

WP/01/17

MRA Working Paper

Tax Policy and Administration Evolution and Revenue Performance in Malawi

A paper presented at the Inaugural ECAMA-IFPRI Research Symposium "Achieving Inclusive Sustainable Economic Growth from Rhetoric to Practice" held in Lilongwe Malawi 8th-10th October 2014.

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MALAWI REVENUE AUTHORITY

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June 23, 2017

Abstract

Since independence, Malawi has implemented a number of policy reforms in the area of taxation. The taxation policies had different objectives to achieve including: increasing Government revenue generation; improving levels of investment and exports; and improving efficiency and fairness. The major policy changes in taxation also included restructuring of the tax administration by merging two tax-collecting departments into one organization, the Malawi Revenue Authority. The driving force for the shift in tax policy agenda has been Government, international multilateral institutions and development partners, particularly the International Monetary Fund and the World Bank. This paper analyses tax policy changes and the impact of these policy shifts by looking at the trend and performance of revenue collection. Our analysis has shown that tax policy changes have resulted into mixed results. In real terms, tax collection has continually increased as percentage of GDP from 10 to 21 percent; In addition, the tax base still remains very narrow despite increased levels of entrepreneurship signaling high levels of informal businesses and low tax compliance.

Keywords: Malawi; tax policy; buoyancy; elasticity; compliance, IMF, World Bank

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1 Introduction

In the last five decades, the Malawi tax system has undergone a number of policy reforms with varying objectives, either in the short or long-term. Some of the key objectives were: increasing revenue generation capacity; encouraging both domestic and foreign investment in the economy; promoting equity and efficiency as well as international trade competitiveness. Despite all these reforms, the tax system does not generate sufficient revenue to keep pace with the ever growing government expenditures. Consequently, the budget deficit has widened leading to heavy reliance on budget support from the donor community[1]. Lately, Malawi has been rated as the country with lowest GDP per capita in the world[2] implying that there is a greater need for increased public expenditure in poverty reducing programs. Government is, therefore, challenged to establish a robust revenue base relative to its expenditure requirements within the framework the poverty eradication programmes. Like most countries in the world, Malawi depends heavily on taxes to generate resources for the provision of public services demanded by her citizenry. Soon after independence, the government realized the resource constraint it faced, given the expectations the Malawian population had to have their lives changed for the better. This prompted the reformation of the tax system the country inherited from the British government with a view of generating adequate revenues to finance the ever growing public expenditures. However, the earlier tax reforms were taken on an ad-hoc basis, lacking long-term vision, in-depth macroeconomic analysis and proper coordination, which led to deterioration of the tax system and causing severe distortions in the economy. The Government of Malawi sought the assistance of the International Monetary Fund (IMF) and the World Bank to reform the tax system in the mid-1980s under the Structural Adjustment Programmes (SAPs). The comprehensive tax policy and administration reforms were not only for revenue generation, but also for improving efficiency and equity

[1] On average donor community have contributed 40% to government budget although in the last two years the contribution has diminished due to mismanagement of funds in government famously called Cashgate

[2] World Bank: National Accounts data, 2015

of the tax system as well as improving the country's international trade competitiveness. Largely, the tax policy reforms emphasized the need to expand the tax base by incorporating other forms of income in the tax fold, reviewing the tax rates, sealing loopholes, discouraging tax evasion, reducing exemptions and changing the tax administrative structures. In addition, the reforms also coincided with trade liberalization programmes and the need for regional integration, which gained popularity in the late 1980s throughout the 1990s and early 2000s. Although Malawi embarked on tax policy and administrative reforms in the late 1960s, literature is scanty on the impact the reforms on revenue generation, and improvement in investment and savings levels. Furthermore, less is also known about the participation of Political Parties, Parliamentary Committees, Civil Society Organization and the general public on formulation of the tax policies, especially after adopting the democratic dispensation in 1994. This study, therefore, broadly analyses the trend of tax policy and administration reforms and their impact on revenue generation in Malawi. It specifically evaluates the process of the tax reforms and response of the revenues to the policy shifts. The paper further evaluates the driving forces for various reforms being implemented. Evaluation of the tax reforms and their performance is not only important but also critical for Malawi in order to ascertain the interventions that will yield the desired results. First, after gaining her independence in 1964, Malawi inherited a tax system that was designed by the British colonial government and this system was heavily reliant on direct taxes. Its implementation yielded some positive results in the early years as the overall tax revenue as percentage of GDP increased from 10.18 percent in 1970/71 to 11.86 percent in 1977/78[3]. However, Government embarked on tax policy reforms, which eventually transformed the tax system, with a view of addressing the widening fiscal imbalance, broadening the tax base, promoting domestic industry growth, improving equity and efficiency in the tax system, and finally improving its administration. Unfortunately, there is scanty empirical evidence on whether the reforms Government undertook achieved the set objectives. Secondly, Malawi continues to occupy the lowest

[3] Chipeta et al. (1998)

echelons on development rankings as evidenced by the latest World Bank report (2015), which suggests that the country is the poorest in the world, based on per capita income. The budget implication of this status is that there will be a higher need of government expenditure public and social programmes to stimulate growth[4]. The ranking of the country raises some questions on the effectiveness of the past tax policy reforms on revenue generation for the country to achieve economic independence in budget financing. Thus, this paper will analyze the responsiveness of the tax system to the policy and administrative reforms the country has been undertaking since independence. In understanding this, the paper will also achieve one milestone of filling the research gap in the area of tax policy and administration as few studies[5] exist in this field in Malawi.

2 Tax Policy and Administration Reforms

It might be argued that the Malawian tax system has gone through four major reforms since the country gained her independence in 1964. The first reform covered the period between 1969 and 1977. The reforms were inward looking as they were aimed at increasing savings and investment levels and discouraging consumption of imported luxury goods. The second reform period was between 1978 and 1984 and was characterized by frequent and ad hoc changes in the tax system without exhaustive analyses. It might be argued that these reforms were aimed at responding to the increased pressure on Government expenditure. The third period of reforms was implemented under the structural adjustment programme (SAPs) period; trade liberalization program and Southern Africa Development Community (SADC) trade protocol and stretched from 1985 to 1999 just before the operationalization of the Malawi Revenue Authority (MRA)[6]. The reform programs sought to improve efficiency and equity of the tax system; encouraging a free trade market; increasing the level of Foreign

[4] See Kelly (1997), Alexiou (2007) and Alexiou (2009) on how public expenditures increases economic growth and per capita income.

[5] Shalizi and Thirsk (1990) and Chipeta et al. (1998).

[6] See Shalizi and Thirsk (1990)

Direct Investment (FDI); increasing tax collection and improve the tax administration. The period was characterized by the introduction of new taxes to widen the tax base; gradual reduction of direct tax and import tariff rates; the inclusion other forms of income into the tax base and goods and services that were previously not taxed; and the increase of excise rates and the rationalization of surtax. On the administration side, it was a period when Government enacted the law of establishing MRA in 1998 and also the formation of a Tax Policy Unit in the Ministry of Finance in 1993. The fourth period stretches from 2000 to date, which involved, among others, the evolution of surtax to Value Added Tax (VAT) in 2005 and customs tax reforms under Common Market for Eastern and Southern Africa (COMESA)[7].

2.1 Tax Policy Reforms between 1964 and 1977

The taxation of income from individuals and business entities is enshrined under the Taxation Act which became operational on 1st January 1964, whereas collection of customs duties and excise tax is administered under the Customs and Excise Act of 1969. When the country gained independence in 1964, it inherited the British tax system which heavily relied on direct taxes collected from individuals and business entities. The system was akin to that adopted more by the developed countries rather than most developing countries. This tax system remained stable for some period with company and personal taxes contributing almost 50 percent of tax revenues. However, the tax base was very narrow as personal taxes were mainly collected from workers in public sector and large companies, whereas company tax was collected from few large private firms involved in manufacturing and distribution. Import duties were mainly imposed on luxury and consumer goods with excise tax leaning more towards traditional excisable goods (liquor, cigarettes and fuels).

