builds on these early findings, and in general conclude that openness and an export orientation will increase economic growth levels in a country impacted by high debt. Countries seeking to apply this model tend to adjust their tax base to make exports easier. This logic leads inevitably to a skewing of the tax system away from tariffs and border taxes towards taxes that are considered to support productivity, such as consumption taxes and levies on products used locally. This is hugely problematic in countries with widespread poverty and large informal economies, where such taxes not only place a massive burden on poor people, but also are extremely difficult to collect in the absence of strong fiscal policies and institutions and an efficient taxing system.

The effect on poor and vulnerable communities is exacerbated by the impact of the perceived future costs of servicing an overhang of public debt on the spending choices of governments. These have been found to have a measurable impact on the ability of a debt-laden country to build up infrastructure in education (Fosu 2007) and in health (Fosu 2008).

These studies paint a depressing picture of high external debt leading to poor government spending choices, and triggering an urgent need to raise domestic taxes using the least sustainable, enforceable and equitable forms of taxation.
The impact of debt on tax is twofold: it raises the requirement for revenue, and at the same time steers the government away from taxes on business and withholding taxes on international transfers and exports. The next section examines how this pattern has played out in Malawi.

3.Malawi

Malawi is a small land-locked country with one of the lowest per-capita incomes in the world. Approximately 90% of the population live in rural areas on subsistence smallholdings or depend on fishing in Lake Malawi which occupies almost a fifth of the country's area. Both poverty and the inadequacy of the infrastructure needed to address it are overwhelming. Taking just the areas of education and health as examples, (O'Neil, Cammack et al. 2013) report 'low rates of school completion, deteriorating exam results, nationwide stock-outs of key medicines and persistently high rates of maternal mortality.' Similar deficiencies are rife in agriculture, water supply, housing etc.

The poverty of Malawi is more than a legacy of its colonial history, though this, as described in (Acemoglu and Robinson 2010), has impoverished the whole region through the cluster effect of slavery, poor infrastructure, capital flight, weakened institutions and exploitation by European elites. The problem, as the authors see it, is that the structures put in place for colonial rule were designed to create dependency, facilitating a system of patronage and favours that strengthened the status quo. 'Those who exercised power created economic institutions and policies to perpetuate this power and this undermined economic development'.
Malawi's circumstances did not improve when it became independent of Britain in 1963 as self-governing Nyasaland. In 1964 Dr Hastings Banda

became president of Malawi, a post he would hold for thirty years under one-party rule. The combination of frequent drought and a high fertility rate led to a population explosion, and through the 1970s the practice of dividing family smallholdings among adult children led to families who were dependent on ever-decreasing plots of land, growing mainly maize. (Durevall and Erlandsson 2013) describe how from the 1980s, external agencies such as the World Bank and IMF influenced economic policy and the structure of the public service in Malawi through conditionality attaching to structural adjustment lending. (Gaynor 2010) cites (Chisinga 2002) among others in concluding that 'the devastating social consequences (as well as economic failings) [of this intervention] have been well-documented.'

A famine in 1987 followed by a drought in 1992 fuelled growing opposition to Banda's rule. As the cold war ended, his overseas support waned and he lost power in the country's first multi-party elections in 1994. Since then, more open elections and a more democratic constitution have improved governance in the country, although concerns remain on the even application of laws and regulations within the country, as articulated by (Svåsand 2013). The country's second president, Bakil Muluzi ruled for the maximum permitted ten years, succeeded by Bingu Mutharika who died in office in 2012 and was replaced by his vice president, Joyce Banda. She was widely regarded in the North, and by the IMF, as a reformer, but her devaluation of the local currency, while popular with international funders, caused severe hardship within the country (Mapondera and Smith 2014). Following corruption scandals, she was voted out of office in the 2014 elections which returned the opposition leader, Peter Mutharika, brother of her predecessor, as president.

(Blackie, Conroy et al. 2006) observe that while there is some wealth in the country from commodities such as tobacco and uranium, devastating poverty and vulnerability to drought and famine remain a serious problem. (World Bank 2006) echoes this, observing that almost a third of poor children do not even start primary school, and very few complete even basic schooling, and cataloguing dire poverty, child malnutrition, a widening inequality built roughly around the urban-rural divide and little or no progress in reducing poverty from 1998 to 2006. Lack of investment in irrigation despite the presence of Lake Malawi continues to make for a high level of seasonality in land use, increasing the vulnerability among poor, land-dependent families to drought. It also restricts the ability of poor farmers to invest in livestock or diversify production away from maize. Transport and financial infrastructures are also severely limited, which exacerbates the rural-urban divide and curtails the ability of those earning a wage to save, invest or insure themselves against risk. It also adds to the risk of HIV/Aids, for example, making education, prevention, counselling and treatment more challenging. A 2011 World Bank study notes that while Malawi has made some progress in the creation of infrastructure, notably in the areas of telecommunications and the supply of clean water, there is still an estimated need to spend over $300 million a year in a system already riddled by inefficiencies in the region of $200 million per annum (Foster and Shkaratan 2011). This almost certainly understates the total spend required; because the focus of the study is limited to the infrastructural needs of the economy, this does not take into account the social spend needed in a country with widespread poverty.

JUBILEE DEBT CAMPAIGN ON POLICY CONDITIONALITY

"One reason Malawi took so long to get debt relief was due to the strict conditions for getting debt cancellation. Malawi was forced to privatise state owned enterprises. This included the agricultural marketing board, which had stored crops and provided subsidised fertiliser to small farmers.The IMF and World Bank pushed the Malawian government to privatise, end agricultural subsidies and sell grain stocks in order to reduce government deficits and because they were seen as a 'distortion of trade'. In 2001/02, and again in 2004/05, the removal of support for farmers and selling of grain stocks combined with drought to create serious food crises. Thousands of people died and millions suffered. Drought had also reduced the harvest in 1991/1992 but the resulting famine was much less severe, due to greater government intervention. In the early 2000s, food shortages forced the government to import maize at a cost much greater than the original agricultural subsidies." - Jubilee Debt Campaign (2012).

In short, the country is in dire need of increased domestic revenue and reduced expenditure on debt in order to invest in infrastructure which will raise the welfare of some of the poorest people on the planet.

