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CONCEPT STAGE

Report No.: AB2789

Project Name	Business Environment Strengthening Technical Assistance (BESTAP)
Region	AFRICA
Sector	General industry and trade sector (100%)
Project ID	P103773
Borrower(s)	GOVERNMENT OF MALAWI
Implementing Agency	Ministry of Industry, Trade and Private Sector Development
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1. Key development issues and rationale for Bank involvement

Private Sector Development Issues:

1. The constraints to private sector development in Malawi are well-known, due in part to the large amount of analytical and diagnostic work that has been carried out in recent years. In particular the Investment Climate Assessment of 2006 based on a detailed survey of 300 enterprises, and the annual publication of Doing Business survey indicators has helped to focused the reform efforts of the Malawi Government.

2. The poor regulatory environment for business impedes investment and constrains private sector development. Firms in Malawi face numerous hurdles in terms of red tape, regulations and requirements in carrying out every-day business activities. Many of the key laws which govern private sector activity are out of date and in need of wholesale revision. Limited legislative capacity and the low priority attached to reforming the business environment in the past mean that there is a large backlog of legislative change that has yet to be implemented. In addition, gaps have been revealed in the legal framework – for example, the absence of an enabling law for creating a registry of charges or credit reference bureaus, reduce the scope for private sector initiatives in improving access to finance.

3. Overall Malawi is ranked 110 out of 175 countries on the Doing Business indicators. While such qualitative surveys only give an indication of the overall enabling environment for business, it is clear that

the private sector in Malawi suffers from a heavy regulatory burden. Malawi's performance compared to neighboring countries in Sub-Saharan Africa is actually quite good; however the country needs to be well above regional averages in order to offset the disadvantages of being landlocked.

4. The economy is characterized by weak contract enforcement and limited access to commercial justice. Criminal and political cases tend to absorb most of the capacity and receive higher priority in Malawi's judicial system, resulting in a large backlog of commercial cases. In addition, the judiciary is ill-equipped to deal with the more complex cases, particularly involving liquidation. According to the Doing Business indicators, the average recovery rate after insolvency is just 13.2 cents on the dollar. Similarly it takes an average of 377 days to enforce a contract and costs an average 136.5 percent of the debt to claim payment[1]. With an average enforcement cost greater than 100 percent of the debt, it is unsurprising that few enterprises resort to the courts. The net effect is a general reluctance within the private sector to extend credit facilities or enter into contract arrangements to all but the most trusted of clients. Although arbitration and mediation of commercial disputes are provided for in law, the institutional framework for accessing these services does not exist. If these alternative dispute settlement mechanisms were working well, contract enforcement and access to commercial justice would be much improved in Malawi.

5. Low capacity in property rights institutions prevents the private sector from unlocking the value of fixed capital. The process for registering the ownership of land in Malawi is based on two parallel systems: deeds and titles. Entirely centralized and manual systems, together with excessively bureaucratic procedures make the transfer of private property a slow process. According to the Doing Business indicators, it takes an average of 118 days to fully secure rights to property[2]. This acts as a deterrent to foreign investment where land is required, and makes it difficult for businesses to use private property as security for borrowing. This also limits the scope for the securitization of land-based assets and their use as collateral to improve access to finance.

6. Similarly the process of registering a company or business name is also subject to a single centralized and manual system that is based in one corner of the country and is both slow and costly for the private sector. The Doing Business indicators show that it takes an average of 135 percent of GDP to start a business[3] This contributes to barriers to entry and to costs of formalization that impede the growth of a vibrant SME sector.

7. A cumbersome business licensing regime imposes unnecessary costs on the private sector. A complex web of overlapping licenses and permits, many of which serve only a very marginal regulatory function, govern the environment in which enterprises operate. This creates obstacles to the process of market development by raising the costs of business entry and growth and creates barriers to transition from the subsistence and very small scale economy to the modern more productive sector. Excessive licensing requirements also create opportunities for rent seeking behavior among bureaucrats, to the obvious cost of the private sector. Many entrepreneurs in Malawi remain trapped in the informal private sector due to the high costs of formalization, partially associated with licensing requirements. Such firms, therefore, are unable to grow and benefit from economies of scale or access the additional benefits of formalization such as bank finance and business development services.