[7]Government of Malawi (2000)

2.1.1 Personal (individual) taxes

Personal taxes were in four categories: minimum tax, graduated tax, assessed tax and Pay as You Earn (PAYE). Under minimum tax, all males above the age of 18 were required to pay a specified amount of tax (poll tax) if their income was less than the amount set for those qualified under graduated tax. For graduated tax, the income was divided into five different bracket levels and each bracket had a fixed tax rate. This graduated tax exempted males below 18 years and women whose income was less than the minimum wage fixed for adults. Assessed tax was similar to graduated tax but was applied to persons in self-employment, particularly farming and petty trading. For people who were employed in the public sector and large firms, PAYE tax system was applied on income above the set threshold. Table 1 highlights the different taxes for personal income.

Table 1: Personal tax system

Graduated Tax

Earnings paid monthly		
Not exceeding K10.17		30t
Exceeding	Not exceeding	
K10.17	K20.00	30t
K20.00	K33.33	83t
K33.33	K50.00	K1.22
K50	K75.00	K1.82

Assessed Tax

Tax paid	Taxable income	Tax per year
Not exceeding	K122	K3.75
Exceeding	Not exceeding	
K122	K240	K5.75
K240	K400	K10.00
K400	K600	K15.00
K600	K900	K22.00

Source: Chipeta 1998

The personal tax system had several allowances including personal allowance for being either single or married; personal allowance for maintenance of lawful child and child allowance up to four children if they are below the age of 18 years or beyond provided the child is attending education. However, if the child has income above or equal to the set minimum income meant for poll tax, child allowance was not allowed as deduction from the guardian's income. Other allowances included life insurance premiums of the taxpayer or spouse, cost of building a house; educational costs and contributions to an approved pension or provident fund. The tax system had two schemes for calculating taxable income. The first scheme (taxable income) was disallowing deductions and exemption while the second (chargeable scheme) was considering the personal exemptions and deductions. Taxpayers were allowed to calculate their tax liabilities under both schemes and pay the larger of the two computed taxes. Table 2 shows the differences in the two income tax schemes.

Table 2: Personal tax system

Taxable Income Scheme

Taxable income		Tax per year
Not exceeding K122		K3.75
Exceeding	Not exceeding	
K122	K240	K5.75
K240	K400	K10.00
K400	K600	K15.00
K600	K900	K22.00
K900	K1,200	K30.00
K1,200	K1,500	K37.00
K1,500	K1,800	K43.00
K1,800	K2,100	K49.00
K2,100	K2,400	K55.00
K2,400	-	K61.00

Chargeable Income Scheme

	Taxable income	Tax per year
First	K1,000	20t
Next	K1,000	40t
Next	K1,000	60t
Next	K3,000	65t
Next	K3,000	70t
Next	K5,000	75t
Excess over	K11,000	80t

Source: Chipeta 1998

The main reforms under personal taxes were done under three distinct amendments of the Taxation Act: Bill 14 of 1969, Bill 19 of 1969 and Bill 6 of 1972. Amendments under Bill 14 of 1969 aimed at encouraging individuals to save through a pension or provident fund. Thus, the amendment allowed taxpayers to deduct an amount contributed towards pension or provident fund from their income. On the other hand, the amendment under Bill 19 of 1969 expanded the tax base through the inclusion of a spouse's or minor's income into assessable income when the taxpayer is computing his/her taxable income. This aimed at ensuring that every person pays a fair share of their income to support Government public services delivery. In an effort to improve administration of personal tax and avoid tax evasion, Bill 6 of 1972, introduced deduction (withholding) of tax upon payment of salaries and wages (PAYE). With increased pressure on public expenditure, the top marginal rate was raised to 45 percent in 1975 from 40 percent and was aligned to company tax rate[8].

2.1.2 Company (corporate) taxes

Due to the need to attract investments, increase domestic production and trade, and promote various economic activities, Government introduced a number of tax incentives to the private sector. Using Bill 19 of 1969, Government introduced capital, annual and investment allowances as incentives to companies. Capital allowance rate was set at 10 percent as initial allowance on capital expenditure on farm improvements, industrial buildings and railway lines; 33 percent as initial allowance on expenditure incurred in farm fencing; 20 percent in respect of articles, implements, machinery, or utensils and other additions to any capital expenditure used for the purpose of the taxpayer's trade. The annual (depreciation) allowances rate was set at 5 percent on farm improvements, industrial buildings and railway lines; 10 percent on farm fencing whereas the rates of other assets were determined by the Commissioner of Taxes. On the investment allowance, 10 percent allowance was for manufacturers on the cost of new and unused industrial building and plant or machinery used in the process of manufacturing. The same Bill also provided incentives to mining operations where 20 percent of expenditures incurred were set to be claimed in the first year and the rest in the subsequent four years. To further encourage savings, Government using Bill 14 of 1969 allowed employers to deduct any contribution made to a pension fund on behalf of the employee from their income. On the other hand, Government had to expand the tax base and scope of income to be taxed. Using amendments under Bill 7 of 1968, foreign exchange gain or loss was included in computation of taxable income. Later in 1969, under amendments of Bills 16 and 19, Government extended taxation to income earned by consumer's co-operative societies, clubs and associations though with some exemptions when such institutions operate solely for social welfare, civic improvement or other similar purposes. Further, Government using Bill 14 of 1971 included into the tax base the income realized from the sale of timber and

[8] See Chipeta et al. (1998)

livestock which was previously not taxed. The Bill also extended taxation of income from non-residents who partly or wholly produces, grow, mine, create, manufacture, fabricate, improve, pack, preserve, or construct anything within Malawi and export before sale. In terms of tax rates, the top corporate rate was set at 40 percent in 1966 for companies incorporated in Malawi and additional 5 percent for foreign incorporated companies. The rate was reviewed and raised to 45 percent in 1975; making an effective average tax rate of 24 percent on companies (Chipeta et al., 1998). The objective of raising the rate was to generate more revenues to meet the increasing pressure on public expenditure.

2.1.3 Customs Duties

On the indirect tax revenues, Malawi's primary source was custom duties. The tariff rate structure was designed to promote import substitution of consumer goods and discourage consumption of imported luxury goods. Thus, durable and luxury consumer goods had high tariff rates compared to capital and intermediate goods which had very low or zero rates. The average import tariff rate at the time of independence was 10 percent and remained stable until 1968 when the average tariff rate increased to 16 percent and went above 16 percent in 1969 following Government introduction of 8.5 percent surcharge. With the prospect of revenue account deficit, tariff rates for beer, wine, spirits, cigarettes and a wide range of consumer and luxury goods were raised to 30 percent from 10 percent and 20 percent in 1977. Despite the increase in import tariff rates, Malawi's rates remained low as compared to other African countries (Chipeta et al., 1998).

2.1.4 Excise taxes

The excise tax system the country inherited was also similar to that of developed countries. The tax was applied on a limited list of domestic products such as cigarettes, beer and liquor which were main revenue generators. Besides these, there were other important products on which excise tax was collected which included soap, sugar and cotton[9]. Since the system was

[9] Chipeta et al. (1998)

more of Commonwealth countries, the country was using specific rate method in collecting excise tax unlike ad valorem method. The country experienced a relative stable excise tax policy in early years after independence until mid-1970s as budget deficits were mainly covered by accumulated reserves and foreign debts. The only reform took place in 1977, when the excise tax rate of beer especially Malawi Gin was increased by 100 percent[10].