The level of external debt is key to understanding the Malawian economy and the welfare of her people. It should be borne in mind that most studies of the issue take a broad macroeconomic approach, examining the impact of debt or bank lending on the overall economy. A typical example is (Brambila-Macias, Massa et al. 2011) who find that cross-border lending boosts growth in African economies generally. Such studies tend to understate the impact of debt on the very poor, which is particularly problematic in a country like Malawi with devastating poverty and widening inequality. With this caveat in mind, (Tchereni, Sekhampu et al. 2013) analyses the impact of foreign debt on the country over the period from 1975 to 2003, spanning the major period of IMF and World Bank intervention, and finds some evidence of a negative relationship between debt and growth. Similarly, (Nkuna 2013) examines the sustainability of the current account in Malawi, and finds not only that Malawi's current account deficits were excessive and unsustainable over the period 1980-2010, but also that the current account was still unsustainable even after the highly indebted poor countries (HIPC) relief. That study concludes that for a sustainable current account to be achieved, Malawi needs a sustainable level of external debt, and also endorses policies that grow exports and manage the exchange rate. This echoes recommendations in (Tchereni, Sekhampu et al. 2013) for the government to focus on export incentives for local manufacturers. This strategy is also endorsed by (Lea and Hanmer 2009) who also describe how dependence on foreign aid has an amplifying effect on exchange rate problems, as inflows of aid in foreign currency – in Malawi's case over half the volume of exports – result in the home currency being overvalued, further constraining growth.

Capital Flight is also a serious problem for the country, in common with the rest of the region. (Ndikumana and Boyce 2010) highlight the extent of capital flight from 33 sub-Saharan African countries over the period 1970-2004, and estimate total capital flight from the region amounted to $443 billion (in 2004 dollars) over the period of study. The authors estimate that in Malawi's case, 91% of the capital flight manifested in the form of trade mis-invoicing, and observe that this represents 'a cause of serious concern for a continent that is struggling to meet large and growing financial needs to support its development agenda' (Ndikumana and Boyce 2010: 477). The figures for Malawi are striking not only in their scale, but in the variability from year to year.

This highlights the second major problem created by capital flight: not only is there the obvious deprivation for the country as money is taken from the system; there is also a secondary problem of uncertainty and instability created by large inward and outwards flows of capital which are unpredictable from year to year. Combining this with aid-dependence leaves the Malawian economy particularly vulnerable to external shocks, and exchange-rate fluctuations. Adding unsustainable levels of external debt to this mix exacerbates the fragility of the economy overall, and limits the potential for the people of Malawi to achieve prosperity. One possible pathway towards a solution as proposed by (Tchereni, Sekhampu et al. 2013) is for Malawi to strive to become a net producer and exporter of goods, rather than a net importer. This would ease the exchange rate problem as well as giving a more reliable stream of revenue to the government. An extension of this approach would be to couple the focus on real economic growth with the cancellation of some debt.

Apart from external debt, the level of internal debt (credit and lending within the economy) in Malawi is also problematic, as highlighted by (Blackie, Conroy et al. 2006). Macroeconomic theoretical studies are mixed on the impact of internal debt on economic growth. The World Bank and other international actors often promote a freeing up of credit as a means to promote industrial growth. However, (Kabango and Paloni 2011), in a study based on the financial reforms introduced in Malawi in the 1990s, provide a counterpoint to this view. They examine the impact of credit expansion in the wake of liberalization on the structure of the industrial sectors in Malawi, and find that the credit expansion led to a rise in industrial concentration and a fall in net firm entry in Malawi, particularly in sectors most dependent on finance. Essentially, the freeing up of lending was mainly of benefit to the larger more established firms, and gave them a strategic advantage over smaller, struggling firms. The authors note that in the case of Malawi financial liberalization has often been justified precisely on the basis that it is a catalyst for industrial development, and that the implementation

of the policy has been regarded abroad as relatively successful. However they write: 'We find the opposite. Liberalization appears to be associated with a significant increase in concentration and a significant drop in firm entry' (Kabango and Paloni 2011:1781).
Taxes are relevant because of their potential in generating domestic revenue to meet the basic needs of the population and the overpowering need to invest in appropriate infrastructure. However, Malawi operates with a narrow tax base, and a taxing authority with limited capability to tackle the significant informal sector in the country. A 2012 study carried out by the Reserve Bank of Malawi investigates the impact of tax policy and donor inflows on economic growth in Malawi over the period 1970-2010. Of note is the observation that the authors view tax policy formation as a choice between greater economic growth or greater equality' (Chiumia and Simwaka 2012: 170). A striking highlight is that consumption taxes have on average provided 60% of total tax revenue over the period. Socially, this is particularly problematic given the disproportionate impact of consumption taxes on the poor. The remaining 40% of total government tax revenue almost all comes from income taxes, with virtually no revenue being generated from wealth or property taxes. The study notes that such high taxes have had a negative impact on growth, and supports the idea in (Chipeta 2002) that high consumption taxes in Malawi have driven activity out of the formal, taxed sector into the shadow economy. The authors argue that a move from consumption taxes which indirectly favour the informal economy by affording it a competitive advantage, and towards income taxes will contribute to more growth, providing an economic as well as a moral rationale for shifting the tax system away from regressive consumption taxes.

The narrow tax base severely limits what the government can do with the tax system to stimulate the economy. For example, in the 2013 budget, incentives for various industrial sectors such as tourism, agriculture and media were only provided through the removal of taxes from capital equipment, rather than through the kinds of investment incentives that would be more familiar in a country with a more developed taxation system (KPMG 2013). At the same time, some aspects of the tax system are plagued with bureaucracy and opacity. This applies to income tax (Aiko and Logan 2014) as well as issues around importing and exporting goods (World Bank 2013) and the negotiation of bespoke tax deals with investing multinational firms. In turn this places a particular burden on smaller indigenous industry which again advantages the informal sector.

These studies suggest that Malawi can be characterised as impoverished by its past, crippled with external and internal debt, capital flight and aid volatility, and struggling to redress the situation with a narrow, inadequate tax system. The next section mines publicly-available datasets for illustrations of the evolution of the current economic problems in the country.

4. Snapshots

This section presents a series of fact-based, mainly financial and economic snap shots, presented as simply and graphically as possible so that each one can be used independently as needed to illustrate an issue. They are loosely arranged under the following headings: inequality; economic growth and financial flows; aid dependency; external debt; internal debt; taxation, currency volatility and mining.

4.1: Inequality

Chart one shows the percentage of income held by different sectors of the Malawian population.