8. Inadequate infrastructure services undermine the competitiveness of goods and services produced in Malawi. Years of underinvestment and poor state management of the key power, water and telecommunications utilities has resulted in high costs, unreliability of service and poor outreach. This is a

[1] Doing Business database (2006)
[2] ibid
[3] ibid

major contributing factor to low firm level competitiveness in Malawi's private sector and hence, to the country's inability to take full advantage of available export trade opportunities.

9. 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. The poor state of transport infrastructure, not least in transit countries en route to major ports, contributes to the high costs of production. A more adequate infrastructure platform would make Malawi's economy more competitive. Yet, the public resources available (even when donor resources are taken into account) are not enough to close this "infrastructure deficit".

10. Weak policy analysis, formulation and implementation create uncertainty in the private sector. Dialogue between the public and private sectors in Malawi has historically been very weak and characterized by distrust, and occasional hostility. Limited consultation and partnership with the private sector has tended to result in poorly informed public sector decision making that often fails to foresee the impact of decision on the private sector. A general lack of mutual accountability between the public and private sectors has also resulted in very weak policy implementation and, therefore, disappointing results.

11. Low cost advantages are eroded by the limited availability of skilled workers and the low productivity of labor. Evidence from the recently completed Investment Climate Assessment suggests that Malawi possess a comparative advantage in the region in terms of low-cost labor. However when considering total factor productivity, that is taking into account the relative costs and returns to both labor and capital together, Malawi's cost advantage evaporates.

12. Limited access to finance is the leading constraint to private sector investment. The Reserve Bank of Malawi's base rate was reduced from 25 to 20 percent in November 2006. This is a welcome step in terms of reducing the cost of finance to the private sector, especially given that base rates were as high as 45 percent in 2004. Previous government budget overspending and a reliance on domestic borrowing resulted in severe crowding out of private sector lending in the banking system.

13. A lack of a national identification system makes it difficult for credit providers to assess client credit-worthiness and identify whether loans have already been secured against assets, thus resulting in an excessively cautions approach to small business lending.

Rationale for Bank Involvement

The Government of Malawi has finalized a new national development strategy, the Malawi Growth and Development Strategy (MGDS) which was discussed by the World Bank and International Monetary Fund (IMF) in …, 2006. The MGDS merges the previous social sectors focus of the Malawi Poverty Reduction Strategy (MPRS)[4] with the productive sectors focus of the Malawi Economic Growth Strategy (MEGS)[5]. The causality is clearly seen in terms of achieving poverty reduction through economic growth. Fundamentally, the MGDS is a private sector led growth strategy which recognizes the private sector as the "engine of economic growth". The strategy aims to achieve the Presidential vision of transforming Malawi from being a predominantly consuming and importing country, to one which produces and exports.

Malawi's recent attainment of irrevocable debt relief under the Highly Indebted Poor Countries (HIPC) initiative signifies the return to macro-economic stability that has been championed by the current administration. Despite poor rains and a major food security crisis in 2005/06, Malawi has managed to

[4] Launched in 2001, the MPRS notionally expired in 2005, hence the need for a new national development plan.
[5] Developed in 2004 in order to strengthen Pillar One (Sustainable Economic Growth) of the MPRS.

maintain budgetary and fiscal discipline, and see improved exchange rate stability and relative reductions in inflation and interest rates. Such macro management has regained the confidence of the international community, demonstrated by resumption of budget support by bilateral donors, a new IMF Poverty Reduction and Growth Facility, and through debt relief. A stable macroeconomic environment is a pre-requisite for sustainable private sector development, and Malawi's strong progress in regaining macro stability means that the Government is increasingly looking to a "second generation" of reforms in the domestic business environment which will seek to stimulate private sector investment and employment creation.

The 2006 Malawi Investment Climate Assessment (ICA) provides an up-to-date picture of Malawi's private sector and an effective base line assessment prior to the launch of private sector reforms. Results from the ICA show that Malawi's manufacturing sector is small (accounting for just 11 percent of GDP) and inward oriented (only 14 percent of manufacturing output is exported). Malawi's low cost labor advantages are eroded by poor productivity resulting from poor infrastructure, unreliable utilities and difficulties in accessing affordable finance.

The ICA findings confirm the results of previous studies including the 2004 Diagnostic Trade Integration Study (DTIS), which found that many firms are constrained by the small domestic market. The evidence is increasingly showing that the binding constraints to improved trade performance in Malawi lie on the supply-side of the economy. Expansion by Malawi's domestic private sector into regional markets is essential for the country to diversify away from its vulnerable reliance on exports of tobacco, sugar and tea. With the structure of the private sector being a few large firms at the top, many small ones at the bottom and a "missing" middle, a key policy challenge in Malawi is therefore to encourage the large number of small enterprises (many in the informal sector) to grow into the middle space by reducing the costs of formalization and of doing business.