2.1.5 Surtax

In 1970, Government decided to further broaden the tax base, especially through indirect taxes. This prompted the introduction of a sales tax named Surtax under Bill 38 of 1970. The tax rate was set at 5 percent and was applied on sales of domestically manufactured goods and duty paid for imports. The surtax, being a local sales tax, exempted exports, capital goods, manufacturers' raw materials and low-income basic consumer goods. The tax also had a peculiar feature called ring system where transactions between producers were not taxed. In order to avoid taxing these transactions, producers who qualified under the system were registered with the Controller of Customs and Excise for a rebate on the purchase of intermediate inputs. The other feature of the surtax was 1.2 uplifting factor imposed on imported goods. The uplifting factor was introduced to cover for currency overvaluation so as to place imports value on the same competitive level with domestic producers. The surtax rate remained relatively stable between 1971 and 1977; as the only changes happened in 1971 and 1977, when the rate was raised to 10 percent and 15 percent respectively.

2.2 Tax Policy Reforms between 1978 and 1984

The economic upheaval of late 1970s and early 1980s left the Government with heavy public expenditure requirements. First, there was a drought in 1979/80 which reduced food production. There was also a global economic recession which negatively affected economic fortunes of the early 1970s. Further, the country was affected by a sharp decline in foreign private lending from developed countries and also abrupt termination of rail access through

[10] Government of Malawi (1977)

Mozambique as a result of war. During this period, the country faced increased public expenditure especially on food imports and distribution; increased servicing of external and internal debts; increased transport costs and defense expenditure (Shalizi & Thirsk, 1990). The overall decline in economic activities coupled with increased need of public expenditure put more pressure on revenues which necessitated some tax policy reforms. The tax policies made on both direct and indirect taxes focused on revenue generation rather than promoting economic growth, savings, investments and trade competitiveness as envisaged in the late 1960s and early 1970s. The reforms were ad hoc in nature and not sustainable in the long-term as they concentrated on increasing tax rates; expanding the tax base by taxing other items which were not previously taxed and introducing new taxes.

2.2.1 Personal (individual) taxes

The personal tax policy taken was to increase revenue generation and maintain some degree of equity. As the country was going through revenue crisis due to increased pressure on public expenditure, Government increased the rate of personal taxes to 50 percent from 45 percent in 1982. This followed a similar tax rate increase in company taxes in the preceding year. Government also decided to broaden the tax base in order to generate adequate revenues to meet growing public expenditures; all allowances[11] applicable to individuals were therefore eliminated using Bill 10 of 1983. The Government further simplified the income tax system for individuals, bringing equity among individuals who earn same income by merging taxable income method and chargeable income method into one method. Although the objective of the reforms was to generate more revenues, the principle of promoting savings and investments still prevailed. The notable reform was an allowance of pension premium contributed by members of parliament to pension scheme which became deducted from income through Bill 4 of 1981.

[11]Personal allowances included child allowance, single and marriage allowance, mortgage allowance and education allowance.

2.2.2 Company taxes

Few reforms were undertaken on company taxes by Government during this period. These reforms aimed at consolidating the tax base further, giving relief from taxation and simplifying the tax system. One important reform in company tax focused on increasing revenue generation as the rate increased to 50 percent from 45 percent in 1981. The other reform for increasing revenue was the expansion of the tax base using Bill 4 of 1982 where income from carrying on the business of insurance other than life assurance was included into the tax base. The reform was to ensure that every person contributes a fair share to Government revenue and the country's development. As Government policy was still on attracting investments, the same Bill 4 expanded the definition of industrial buildings so as to give investors more investment incentives. In 1981, Government also allowed dividends received by companies to be an allowable deduction in computing their taxable income. The other policy reform was done under Bill 109 of 1980 where the Minister of Finance was given powers to exclude any person's income from income tax as long as there is an agreement to exempt such income from tax.

2.2.3 Customs duties

Trade taxes policy direction of late 1960s and early to mid-1970s was to support domestic industries grow through import substitution policy. In the late 1970s and early 1980s, the focus was to raise revenue for public expenditure. The increased pressure on public expenditure gradually shifted the 1970s policy direction as Government introduced lower import tariffs on intermediate and capital goods in 1981 though these goods were essential for economic growth. The introduction of the tax was necessitated following the surge in imports of these goods which eventually had put high pressure on the balance of payments. With high tax rates on traditional tax bases and need for equity of tax system, new taxes were introduced. In 1981, Government introduced import levy at the rate of 3 percent and was collected on Cost, Freight and Insurance (C.I.F) value for all merchandize goods imported into the country. The rate was increased to 4 percent in 1982 and it rose further to 5 percent in 1983 (Shalizi & Thirsk, 1990). In addition to import levy, Government also introduced new taxes in the form of an accommodation and refreshment tax at the rate of 10 percent using Bill 21 of 1981 and export levy in 1984.

2.2.4 Surtax

The policy shift on surtax during this period was aimed at consolidating Government revenues by increasing the rate and the number of goods to be taxed. One of the surtax policy shifts during the period was increasing surtax rate of domestic transactions from 15 percent in 1977 to 17 percent in 1979 and 20 percent in 1980. The surtax rate on imports also increased to 20 percent in 1979 and 25 percent in 1980. The difference in rates between domestic transactions and imports rose from 1.2 uplifting factor which Government was applying on import value. The other important reform was the introduction of a lower surtax rate on some capital and intermediate goods in 1981 while other important capital and intermediate goods continued to be exempted as they were deemed essential for economic growth. However, in 1984, surtax was extended to capital and intermediate goods which had previously been exempted in 1981. A 5 percent rate was applied on these capital and intermediate goods. On the other hand, the capital and intermediate goods that were previously taxed at a lower rate in 1981 had their rates increased to 25 percent in 1984. Similarly, surtax rates on imports also increased to 30 percent from 25 percent in 1984. These rates were aligned to the basic surtax rate for domestic output which also increased to 25 percent from 20 percent in the same year. These surtax policy reforms overrode the policy direction of 1970s of supporting savings and investments as evidenced by frequent increase in rates and number of taxable items.

2.3 Tax Policy Reforms between 1985 and 1999

The 1970s and early 1980s tax policy reforms could not address the long-term plans for development of the country's tax system, improvement of savings and investments trade growth and overall economic growth. The policy designs mainly focused on revenue mobilization as evidenced by high rates and other protective features. The surtax policy direction was characterized by higher rates on imports as compared to domestic goods whereas import tariffs also served to influence consumption shift from imported to domestic goods. The imposition of positive import tariff rates on intermediate and capital goods distorted the incentives for domestic production as the effective rates of protection for imports was reduced. At the same time, the tariff rates negatively affected exports as the cost of production increased rendering the domestic goods expensive on the international market. Overall indirect taxes policy direction negatively affected the industrialization process which the country embarked on in 1960s. On individual and company taxes, the policy direction clearly demonstrated the support for income redistribution and shift from taxing a limited number of individuals and entities. The attempt to use income taxation to achieve equity objective was more apparent with the increase in rates during the period and maintenance of more tax brackets for personal taxes. However, the policy direction discouraged savings and investments. These policy reforms focused more on short-term objectives, bringing about more worrying features into the tax system. Recognizing the need for greater economic growth and movement to the market economy, Government with assistance of International Monetary Fund (IMF) and World Bank agreed to embark on the process of further reforming the tax system. The agreement was made following the concerns the two institutions expressed to Malawi Government under Structural Adjustment Loan Program. The main concern was tax incentives that were available for agriculture and manufacturing sectors which were not desirable for the sustainable growth of the sectors and long-run country's economic growth. World Bank then recommended the reformation of the whole tax system to address the challenges the mission had identified[12]. The main objectives of these reforms were five fold. First was to improve efficiency of the tax system by developing a system which is neutral and that would not interfere with efficient allocation of production, trade and investment resources. The second objective was to achieve equity in the tax system where the burden

[12] See Shalizi and Thirsk (1990)

of taxation should depend on individual's ability to pay. The third aspect aimed at improving the quality of tax administration which required institutional changes in the way taxes were being administered. The fourth objective of the reforms focused on creating a sustainable tax system that could generate enough revenues to support expenditure on various public services. The fifth objective was to create a conducive environment for investment by shifting tax reliance from trade taxes to consumption taxes.