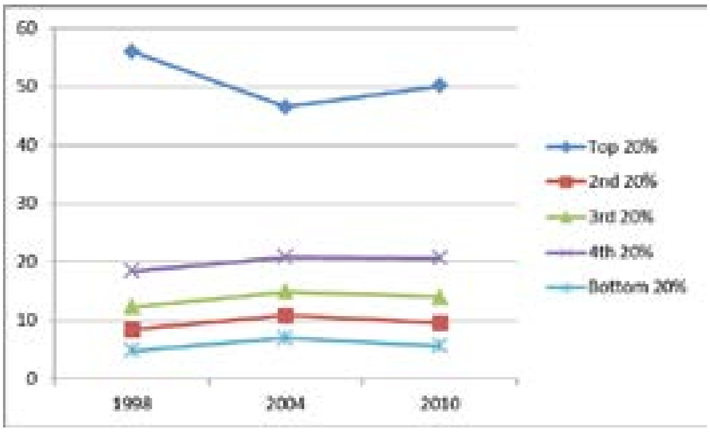

Chart one: Income distribution from 1998 to 2010

Source: World Bank, Development Research Group

The chart shows that the top one-fifth of Malawi's population continue to enjoy more than half of the country's income, while the bottom one-fifth subsist on roughly a tenth of that level. Two things are noteworthy about this graph. The first is the relative size of the gap between the top fifth and the rest, indicating the presence of an elite which is removed from the economic concerns which affect the majority of the population. Secondly, in the latest year for which figures are available, the poorest 80% of the population have a smaller proportion of the overall income, while the income share of the top 20% rises, widening the gap at the top.

Chart two shows the poverty gap separately graphed for the urban and rural poverty lines in Malawi. The poverty gap is a term which describes the average shortfall from the poverty line (counting the non-poor as having zero shortfall), expressed as a percentage of the poverty line. This measures the depth of poverty, as well as its incidence. So for instance if most of those whose income fall below the poverty line had income which was only just below the line, the poverty gap would be very small.

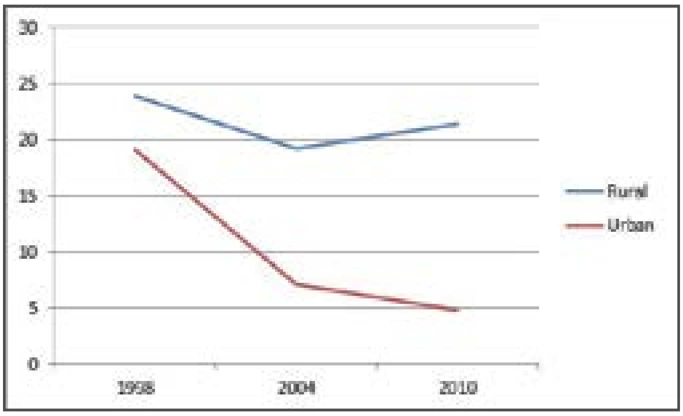

Chart two: Urban and rural poverty gaps from 1998 to 2010

Source: World Bank, Global Poverty Working Group.

The chart shows that while progress is made towards reducing the depth of poverty in urban areas, the rural poor continue to be most affected by poverty, and their situation has not improved in the most recent year for which figures are available. The graph illustrates the extent and trend of the rural-urban divide in Malawi. 56.6% of the rural population are at or below the poverty line, while the figure for the urban population is 17.3%.

Chart three shows the percentage of the population whose income falls below three benchmark figures: $2 a day, $1.25 a day or the national poverty line.

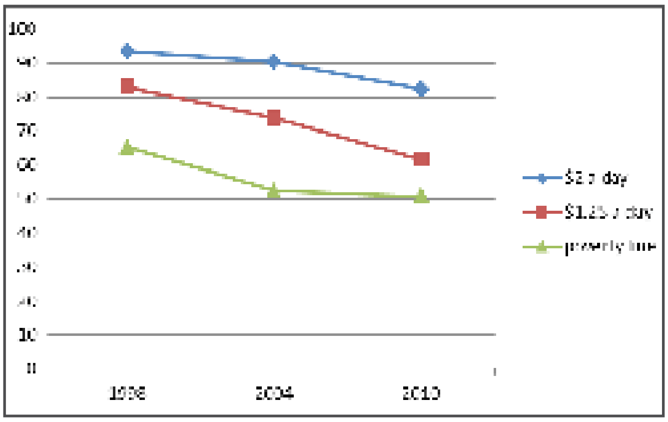

Chart three: % of population at selected low income markers, 1998 to 2010

Source: World Bank, Global Poverty Working Group.

The chart shows the numbers at fixed income levels falling, while the overall percentage at or below the poverty line is beginning to level out at just over half the population. The differences may be accounted for in part by inflation. Even with the apparent improvements, more than 80% of the population are still earning less than $2 a day.

4.2: Economic growth

Charts four and five show the scale of foreign direct investment into Malawi, and the levels of imports and exports in each year. Chart four tracks exports and imports over 50 years from 1961 to 2011.

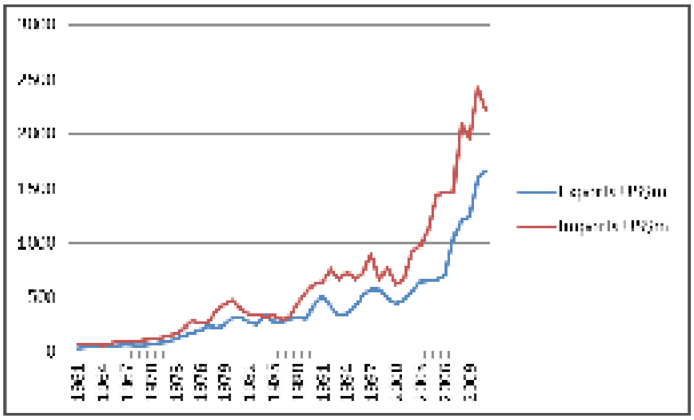

Chart four: Annual import and export levels in US$ Million

Source: World Bank national accounts data, and OECD National Accounts data files

The chart shows an overall increase in the absolute US$ value of imports and exports, but also shows imports exceeding exports in every year since 1983. This shows that despite the range of export-oriented measures introduced by the IMF, Malawi continues to be a net importer.

Chart five shows the level of net foreign direct investment (FDI) in Malawi in US$. FDI is defined in these World Bank data as net inflows of investment from abroad to acquire a lasting management interest (10 percent or more of voting stock) in an enterprise. The figures are shown net of any disinvestments.