In response to the challenges facing the economy outlined above, the Government - through the Ministry of Industry, Trade and Private Sector Development - is leading a PSD reform program that will seek to put private sector development at the heart of Government service delivery. The Government's PSD program draws upon the Bank's ICA and the WB/IFC Doing Business surveys as its analytical foundations and as the basis for monitoring the progress of reforms in key areas affecting Malawi's business environment.

2. Proposed objective(s)

The project will support acceleration of economic growth by reducing the cost of doing business, improving service delivery to the private sector and providing targeted support to small and medium enterprises.

3. Preliminary description

Basis: Malawi ICA identified the following key constraints: Macroeconomic Stability; Cost and Access to Finance; Infrastructure, in particular availability and cost of infrastructure, Taxes and Skills.

Project Components: The project will try and address these and other priority constraints, under the following pillars:

(a) Business Environment: Support to the efforts being made by various technical working groups to improve the regulatory environment (as reflected in the Doing Business indicators), e.g. (a) TA for establishment and running of commercial courts which significantly improve access to commercial justice; (b) TA to the Ministry of Justice would fast track the updating and revision of economic laws; (c) TA to improve customs processes, to facilitate import-export trade, including assistance for harmonization of procedures and documentation at borders, and computerization of immigration processes at borders; (d) TA to improve administration of taxes, including streamlining of number of agencies involved in paying taxes, and simplification of tax forms and processes involved in filing and paying indirect taxes; (e) On going TA for the Doing Business Reform agenda.

(b) Support to Agencies that Serve the Private Sector: To improve the volume and quality of service delivery to the private sector, and as part of the efforts to strengthen the business environment, this component would involve building capacity in some key public sector institutions directly supporting the private sector: e.g. the Registrar General, Lands Registry, the Malawi Bureau of Standards and the Malawi Confederation of Chambers of Commerce and Industry. Support to the establishment of a Public Private Partnerships (PPP) unit, currently under discussion and the Malawi Investment Promotion Agency, is also a possibility. Upon the completion of the Privatization and Utilities Reform Program (PURP) in June 2007, a number of privatization transactions will remain uncompleted. A small fund would be provided to follow through on the completion of these transactions, e.g. Shire Bus Lines, ESCOM, Air Malawi, etc. Such a fund would enable sufficient flexibility for opportunistic responses to made for needs that may occur during the implementation of the project.

(c) Promoting Access to Finance and enhancing productivity of MSMEs: This component could include IDA participation in promotion of a development fund, involving the private sector with a contribution by Government (discussions have already been initiated with GoM on this). Another possible sub component would be TA for the merger and restructuring of the Malawi Rural Finance Corporation and the Malawi Savings Bank into a viable rural micro finance institution. Discussions have already begun and the expected result of such a merger would be an increase in opportunities for SME financing. The provision of business development services (BDS) services will assist this objective by helping entrepreneurs improve their preparation and presentation of bankable SME projects. In addition, other instruments, such as a Business Plan competition (initiated with much success in Rwanda and Ethiopia) might be considered. Support to micro and small enterprises in improving their level of skills (for entrepreneur and workers) through a matching grants or similar fund. Such an instrument would be based on the principle of a matching contribution from the entrepreneur or worker seeking training, thereby ensuring a degree of commitment to the training, and funds disbursed - which could be for a variety of specifically described purposes for activities to be funded under this component - would be accompanied by a hand-holding component, whereby the fund managers would assist in identifying relevant training courses and opportunities.

4. Safeguard policies that might apply

Although the Borrower has limited safeguards policies capacity, it is expected that none of the safeguard policies will apply. During project preparation, the borrower's current capacity will nevertheless be assessed and measures to strengthen it identified. As appropriate, the project will outline the institutional arrangements, including the roles and responsibilities of the various stakeholder groups, to implement and monitor environmental and social mitigation measures, and make appropriate recommendations.

5. Tentative financing

Source:		($m.)
BORROWER/RECIPIENT		0
INTERNATIONAL DEVELOPMENT ASSOCIATION		15
EUROPARTNERS BANK		3.7
	Total	18.7

6. Contact point

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