2.3.1 Personal (individual) taxes

Personal income taxes before the 1985 tax policy reforms were largely from salaries and wages from employees in the public sector and large firms with some limited contribution from self-employed individuals and employees from small firms. The substantial income which individuals were earning from interest, royalties, fees, commissions, rent and dividends was not taxed. This contributed to an inefficient allocation of investment as financial assets were favored. In addition, like many other developing countries, the economy is dominated by the agricultural and informal sectors which presented serious challenges to be subjected to tax. Therefore, the policy reforms that were initiated from 1985 to 1999 focused on expanding the tax base by extending tax to earned passive, compensation, business and professional income that were not previously taxed. Government embarked on the process of expanding personal taxable income base during the same time it was expanding the base for company tax. One of the policy reforms on expanding personal taxable income was introduction of tax on non-residents earnings using Bill 12 of 1987. Under this Bill, any income payable to a person who is not a resident of Malawi, arising from a source within Malawi and not attributable to a permanent establishment of that person in Malawi became taxed at final rate of 15 percent on the gross amount of the income. The base of personal income tax was also expanded in 1991 as Government eliminated the interest deduction on housing mortgage loans for owner occupied houses. Using Bill 7 of 1992, Government further consolidated the tax base by extending tax on dividend and capital gain income earned by individuals. The other policy reform was done under Bill 6 of 1995 where income received or accrued to or deemed to be received or accrued to a spouse who is a director and controls either directly or indirectly more than five per centum of the voting rights in a company to include the received, accrued or deemed income in the spouse's taxable income. The same Bill extended tax to income received or accrued by minor children from parents to include that income into parent's taxable income. The 1995 Bill also expanded the tax base by extending tax on house allowance above the set minimum threshold which was always indexed to inflation. Upon recognition that elimination of personal taxes and merging of schemes for calculating personal income in 1983 negatively affected disposable income and savings, Government made some changes to relieve tax burden on individuals. One major reform was the introduction of a zero tax rate bracket using Bill 1 of 1991 to compensate for the personal allowances which were eliminated in 1983. In order to counter inflation creep and provide relief to low income earners, there has been regular adjustment of the zero income bracket almost every financial year. Government also abolished the minimum (poll) tax that was paid by individuals who were earning income below the minimum threshold for tax purposes in 1993. In an effort to provide more personal incentives to save, Government embarked on reduction of the top marginal rate, with the aim of improving the savings pools, thereby, making more investment resources available. In 1992, the top marginal rate was reduced to 35 percent before raising the rate to 38 percent in 1995 due to the need of finances for drought recovery. As part of bringing equity to the tax system on personal taxes, Government removed exemption of tax on the income earned by specified personal staff of the President in 1995. However, the exemption remained on official salary and emoluments for the President and Vice President and the exemption extended to gratuity, pension and other benefits for the former President and Vice President.

2.3.2 Company taxes

Prior to the 1985 reforms, company tax rate was 50 percent with average effective tax rate of 39 percent. However, there was distinction of marginal effective tax rate between manufacturing and non-manufacturing sectors where the former had 43 percent marginal effective rate and the latter had 58 percent marginal effective rate by 1984 (World Bank, 1985). The system was also characterized by exclusion of state-owned companies from payment of tax. In addition, companies were paying taxes with a lag of one or two years which ended up lowering the marginal effective tax rate (Shalizi & Thirsk, 1990). Moreover, incentives were varying across the sectors which in turn lowered marginal effective tax rates for other sectors. The policy shifts focused on enabling the country to become investment friendly and consolidate the tax base for revenue mobilization. One important reform to expand and consolidate the tax base was extension of company tax to state owned enterprises using Bill 4 of 1987. The extension of the tax to state owned enterprises was also to bring equity in the tax system as companies with same economic status were supposed to pay tax at the same rate. Using the same Bill, the tax base was further expanded as dividends received by companies incorporated in Malawi were now included in the income of that company as are deemed to accrue from the source within a country. Later in 1988, Government changed the payment period of company tax to current year as companies were now allowed to estimate their total tax amount (provisional) in that year, the way personal income taxes were treated. The Bill aimed at achieving time value of revenues as payment after a lag of one or two years ended up lowering marginal effective tax rate. The base was further consolidated using Bill 1 of 1990 as company tax was extended to income from private trusts which were not previously taxed at the rate as specified in the eleventh schedule of the Taxation Act. In the same year, Government introduced minimum business tax according to turnover, so as to allow individuals and corporations declaring losses to contribute something towards Government revenues to support provision of public services. The tax base expansion reforms continued as Government introduced tax on fringe benefits using Bill 1 of 1991 at corporate rate to employers other than Government on fringe benefits provided to their employees. The reforms continued in 1992 using Bill 7 which brought the accrual concept of income. The Bill also included capital gains into the tax net. The same Bill changed the calculation of tax on dividends from income imputation (grossing up) method to dividend tax account.

The other important tax policy reform for expanding tax base was inclusion of interest income earned on holding Government securities bills into the tax net in 1996. The base was also expanded in 1998 where initial allowance of private passenger vehicles was removed as such vehicles were included in businesses balance sheet. The other rationale of removing such initial allowance was to reduce the scope of abuse. The other side of the company tax policy reform was geared towards providing tax incentives to promote investment. The reforms such as tax holidays, reduced company tax rates, exemption of some income from tax and other favorable investment allowances became critical in attracting new investors. One of the policy reforms for attracting investors was implemented using Bill 4 of 1988 where companies involved in exports were allowed to claim export allowance in line with Section 14 of Export Incentives Act. The same Bill also streamlined initial and investment allowances by bringing in immediate expensing (accelerated depreciation allowance) at 40 percent rate. Following the passing of Investment Promotion Bill in 1992, the Bill provided more incentives with the general objective of promoting, encouraging and facilitating local and foreign investments in the country. The incentives were given under Bill 7 of 1992 which included reduced company tax rate of 15 percent, exemption of withholding tax on repatriation of dividends, 25 percent transport allowance to cover international transport costs, 12 percent export allowance for non-traditional exports, 100 percent allowance for manufacturing companies on operating expenses incurred up to 18 months prior to commencement of operation, 20 percent investment allowance for qualifying buildings and machinery and additional 15 percent investment allowance for investing in designated place gazetted by the Minister of Finance. In 1997 using Bill 5, additional incentives were given to encourage further investments by reducing company tax rate for firms manufacturing in Export Processing Zones to zero rate whereas new investment between US$5 million and US$10 million were given reduced company tax rate of 15 percent indefinitely or zero rate for five years while new investments in excess of US$10 were given 15 percent rate indefinitely or zero rate for 10 years. There were other incentives given to investors under Bill 1 of 1990 and Bill 1 of

1991. These incentives include allowances on expenditure incurred on research related to taxpayer's trade, expenditure incurred for erecting staff housing and expenditure incurred on training Malawian employees of the taxpayer. Other incentives were given under Bill 2 of 1996 and Bill 6 of 1999 where individual donations to non-profit organizations for social welfare, civic improvement, educational development or similar purposes as the Minister of Finance may gazette and amount payable by an employer, who is also a taxpayer, as payroll-levy as determined in Section 20 of the Technical, Entrepreneurial and Vocational Education and Training Act, 1999 is allowed as a deductible expense. The Government policy reforms also focused on lowering the rates not only to combat the competition for investment funds but also to present itself as an attractive destination for investment. Before the reforms marginal top rate for companies was 50 percent with marginal effective tax rate as high as 58 percent for other companies. As part of the reform agenda, Government embarked on lowering the company tax rate in 1990 when the rate was cut from 50 percent to 45 percent. The rate was further reduced in 1991 to 40 percent and 35 percent in 1992. As the country faced drought in 1994 through 1995, Government increased company tax rate to 38 percent using Bill 1 of 1995 from 35 percent. The additional 3 percent was put as a temporary rate which was to be reviewed downwards upon collection of enough revenues to support the country's effort of recovering from the drought.