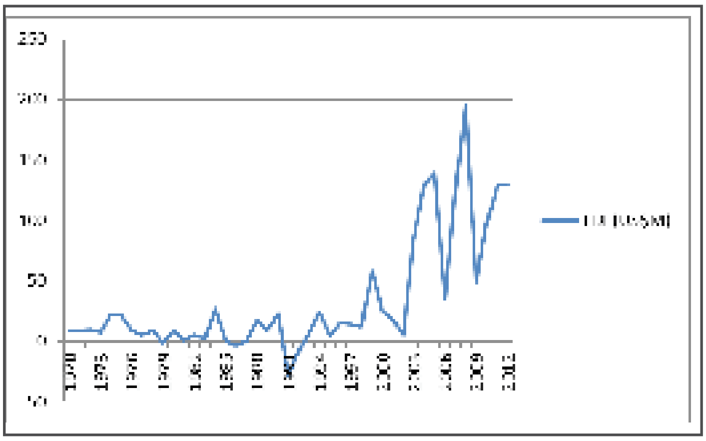

Chart five: Net FDI in US$, 1970 to 2012

Source: International Monetary Fund, International Financial Statistics and Balance of Payments databases, World Bank, International Debt Statistics, and World Bank and OECD GDP estimates.

The chart shows a dramatic increase both in level and volatility of FDI since 2000. this indicates a pattern of large and irregular investments, which does less to address issues of fragility and vulnerability than smoother more regular investments. To achieve the latter will be challenging, however, particularly with Malawi's low ranking on the World Bank "Doing Business" Index (World Bank, 2014).

Charts six and seven focus on changes in Gross Domestic Product (GDP) since 1961. GDP is basically the total price of goods and services produced by residents of Malawi. These graphs are based on US$ to filter out the volatility of the local currency. Together the two graphs paint a picture of a slow-growing and volatile economy which does not keep pace with population growth.

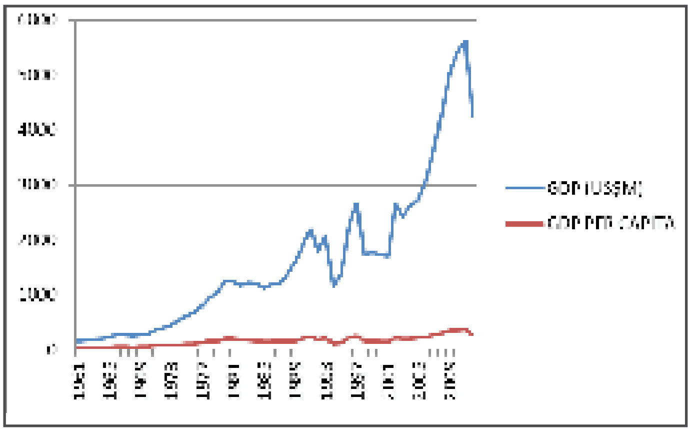

Chart six: GDP (US$M) and GDP per capita

Source: World Bank national accounts data, and OECD National Accounts data files.

The chart shows the obvious increase in GDP over time, but mapping it against the GDP per capita shows how the growth has not, even in macroeconomic terms, translated into wealth for the people of Malawi since the population growth has roughly matched the overall growth in GDP.

Chart seven makes the volatility in GDP a little clearer, by taking the overall level of GDP and mapping the year on year changes since 1962.

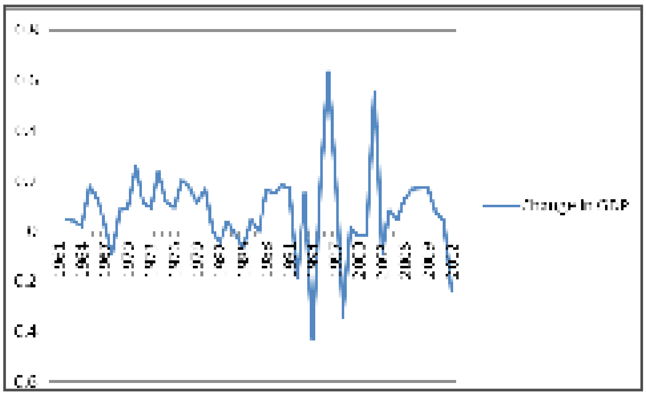

Chart seven: Year-on-year changes in GDP, 1962 to 2012

Source: World Bank national accounts data, and OECD National Accounts data files.

The chart illustrates two things: the very low rates of economic growth in the years in which the change is positive, and the volatility shown in the 1990s and again in recent years.

Gross macroeconomic figures like these can mask the impact on the people of a country, and so they need to be taken in the context of the inequality figures above. Another important variable is inflation, which is basically the annual percentage change in the cost of a standardised basket of goods and service. Chart eight shows this over the thirty years since 1981.

Poverty and Inequality statistics

Ratio of top to bottom income quintiles 1000%	
% of population earning less than US2 per day	**82%**
Consumer Price Inflation (2012)	**21.7%**
Life expectancy at birth (2012)	**54.8 yrs**

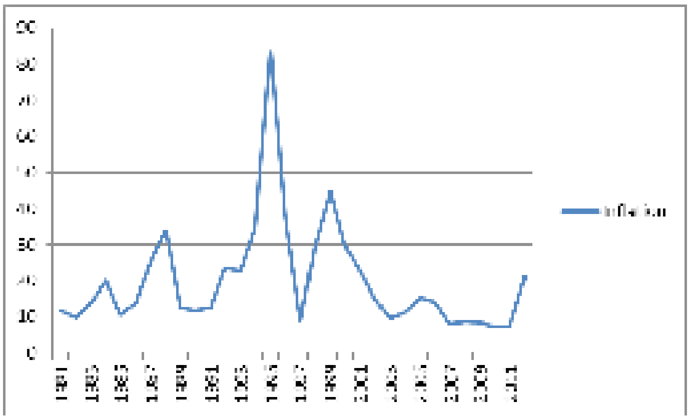

Chart eight: Annual inflation figures

Source: International Monetary Fund, International Financial Statistics and data files.

Annual inflation has rarely fallen below 10%, and shows a worrying trend upwards reaching a staggering 22.6% in May 2014 (IMF 2014). This has obvious hardship implications for poor people, a severe adverse impact on lending rates and both directly and indirectly discourages the sort of small scale investment and saving that can produce prosperity.

4.3: Aid dependency

Charts nine and ten illustrate the scale of overseas development assistance (ODA) to Malawi, in the context of the domestic economy.