2.3.3 Withholding taxes

Withholding tax was introduced under Bill 1 of 1985 as part of the effort to expand and consolidate the tax base. The Bill compelled all payments made to any person (individuals and companies)[13] be made after a deduction of tax at the rate which was specified in the Fourteenth Schedule of the Taxation Act. However, the Bill allowed withholding tax that has been deducted at source to be credited against total tax liability and remained the final tax if the taxpayer did not file a tax return. The major objective of the policy was to expand the

[13]The withholding of payments was first introduced in 1972 under Bill 6 but was exclusive to wages and salaries (emoluments), the 1985 extended to any other income payments which were not covered under 1972 law.

scope of taxable income as substantial income especially passive income, professional income and some compensation income was excluded from the tax net. The system extended to other types of income including agricultural produce income, royalties, rent, interest income, fees, commission etc. The introduction of withholding tax also aimed at improving compliance so that every person is in the position to contribute revenues for provision of public services. The withholding tax general rate was put at 15 percent on most income types. Despite the rate remaining relatively stable from 1985, Government revised the rate upwards to 20 percent in 1997.

2.3.4 Customs Duties

The overall objective of customs reforms was to achieve openness following a number of trade agreements the country signed in mid and late 1990s under SADC Trade Protocol and World Trade Organization (WTO). The reforms were also pursued to boost productivity by creating an enabling environment for private sector growth. Prior to these reforms, customs tax policy objective centered on protecting domestic industries through high tariff rates. The 1985 policy direction focused on reducing the cost of production by lowering the tariff rates and moving the country towards export orientation. Though the new thinking was to fully liberalize the economy, some elements of protectionism continued for some sectors of the economy. The main focus for achieving customs policy reforms was the lowering of tariff rates especially on intermediate and capital goods and other raw materials to encourage domestic production. The main policy reforms started in 1988 when Government merged non-protective import tariff rates for some goods and the import levy into import surtax using Bill 25. The Bill also transferred luxury tariff rates into surtax. These 1988 policy reforms were also aimed at simplifying the administration of import tariffs. In 1990, the country fully embarked on the drive to increase domestic production, consequently import tariff for some raw materials attracting high rates were reduced to lower rates like other raw materials. Between 1992 and 1997, the general maximum tariff rates were lowered to 40 percent in 1994 and 35 percent in 1997. Within a five year span, tariff rates decreased from as high as 100 percent for textiles, 65 percent for luxury goods to a maximum of 35 percent. The tariff rates for some raw materials used in manufacturing were completely reduced to zero percent in 1997 in order to improve the competitiveness of domestic manufacturers at international level. The drive for trade liberalization and increasing domestic production was coupled with the need of improving tax compliance between 1998 and 1999; hence, Government reduced tariff rates to a maximum rate of 30 percent and 25 percent in 1998 and 1999 respectively. The tariff reduction underscored the Government commitment to trade liberalization and improving competitiveness of local goods on the international market. On the other hand, elements of revenue generation are traced during this period as Government introduced export tariff rates on tobacco, tea, and sugar at 10 percent rate using Bill 5 of 1985. Though the amended section of the Law was removed in 1986, Government reintroduced the Section in 1995. The other aspect of reinforcing revenue generation drive is also observed through introduction of 25 percent tariff rate on petrol and diesel and 20 percent rate on jet fuel in 1994. Moreover, Government imports of motor vehicles and building materials were subjected to import tariffs and surtax from 1998 in line with the tax inclusive budget policy that Government introduced in 1995.

2.3.5 Excise tax

The major objective of the excise tax reform in the 1990s was to increase revenue capacity. The policy changes focused on increasing the excise rates and expanding the tax base with a view of compensating the revenue loss from the reduction of import tariff and surtax rates. To ensure an even distribution of the tax burden, the reforms also extended the excise tax to other products that were previously not included in the taxable category. As part of ensuring that revenues are changing in parallel with inflation changes, Government switched from specific excise tax rates to ad valorem rates on some products including soft drinks, beer and tobacco in 1989. The rates that were introduced ranged from 10 percent to 60 percent. On the other hand, specific rates remained on non-luxury products such as textiles, soap and sugar though in 1991 the tax was removed on these products including soft drinks.

The complete switch to ad valorem rates on the remaining products was finalized in 1995. As excise tax policy changes were largely a compensation of the revenue loss from tariff rates reduction i.e. Government's immediate response to the revenue loss was imposing almost similar margin of excise tax on the same or similar products as the reduced tariff rates. For instance, between 1993 and 1999, Government introduced excise tax rates on products such as radios, music equipment, motor cycles, perfumes, some spirits and other products in the range of 10 to 50 percent though the tariff rates of these goods reduced by the range of 5 to 20 percent. On the products whose rates were low, Government increased the rates by 10 percent whereas the goods whose tax was removed in 1991 such as sugar, soap and textiles, the tax was reinstated in 1996 at a 10 percent rate. Government also harmonized the tax rate on domestically produced and imported goods in 1993 to remove the inherent discrimination and protectionism, which was observed in the excise tax system.

2.3.6 Surtax

The surtax reforms focused on shifting the taxes from a production and trade base to a consumption base. The reforms started in 1988 and were done almost each financial year by either including or excluding some products into the tax base. Surtax reforms also aimed at stimulating domestic production and attracting foreign investment and, in view of this, Government embarked on the process of lowering the surtax rates. Surtax reforms were first done in 1988 and centered on restructuring the rates to five categories: zero percent, 10 percent, 35 percent, 55 percent and 85 percent. In 1991, the surtax rates for most commodities were reduced by 5 percent whereas luxury goods rates were lowered by 10 percent. The rates were further lowered in 1992 by 5 percent for most commodities including luxury products while the surtax rates which were used to protect domestically produced goods were reduced to 25 percent from 75 percent and 50 percent respectively. In 1993, Government decided to streamline the surtax rates to a standard rate of 20 percent in order to improve compliance, simplify tax administration and further boost production and consumption. The products which were taxed at higher rates were reduced to 20 percent whereas the rates of most products that were taxed at a lower rate were increased to 20 percent. However, there were still few products with lower or higher rates than the 20 percent standard rate. The surtax rate streamlining process was an important policy shift towards a single rate and simplification of the administration of the tax. Government continued with the rationalization of surtax rate structure and by 1999 all products were taxed at a single rate of 20 percent. On broadening the surtax base, Government extended the tax to other services. In 1989 using Bill 25, surtax was extended to services like repackaging, advertising, repair, bottling, financing and assembling. The same Bill also abolished the ring (suspension) system and introduced a credit system. The uplifting factor on import surtax was also eliminated and both domestic and imported goods were subjected to the same surtax rate. The base was further expanded in 1991 as the tax was extended to other services which include electricity for commercial and industrial purposes, telecommunication services and some professional and business services at a 5 percent rate. The tax base was also extended to hotel and restaurant services in 1993. Between 1995 and 1999, the surtax base was extensively broadened and covered many goods and services including electricity usage by all other sectors, imported fruits, photocopying services, rental of registered conference halls, theaters and other services. Thus, during this period the surtax policy focused on streamlining the rates to a single standard rate in order to simplify the administration of the tax, eliminate misclassification of goods, control smuggling and improve compliance. At the same time, the surtax reforms were also meant to stimulate economic activities through increased local production.

2.3.7 Administration reforms

The aim of the administrative reforms was to improve the administration of the various taxes. On the income tax side, Government introduced taxpayer identification numbers (TPINs) in December 1988. On Customs and Excise, Bill 5 of 1985 gave the Minister of Finance powers to prescribe and publish tariffs for customs duty, excise tax and surtax in a Government Gazette. One significant reform was the establishment of a Tax Policy Unit in the Ministry of Finance in 1993. The unit's mandate was to coordinate policy formulation among various stakeholders and also analyze tax policies and their impact on the economy. The epitome of administration reforms was the enactment of Malawi Revenue Authority (MRA) Act in 1998 which merged Income Tax and Customs and Excise Departments of the Ministry of Finance into a semi-autonomous body called MRA. MRA as an institution became operational in 2000.

2.4 Tax Policy Reforms between 2000 and 2010: Post Structural Adjustment

The reforms that were implemented between 1985 and 1999 were aimed at promoting investment, improving economic activities, facilitating international trade and expansion of the base for tax revenue collection[14] . The period 2000-2010 corresponds to the period when Government embarked on IMF's Poverty Reduction and Growth Facility (PRGF) program. The objectives of the program were to improve efficiency in the tax system, promote equity of the tax system and economic growth thereby reducing poverty levels. The emphasis was on strengthening domestic revenue generation as reflected in tax reforms that Government implemented with advice of IMF[15].

2.4.1 Personal (individual) taxes

The personal tax policy reforms aimed at reducing the tax burden, increasing disposable income and broadening the tax base. The 3 percent drought levy that was introduced in 1995, was removed in 2000 as one way of reducing the tax burden on individuals. The removal of the drought levy lowered the top marginal rate of personal taxes to 35 percent from 38 percent. As the Government perceived personal income tax as an essential instrument in achieving, not only equity but also growth of the economy, Government using Bill 9

[14]See Government of Malawi (1987) to Government of Malawi (1999).

[15]See Government of Malawi (2000) to Government of Malawi (2010) and International Monetary Fund (2002).

of 2000 doubled the number of income brackets to 4 from 2. The top marginal rate was further lowered to 30 percent using Bill 4 of 2001 before increasing it to 40 percent in 2002 under Bill 11. The increase in the rate was to progressively place a high tax burden on individuals who earn high income as compared to those with low income. The policy was also a direct response for the need to increase revenue generating capacity from domestic sources following curtailment of budgetary support by some donors. Since reducing the tax burden on individuals was the primary objective of the policy reforms, the top marginal rate was reduced yet again to 35 percent 2005 and then 30 percent in 2006 using Bills 6 and 13 respectively. The top marginal rate was also aligned with the company tax marginal rate. Bill 6 of 2006 also reduced the number of brackets to 3 from 4 with the first bracket being taxed at zero percent while the middle and upper brackets tax rates are at 15 and 30 percent respectively. Personal income reforms that followed in later years centered on adjusting income within the brackets almost annually as a cushion for bracket creep resulting from inflation.

2.4.2 Company taxes

Most policy reforms centered on stimulating private sector investment and broadening the tax base through lowering of tax rates to compete for global investment funds. To ensure economic efficiency and growth through the promotion of private sector, Government removed the 3 percent drought levy in 2000 on company tax like for individuals using Bill 9, consequently lowering the marginal rate of company tax to 35 percent from 38 percent. The rate was further lowered to 30 percent in 2001 using Bill 4 to encourage more private sector investment. To attract more investment in the mining sector, a 100 percent investment allowance was introduced under Bill 12 of 2006, on expenditure incurred in the first year of assessment.

More reforms were implemented in 2005 to encourage new investments in the country. Government introduced a 2.5 percent annual allowance on new commercial buildings whose construction cost met the set minimum cost. Government further amended the loss carry forward provision in the Taxation Act to limit deduction of assessed losses from assessable income to a period of six years. Companies were further given relief on computers and capital gain, as annual allowance for computers increased to 40 percent from 20 percent while capital gain calculation for tax purposes allowed exclusion of 40 percent so only 60 percent of the gain has to be taxed.

2.4.3 Withholding tax

Government recognized that the calculation of withholding tax on dividends using the Dividend Tax Account system acted as a disincentive to taxpayers when distributing profits. Hence, the system was abolished using Bill 10 of 2001 and a 10 percent withholding was introduced instead as final tax as a way of improving the investment climate and encouraging companies to be distributing dividends to shareholders. However, the Bill had a negative effect on holding companies, eventually Government in 2002 provided an exemption of withholding tax on income when it is being remitted to the holding company from a subsidiary as long as the income concerned was dividend. Government also increased the threshold of bank interest amount to be exempted from withholding tax so as to give taxpayers more income in 2001. With increased operating costs and need to reduce the burden and cash flow challenges for most taxpayers, withholding tax on supplies of goods and services was reduced to 4 percent from 10 in 2003 while that of fees and rents was reduced to 10 percent from 20 percent in 2005. On the expansion of the tax base, Government using Bill 13 of 2006 exempted the mining sector from claiming export and transport allowance for exports from this sector. The same Bill created a separate tax regime for companies operating in the mining sector. Under this Bill, Government also introduced a 10 percent resource rent tax on profits after tax if the rate of return exceeds 20 percent. Further in 2010, Government changed export allowance calculation to be based on taxable income rather than gross export proceeds and the rate was increased to 15% from 12% to encourage more exports. The company tax base was further expanded through the introduction of a 15 percent tax rate on income earnings from pension funds investment. Like many other developing countries, Malawi has had challenges in taxing income from agricultural and informal sectors. Government tried to tax these sectors in 1994 by introducing minimum tax amounts based on turnover for companies and individuals with very low profit or in a loss making situation. The tax remained until 2006 when Government abolished it resulting into a situation where income earned by the majority of businesses in the informal sector was left untaxed. Government then reinstated the tax in 2009 using a different approach from the first system as the new system placed a rate of 2 percent on turnover amount which the business earn per annum. The tax was imposed on businesses whose turnover is below the VAT threshold and those that cannot submit a tax return for company tax.

2.4.4 Customs Duties

The customs policy reforms were mainly driven by the trade policy which the country had been pursuing under regional and multilateral trade arrangements through COMESA and SADC trade protocols as well as GATT in the WTO. The country also continued with the trade liberalization program despite pressure on revenues. The policies were also pursued to meet the country's objective of increasing domestic production to support economic growth through continued reduction of import tariff rates for strategic capital and intermediate goods and raw materials so as to increase the efficiency and competitiveness of local industries. On the part of lowering the cost of production, Government reduced tariff rates for raw materials, intermediate goods and certain types of pick-up vehicles to 10 percent whereas those for computers were eliminated in 2000. On the other hand, Government continued to pursue the policy of increasing competitiveness in 2001 through further reduction of import tariff rates for capital goods used in the manufacturing sector to zero percent while some agricultural hand-tools were reduced to zero percent and others to 5 percent depending on the country of origin. Government also reduced tariff rates for tobacco packaging materials to 0 percent as a means of boosting agricultural productivity. On improving production efficiency, Government removed tariff rates on generators used for industrial other than domestic purposes in 2006. The tariff rates for some goods used in manufacturing or development projects such as renewable energy sources including wind-mill engines, solar panels, and solar energy lamps were reduced in 2009. On aligning the country to regional trading blocs, Government pursued some tariff rates reduction under SADC and COMESA trade agreements. In 2001, tariff rates under SADC trade protocol were reduced by 10 percent. The country effort of increasing free trade across regional borders continued under COMESA as the regional bloc reduced tariff bands to three; 0 percent, 15 percent and 25 percent for raw materials, intermediate goods and finished products respectively. On the part of SADC, in 2010, tariffs for goods originating from countries within the bloc that ratified and implemented the free trade protocol were reduced to 0 rates except for goods from South Africa. The reduction of tariff rates demonstrated the country's commitment of ensuring free movement of goods, which the SADC region was pursuing with the eventual dream of creating a Customs Union.