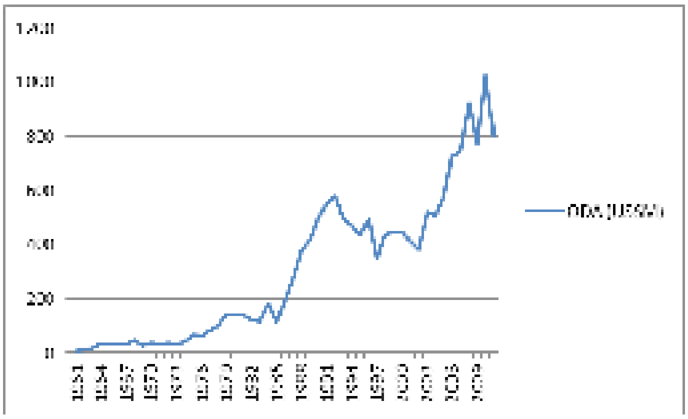

Chart nine: Overseas aid and development inflows, 1965 to 2012

Source: Development Assistance Committee of the OECD, Geographical Distribution of Financial Flows to Developing Countries, Development Co-operation Report, and International Development Statistics database.

The volatility of this inflow of ODA can be more clearly seen in the context of the level of domestic activity in the economy. Chart ten presents the level of aid as a percentage of the Gross National Income (GNI) of the country in each year

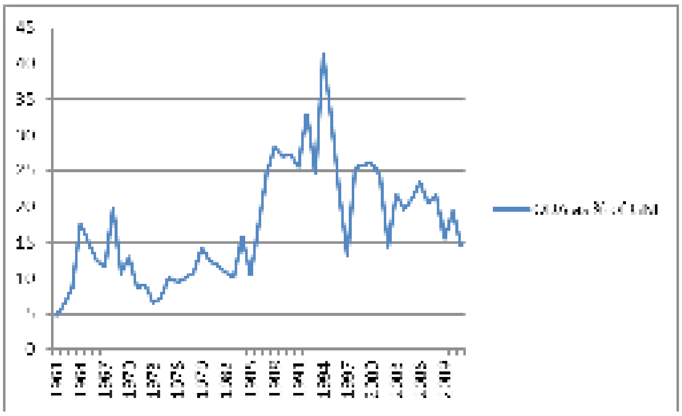

Chart ten: Overseas aid and development inflows as a % of GNI, 1961 to 2012

Source: Development Assistance Committee of the OECD, Geographical Distribution of Financial Flows to Developing Countries, Development Co-operation Report, and International Development Statistics database.

There is no sign of this irregular level of aid being replaced by a more stable flow of domestically-generated taxation (see section 4.6 below) or of inward investment. While Africa as a continent receives less foreign direct investment (FDI) per capita than other regions, (Shiferaw-Mitiku 2014) reports Malawi's share of the total African FDI as consistently below 1% from 1980 to 2010, and at only 0.55% in the most recent decade, 2001 to 2010, a trend also noted by (Nsiku 2013).

4.4: External debt

Chart eleven, based on World Bank data shows the total external debt stocks in Malawi over the ten year period from 2002 to 2012.

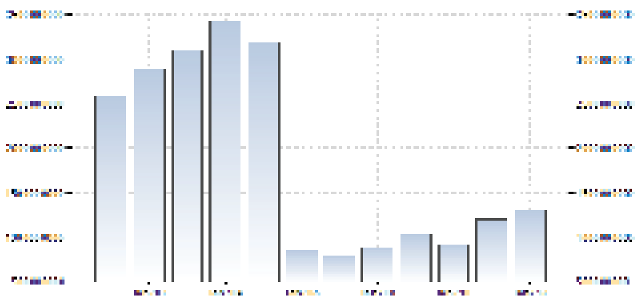

Chart eleven: Total debt owed to non-residents, US$, 2002-2012

Source: World Bank data, via www.tradingeconomics.com

The chart shows the impact of the most recent write off of external debt, and the subsequent creeping increases in debt levels, largely due to devaluations of the local currency.

In an interview to the BNL Times in April, 2014 (Gondwe, 2014), the Ministry of Finance Deputy Director Lukes Kalilombe gave the breakdown of Malawi's external debt as of June 2013 as follows:

Total External Debt Stock:
 - owed to multilateral creditors
US$966.5 million

 - owed to bilateral creditors
US$366.2 million

The breakdown of the debt to multilateral creditors was reported by Mr Kalilombe as approximately 40% to the World Bank, 20% to IMF, 20% to the African Development Bank Group and 20% to a mix of IFAD, EIB, NDF, BADEA, OPEC Fund and PTA Bank. The bilateral creditors were reported as including Taiwan (US$10 million), Mainland China (US$204 million), India (US$97.90 million), Kuwait (US$10.19 million), France (US$10.20 million), Belgium (US$2.10 million) and Saudi Arabia (US$1.10 million).

More recently, as reported in the Malawi Voice in mid-July 2014, a spokesperson for the Malawian Ministry for Finance confirmed the overall level of external debt at US$1.4 billion, with an annual servicing cost of US$10m for the foreign debt (Malawi Voice 2014). This clearly imposes a near-overwhelming pressure on the domestic budget.

Chart twelve shows the net financial flows from external debt from 1985 on. This is basically the cost of servicing long-term external debt and IMF payments, where long term debt is defined as debt that has an original or extended maturity of more than one year and that is owed to non-residents. Note that Malawi joined the IMF in 1965, and as at the end of July 2014 its position vis a vis the fund was a debt of approximately 127 million SDR (the international reserve of the IMF), or approximately US$194 million using the current valuation rate (IMF 2014a).

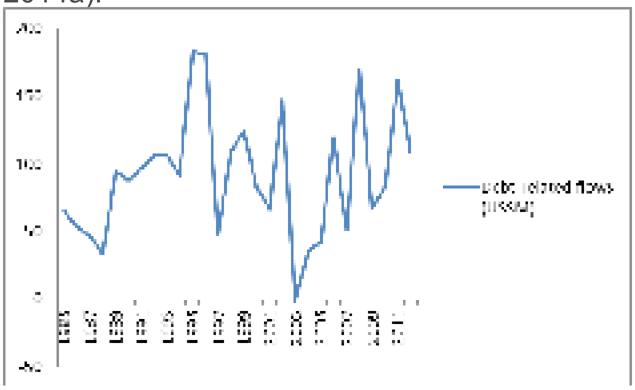

Chart twelve: Net financial flows from external debt, 1985 to 2012

Source: World Bank, International Debt Statistics.

The chart shows not only the level, but the disturbing volatility of the cost of servicing long-term debt. In the context of these massive and variable outflows from the country, it is not difficult to see why domestic infrastructure remains underdeveloped.

4.5: Internal debt

A concern, given the rate of inflation, is the level of interest rate charged on domestic debt. IMF (2014) report the Reserve Bank of Malawi's policy interest rate at 22.5% in early July 2014. This has obvious adverse consequences for access to finance for domestic Malawian business.

Chart thirteen shows two measures of credit and debt within the Malawian economy. Bank loans includes all credit to all sectors including state bodies from banks. Domestic credit refers to loans to the private sector only. All the figures are given as a percentage of GDP, and so form a measure of scale rather than of absolute activity.

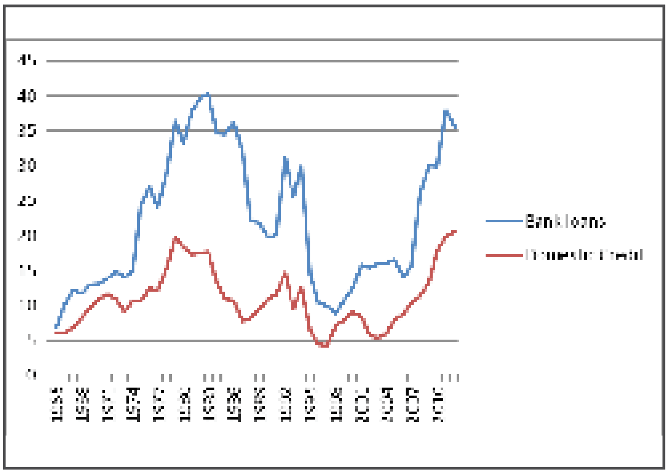

Chart thirteen: Bank lending and domestic credit, 1965 to 2012

Source: World Bank's World Development Indicators

The chart shows rising debt and credit within the Malawian economy. However, the banking infrastructure remains underdeveloped in the country, and the unbanked population remains very significant. Chart fourteen shows the number of people per thousand of population who held a deposit in a commercial bank over the last five years.

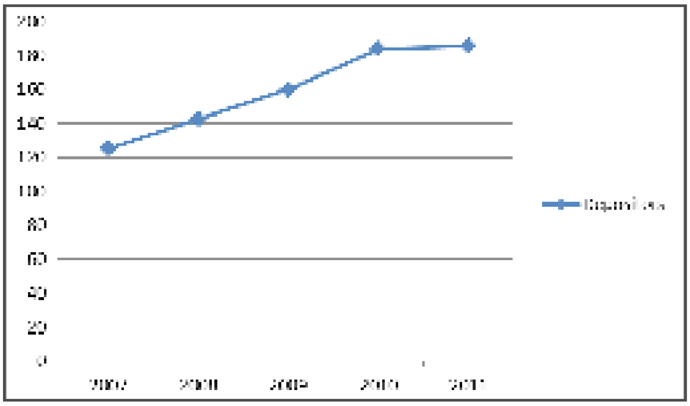

Chart fourteen: Bank depositors per thousand of population, 2007 to 2012

Source: World Bank's World Development Indicators. Note that data for 2008 is not available, and has been extrapolated from adjacent years.

Fewer than 20% of the population hold a bank account, and the growth in the proportion of the population which is banked has slowed in the most recent year for which figures are available. While there is a growing microfinance industry in Malawi, the pricing on these loans and deposits is not always transparent, and the Annual Percentage Rates (APRs) on loans can be very high. See data and analysis here: http://www.mftransparency.org/microfinance-pricing/malawi/.

4.6: Taxation

One of the most obvious drivers of inequality and poverty in Malawi is the consumption tax or sales tax. (Mussa 2014) examined how inequality in spending of Malawian households on health, education and food impacted on overall inequality. In a result that holds for both the urban and the rural poor, they found that their 'results vindicate the exemptions and zero rating of some food, health, and education related goods and services under the Value Added Tax (VAT) system. More importantly, they also suggest that expanding the coverage of zero rating and exemption would have a poverty reducing effect."

Beyond the direct impact of consumption taxes, which as noted by (Killian 2011) is a politically expedient tax particularly when tariffs have been phased out at the behest of large institutional lenders, there is also an indirect impact. Consumption taxes force the burden of collection on to tax-compliant traders. This in turn gives a market advantage to traders who remain in the informal economy, making more difficult the task of persuading the population that taxation is a sound basis for development. This is a particular problem in Malawi, a country where more than 75% of the population report that getting information on the tax they owe is difficult, and where, unlike most countries in the region, a majority of the population does not support taxation as a source of revenue for the government (Aiko and Logan 2014). This is echoed by (Magalasi 2009) who recommends more taxpayer education, making the point that this will also address the problem of tax corruption in Malawi.

This is reflected by the relatively flat share of overall taxation deriving from Income Tax reported by (Okello 2014), which he attributes in part to the fact that the self-assessment system in Malawi for income tax only extends to large taxpayers.

Chart fifteen below from (Mansour 2014) shows the overall taxation collected in Malawi as a percentage of GDP over a thirty year period to 2010.

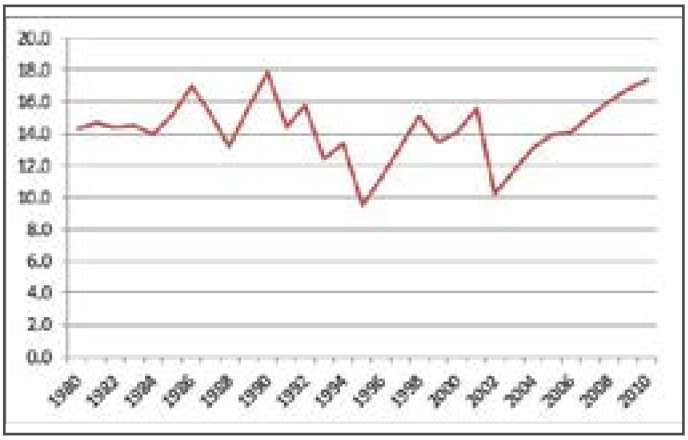

Chart fifteen: Total tax collected as a percentage of GDP

Source: Mansour (2014)

Within this, direct taxes across business and individuals consistently account for less than 9%, again highlighting the high dependence of the exchequer on indirect taxes including consumption taxes. Corporate Taxes have not amounted to more than 3% of GDP in Malawi since 1997 (Mansour, 2014:21).

(Kamlongera 2013) notes that the Malawian government actively seeks foreign direct investment, but that a lack of regulation in some sectors, notably the mining sector, means that the full potential benefits to the host community may not be realised. While noting that indirect financial and regulatory incentives tend to be less visible than published tax incentives, (Nsiku 2013) describes the various incentives offered by Malawi to attract FDI. These include:

- 100% tax depreciation on new buildings and machinery
- 40% tax depreciation on used buildings and machinery
- 50% tax depreciation on training
- A two-year accelerated operating expense deduction for manufacturing companies
- Additional allowances in designated industrial zones.