Although the country had significantly liberalized trade[16], there were still some elements of trade protectionism and revenue generation as Government increased tariff rates for cooking oil to 10 percent in 2002 and 25 percent in 2003 depending on country of origin. Government further introduced a 20 percent export tax on raw and unprocessed tobacco in 2002 but the tax was removed a year later. On the side of import substitution, Government introduced a 5 percent tariff rate on imported wheat flour in 2007 as a way of encouraging local production. These policies of protecting domestic industries resembled the industrialization policy which Government discredited from late 1970s as the policy direction encouraged industrial inefficiencies.

2.4.5 Excise Tax

During this period, excise tax policy reforms were partly meant to offset the revenue loss from the trade liberalization program the country was implementing and also to shift the tax burden to goods predominantly consumed by the rich in the society. The reforms were

[16] The average tariff rates reduced from 28.7 percent in 1990s to 12.7 percent in 2010 (See Borgatti, 2006 and UNCTAD, 2011)

also part of a continued process of expanding the tax base of indirect taxes. On expanding tax base, the Government introduced excise tax on petrol and diesel at a 20 percent rate in 2000, whereas paraffin and other selected consumer goods including wheat flour, fruit juices, textiles and fabrics, furniture, perfumes, some sea food, footwear among others were taxed at a 10 percent rate. In addition, excise rates for certain products such motor vehicles, alcoholic beverages and cigarettes were increased by 20 percent. On the other hand, excise tax on some selected goods was increased by the range of 10 to 20 percent whereas excise tax rate on alcoholic beverages was reduced by 25 percent. Excise tax rates for petroleum jelly, perfumes, precious metals, carpets, textiles and some electric appliances among others were also reduced. The authorities further increased excise tax rates on motor vehicles, alcoholic beverages and textiles by about 50 percent and also expanded the base by extending the tax to edible vegetables, tubers and meat in 2002. The rates for woven and textile fabrics were also increased to 50 percent from 20 percent in 2005. On one side, the base was also expanded by extending to the usage of airtime at the rate of 10 percent in 2008. The tobacco industry was not spared from the reform programme as Government introduced specific excise rates and the use of tax stamps to curb smuggling of cigarettes in 2008. The mode of calculating the excise rate was based on quantity, US$ 18 per thousand sticks for a hinge lid packet and US$12 per thousand sticks for a soft packet. Cigarettes with 70 percent quantity of Malawian tobacco attracted a unit tax of US$ 9 dollars per thousand sticks for a hinge packet and US$ 6 per thousand sticks for a soft packet. In 2010, Government increased excise rates on cigarettes in a soft pack from $12 to $15 per thousand sticks and $30 from $18 on hinge cap cigarettes per thousand sticks. In 2010, as Government's objective of fulfilling the Copenhagen international treaty on minimizing global warming, an additional 20 percent excise tax rate was imposed on old passenger carrying vehicles aged 8 and 12 years and 50 percent on those passenger carrying vehicles older than 12 years. Goods carrying vehicles less than 8 years of age exceeding 10 tonnes had their rates increased to 20 percent from 0 percent. In addition, 100 percent excise tax was introduced on ordinary bulbs to encourage the use of energy saver bulbs. To relieve poor consumers and create a competitive environment for industries, excise tax on plastic footwear was removed in 2001. The tobacco industry benefited through the removal of tax on hessian sacks, which are used for packing tobacco meant for exports in 2003. In a bid to improve consumers' welfare, Government restructured the excise tax regime for motor vehicles in 2005 through the reduction of tax bands to five.

2.4.6 Surtax

During this period, the surtax policy reforms aimed at continuing shifting the sources of revenue from trade to consumption taxes through rationalization of surtax rates on some products and extending the tax to other sectors of the economy. The objective of the rationalization process was to eliminate product misclassification, simplify tax administration, improve compliance, control smuggling and make local products competitive at international market. In 2000, Government extended surtax to commercial transporters and satellite and cable television providers as part of the expansion of the tax base. In the same year, surtax rates on petrol, diesel and paraffin were converted to excise rates and the excise rates were raised by 100 percent to control smuggling of fuel to other countries. On reducing the tax burden on people and industrial strategy of encouraging local production for specific sectors, Government zero-rated fresh and processed milk and capital goods and machinery used for manufacturing goods in 2001. One important policy reform in rationalizing surtax was repealing of Section 12A of the Customs and Excise Act to create stand-alone Surtax legislation in 2001. The new legislation was necessitated by the need to allow a smooth implementation of surtax which was extended to wholesale and retail stages as opposed to the manufacturing stage as it was disadvantaging local manufacturers against competing imports. The extension of surtax to wholesale and retail levels also helped in expanding the tax base. Several other reforms followed the enactment of the new Surtax Act including the extension of the tax to non-life insurance services, rental of commercial properties and removal of concessional rates in 2002. The standard rate of the tax was also set at 20 percent and some products were zero-rated as they are considered to be basic commodities such as salt. More importantly, products like exercise books were also zero rated as a means of increasing accessibility of learning materials and improving education system. To encourage compliance, reducing cost of production and providing more tax relief to consumers, the standard rate of surtax was lowered to 17.5 percent from 20 percent in 2003. In addition to reduction of the tax rate, other products such as hessian sacks for packaging tobacco for export were exempted from the tax. In order to simplify the surtax administration, Government limited the calculation of cost of goods and services to within a month in which they were sold. This was done after realizing that surtax input credit claims facilitated under-declaration of sales and increased the cost of inputs due to inflation. Moreover, the dates for submission were changed from the 30th to 25th day of the month to give more time to officials to assess the return before the end of the month. As the new system had features of Value Added Tax (VAT) such as credit mechanism and taxation of goods and services at wholesale and retail stages; Government replaced the Surtax Act with a Value Added Tax (VAT) Act in 2005. The change of name was also to align the tax to international best practice.

2.4.7 Value Added Tax (VAT)

Bill 7 of 2005 introduced and put VAT in operation on 1st January 2005 to replace Surtax. The tax was designed to avoid cascading effect of surtax. The tax is collected as the difference between the tax levied on sales of goods and services within the national territory or goods imported into the country, less the tax paid on inputs which include raw materials and capital goods. The tax had a single standard rate of 17.5 percent unlike the earlier multiple rates. Besides the normal regime, the tax has four other regimes: voluntary, zero-rated, exempt and relief supply. A taxpayer may fall within one of the regimes: (i) a normal regime, where standard rate applies and minimum turnover is required for qualification while VAT paid on inputs is reimbursed if the taxpayer is in excess situation (ii) a voluntary (simplified) regime, characterized by a turnover below normal regime but the taxpayer may voluntarily opt to register (iii) an exempted regime, whereby there is no payment of VAT on sales, and VAT paid on inputs is not reimbursed to the taxpayer, (iv) a zero-rate regime, where VAT is not paid on sales but reimbursement is done for VAT paid on inputs, and (v) Relief Supply regime which applies to bodies due to their social and economic status. The VAT relieved organizations are required to complete certain requirements when purchase goods and services. Just like other taxes, the objectives of the VAT were largely to relieve tax burden on individuals and increasing trade competitiveness of the private sector. In addition, the tax was extended to capital goods and machinery except goods used for agricultural trade in 2005 in an effort to expand the tax base. The reform also aligned the system to international standards as the system operates on input and output basis. In 2006 using Bill 11, products including petrol goods carrying vehicles and pharmaceuticals were zero rated while wheel chairs were exempted. On relieving taxpayers from tax burden and reducing cost of goods and services, the standard rate was reduced to 16.5 percent from 17.5 percent in 2008 using Bill 10. In the same year, Government also removed VAT on gaming/betting including lotteries while in 2009, rail locomotives, aircrafts, aircraft engine and related spare parts were zero-rated and the minimum VAT threshold was raised to MK6 million.