Perhaps more significant are the tax rebates and exemptions in imports. These can militate against local enterprise. For instance, (Nakagawa, Bahl et al. 2009) observe that in the dairy industry, local producers are disadvantaged as they pay a sur-tax on packaging, while imports are exempt from this. Another major concern is that in the mining industry, a wide range of incentives exist but are not uniformly applied, replaced by 'discretionary incentives' negotiated on an ad-hoc basis between the government and the investing company. (Nsiku, 2013:10).

These discretionary incentives are problematic, not only in perhaps being poor value for money from a government perspective, but also in reducing the overall transparency in the system, and creating a climate where a negotiated deal is to be expected. One step towards greater transparency in the tax affairs of multinational firms would be to maintain a comprehensive network of tax treaties. This would make it externally clear which withholding taxes will be applied to transfers of funds across Malawian borders. Magalasi (2009) reports that as of 2009, Malawi had double tax treaties in force or awaiting ratification with United Kingdom, Mozambique, Botswana, Sweden, Denmark, Switzerland, France, United States of America, Netherlands, and Kenya and South Africa, and treaties were under negotiation with Norway, Zambia, Egypt, Seychelles, Mauritius, Republic of China, Zambia and Zimbabwe. However, as of 2014, (E&Y 2014) reports that not all of the treaties are operational, although the treaty with Norway has been ratified. A concern is that according to (E&Y 2014a) residents of the UK, Sweden, Denmark, Switzerland, France, the Netherlands, Norway and South Africa are not subject to any Malawian income tax on Malawi-source income. Withholding taxes are imposed at rates varying between 10% and 20% on various sources of income under the terms of the double tax treaties.

It is unclear that the tax incentives on offer have a long-term sustainable impact. For example, in a study focused on the tourism industry, (Nsiku and Kiratu 2009) find that while the investment incentives appear to have had a negative impact on the environment, their impact on foreign direct investment in the tourist industry has been insignificant. Nkisu (2013) also notes that as well as costing the government directly in terms of revenue foregone, the incentives on offer for foreign investment have the potential to crowd out local investment, and in the case of the individuallynegotiated deals, have the potential for misuse as well as higher administrative costs than simple, transparent measures. This indicates that a rethink of the nature and focus of these incentives may be useful, and an evaluation of their relative cost and benefit undertaken in a holistic manner would be a useful study.

Overall the tax system in Malawi is characterised by opacity, bureaucracy, low tax morale, a high level of tax foregone through investment incentives whose value has not been established, a rising burden on individuals through consumption taxes and income tax, non-transparent negotiations between individual mining firms and the government, and an overall unsustainability, with expenditure consistently overshooting tax revenue, reinforcing the dependence of the country on overseas aid.

4.7: Currency Volatility

Underpinning much of the fiscal fragility of Malawi is the volatility of the local currency. This is perhaps best shown graphically. Chart sixteen shows the value of one US dollar in Malawian Kwacha over the past two years.

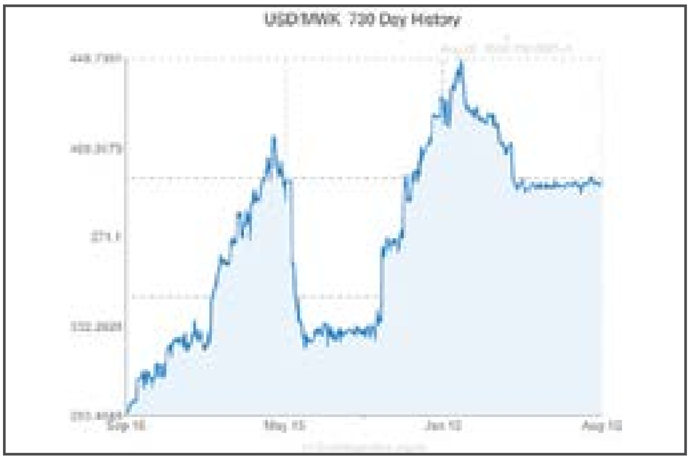

Chart sixteen: Average Weekly exchange rates, US$/MWK, July 2012 to 2014

Source: www.exchangerates.org.uk

This impacts on the everyday lives of people in the country partly because of the importance of remittances from migrant workers overseas, and partly because much of the country's external debt is denominated in other, stronger currencies. Since local taxes are collected in Kwacha, when the currency is devalued this adversely impacts on the government's ability to meet external debt servicing costs which might be expressed in US Dollars.

4.8: Mining in Malawi

In a report for Norwegian Church Aid and the Malawi Catholic Commission for Justice and Peace, Curtis & Hajat (2013) makes the case that Malawi's lack of a strong governance framework in the mining sector results in losses of millions of dollars in potential revenue each year. Lack of transparency means that figures for the total revenue received from the mining sector are not readily available, and cannot be independently verified. The report questions the ballpark figures provided by the Government of Malawi, arguing they are exaggerated. For example, the most recent figure provided by Government was 'slightly over MK 2 billion' in 2010. The report points out that this amounts to only 0.76 per cent of government revenues in 2010, despite mining comprising 10 per cent of Malawi's exports.

As outlined in the taxation section above, a wide and non-transparent range of tax incentives is offered to operators in the mining sector. Dzonzi (2012) estimates that mining tax incentives may have cost Malawi US$ 217 million from 2008-12,

The work of Curtis & Hajat (2013), in detailing a controversial agreement between the Government of Malawi and an Australian company, Paladin, signed in 2007, is a good illustration of the opacity of arrangements in this sector. According to the researchers, the Government of Malawi reduced Paladin's corporate income tax rate, abolished its obligation to pay Resource Rent Tax, reduced its royalty rate to an initial 1.5 per cent (5 per cent is the national rate) and gave it other tax concessions for 'at least' 10 years. This was in return for a 15 per cent stake in the project.
Curtis & Hajat (2013) highlight a discrepancy between internal figures from Paladin, indicating that they paid US$ 1.6 million in tax in 2012, and the higher totals in their annual report. They also highlight a lack of congruence between the level of exports of uranium to Canada and Namibia reported by Paladin and the level reported by the Government of Malawi and in the UN trade database, noting that the non-company figures would suggest a far higher royalty payment was due. In fact, they calculate that the royalty ultimately paid by the company was lower than the reduced rate of 1.5 per cent negotiated by the firm. Paladin has a complex group structure with subsidiaries in Switzerland, the British Virgin Islands, and Mauritius, making it difficult to gain straightforward answers to these questions.

an average of US$ 43 million per year. To put it into context, that is nearly 2.5 times the amount that Irish Aid provided to Malawi in Official Development Assistance in 2013 (Irish Aid, 2013). Curtis & Hajat (2013) express it like this: "Malawians are in effect paying for the privilege of mining companies to operate in their country. The [..] lost revenue could pay for over 60 per cent of the costs of the Ministry for Health in 2012/13 or the entire budget [..] for public universities."

Norwegian Church Aid and the Catholic Commission for Justice and Peace are calling on the government of Malawi to conduct a root and branch reform of mining legislation in Malawi to include access to financial information, inclusion of community consultation in mining agreements, tackling of community resettlement issues and minimum standards regarding government equity in mining agreements. Specifically, they call for the government to:

- Annually publish all revenues from mining, including all tax payments (and indicate that all mining companies should do the same) and all tax expenditure (ie: losses from tax incentives);
- Annually produce an inclusive and wide-ranging review of all tax incentives;
- Make all bespoke mining agreements public (including that of Paladin) & involve a wider range of stakeholders including affected communities in the negotiation of new agreements;
- Conduct an investigation of transfer pricing practice in the mining sector and implement transfer pricing legislation;
- Ensure a minimum of 30% Government equity in mining operations.

They also call on all donor governments to Malawi to press mining companies in the country to make tax related financial information publicly available.

5. Summary and Conclusions

Malawi's economic picture is bleak. Despite relatively recent debt relief, the overall level of external debt is creeping into unsustainable levels, largely due to currency devaluations. Meanwhile inflation is at unsustainably high levels, with a knock-on impact on domestic interest rates as well as prices of basic commodities. Such high inflation also reduces the motivation for saving, a serious concern in a country with a large part of the population unbanked.

The financial infrastructure remains underdeveloped, particularly in terms of its fitness for purpose in dealing with the poor. A graphic example of this is the high cost of cash remittances. Without access to savings, credit and insurance facilities, small enterprise cannot flourish. Regulation is needed to address this.

The tax system is inadequate to meet the current level of government expenditure, partly due to the debt burden and partly to the narrowness of the tax base. A very high proportion of the revenue comes from consumption taxes which tend to be regressive and to exacerbate poverty. The taxing authority may benefit from capacity-building, assistance in negotiating double tax treaties and putting in place a comprehensive taxpayer education programme. A process of evaluating existing tax incentives is urgently required, and a more transparent system should be put in place particularly in the mining sector.

The country is lamentably dependent on overseas aid, which is volatile and largely unsustainable. It would be useful if the donors were to focus some efforts on building up the economic infrastructure of the country, as well as continuing to address the urgent issues of health, education and food security.

The country faces a perfect storm of limiting factors, and in order to resolve these extremely challenging and interlocking issues, the economy needs a step-change. Debt relief of a radical nature, combined with support for a pro-poor financial infrastructure, and an overhaul of the tax system is one option that should be pursued. Action needs to be taken at a national and an international level, by the Malawian government, international bodies, and donor countries including Ireland.

The following five suggestions are possibilities for action at a national level.

- A shift from consumption taxes to taxes on income not only to benefit the poor, but also to remove the strategic tax advantage currently enjoyed by the informal sector. This in turn would encourage more of the population to become banked, benefit the formal sector, broaden the tax base and create a more sustainable revenue basis for the country.

- An expansion of the zero-rating for consumption taxes to a wider range of goods and services in the health, education and food sectors would make these more accessible to poorer people, and so would reduce inequality and poverty

- Regulation on cash transfers, particularly on small remittances from migrant workers abroad, to eliminate a serious injustice in the level of charges on these transfers.

- Work needs to be done to make the tax system more transparent and linked to service delivery and on taxpayer education. Transparency is especially needed on tax incentives in the mining sector, and with regard to bespoke tax deals with inward investors, to address issues of moral hazard and tax morale. Increased transparency, in addition to a root and branch review of corporate tax incentives should aim to end the high and untransparent tax breaks awarded to the corporate sector. This, coupled with a reversal of regressive taxes which impact on poor people the most, would be a step toward a fairer tax system

- A comprehensive review of investment incentives, perhaps assisted by Malawi's donors.

6. Key proposals for Ireland and other donor countries

It is important to consider these suggestions in context. No action should be taken before an open and constructive consultation with the appropriate partners in Malawi. The list below is intended to start a conversation on what actions might be taken or suggested. It is important that they are localised in implementation to take account of the extreme poverty and lack of infrastructure in Malawi, and to play, where possible, to the country's strengths.

With that important caveat, the following proposals are actions which could usefully be taken by the Irish government.

1. Use Ireland's influence within international bodies to push for debt relief for Malawi, as an urgent measure to introduce a step-change to the economy and address the fact that external debt levels are creeping up steadily to an unsustainable level.

2. Negotiate a Tax Treaty with Malawi (and perhaps some neighbouring countries on a multi-lateral basis) using the UN model as the template. The treaty negotiation and agreement process is a long one, and Malawi's network is sparse. This makes it more difficult for them to attract foreign direct investment, reduces the transparency in their tax arrangements with multinational firms and leaves them open to harsh terms if treaties need to be agreed at short notice in order to facilitate a major investment. By negotiating a UN-model treaty with Malawi in the absence of a pressing investment need, Ireland can set a precedent for fairness in tax matters for Southern countries and strengthen the network and experience of Malawi's taxing authority.

3. Add a focus for aid on measures to expand the banking system, perhaps using mobile technology, to make it accessible and useful for the 80% of the population currently unbanked, and to implement a Financial Reforms programme to address the mobilization of domestic savings and better financial intermediation. While this may not be something to be delivered directly by Irish Aid, it could be undertaken under the leadership of Irish Aid and the Department of Enterprise, Jobs and Innovation as a coordination of private company and public sector initiatives.

4. Offer practical assistance and support for a comprehensive review of investment incentives offered to multinational firms, as called for by many Malawian CSOs, and support CSOs to input into that process.

5. Use Ireland's influence within OECD, EU, World Bank and IMF to support Malawi in designing and strengthening their own tax systems and to continue to impose trade tariffs

and customs duties where necessary. This could be done in combination with an expansion of the work of the Irish Revenue in Rwanda, to strengthen the domestic revenue-generating capacity of the Malawian tax authorities.

6. Assist in drafting a wider range of tax treaties, particularly focused where possible on following the UN model rather than the OECD. Again, the expertise and experience of the Irish Revenue could be useful here.

7. Support the introduction of wideranging international reform on tax transparency including: full, publicly accessible country-by-country financial reporting by multi-national companies; the automatic exchange of information on tax matters between tax jurisdictions in a way that supports participation from countries like Malawi.

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