2.4.8 Administration reforms

The pre-2000 reforms in tax administration were aimed at addressing complex and out-of-date administrative procedures, (which encouraged rent-seeking behavior and corruption), unpredictable changes in legislation, lack of transparency, a lack of computerized information storage and taxpayer registry to carry out effective audits and enforcement. In particular, customs management and controls were deficient in all areas because of rent-seeking activities that contributed to low levels of trade taxes being collected. The post-2000 reforms were meant to improve taxpayers compliance. As such in 1999, Government embarked on Automated System for Customs Data (ASYCUDA) project with assistance from United Nations Conference on Trade and Development (UNCTAD) which became fully operational in 2002. As for domestic taxes, MRA established a Large Taxpayer Office (LTO) in 2007 with taxpayers that have at least a tax liability of MK200 million. In 2009, Government introduced a self-assessment scheme and introduced a system of paying of taxes through banks for taxpayers in the LTO. In the same year, Government introduced the use of Tax Clearance Certificates by professional practitioners, such as lawyers, engineers, medical practitioners and architects before the issuance of business licenses and renewal of permits in an effort to improve compliance. In addition, Income Tax Division and VAT Division were integrated and became one Department named Domestic Tax Division (DTD) in order to strengthen the administration of taxpayers/taxes.

3 The Impact Tax Reforms on Revenue Performance

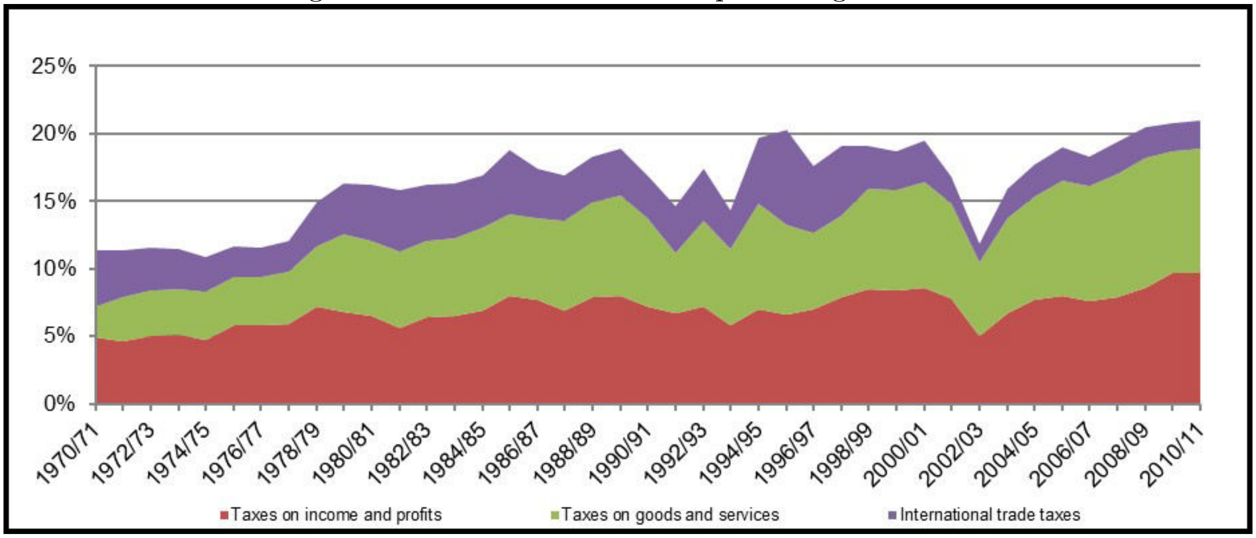
3.1 Analysis of the Approach

There are several methods that can be used to determine the impact of tax policies on revenue performance such as tax buoyancy, tax elasticity and revenue collection as a percentage of GDP etc. For purposes of this paper, the revenue collection as a percentage of GDP approach has been used for the analysis. The method was selected because the data required is readily available unlike the other methods which require complex data that is currently unavailable.

3.2 Analysis of Results

Over the entire period of analysis, the volatile performance of the revenues comes as no surprise given the policy shifts. The revenue performance from 1970 shows that the country revenues made up 12.0 percent of the 1970 GDP then reached 20.3 percent in 1995 before declining to its lowest level of 11.8 percent in 2002 as shown in Figure 1. The revenues rebounded in 2003 and the upward trend has continued up to 20.9 percent as registered in 2010. The volatility in revenues indicates some economic crisis the country has been going through as evidenced by a substantial drop in revenues during every economic crisis like in 1981, 1991 and 2001. Figure 1 presents the revenues as a percentage of GDP. The Figure shows that Government revenues have been substantially increasing over the years as a percentage of GDP. Further,indirect taxes (VAT/Surtax, Excise tax and Customs duty combined) have been dominating direct taxes (personal and company taxes). However, disaggregating the taxes, direct taxes have taken a dominant role since 1970 over other taxes.

Figure 1: Overall revenues as a percentage of GDP

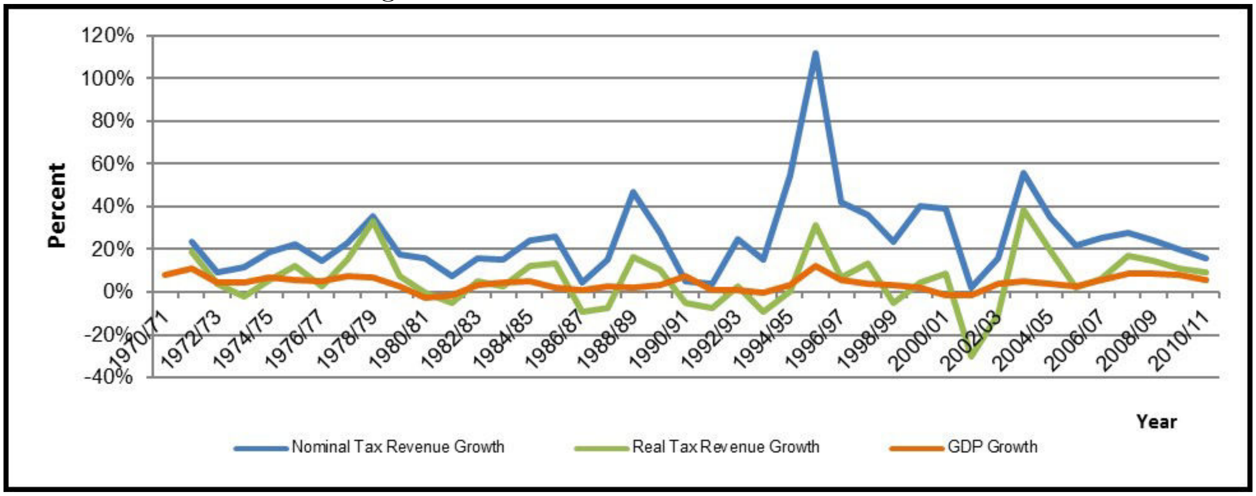


Source: Authors based on MRA and IMF data

Figure 2 presents revenue growth in comparison with GDP growth. The Figure depicts that revenues are pro-cyclic to GDP reflecting a wide variety of factors including changes in tax base, variation in compliance control, alterations of tax rates, exemptions and administrative changes. It also shows that the growth in revenues are faster than GDP, suggesting that the base has been widening and administration has been improving over the years. It is worth noting that there is always a substantial increase in revenues as percent of GDP following every major policy change. It is also interesting to note that since there is real revenue growth after every major policy, the increase in revenues is a result of the widening of the base and not the effect of inflation.

The overall performance of the revenues over the period shows that direct taxes have been dominating contribution to total taxes, with more than 40 percent across the period as presented in Figure 3. However, the trend for taxes on goods and services (VAT and Excise tax) indicates that the taxes have been widening over the years from 10 percent in 1970 to about 47.4 percent in 2007 while international trade taxes (import duty) have been

Figure 2: Growths of Revenue and GDP



Source: Authors based on MRA and IMF data

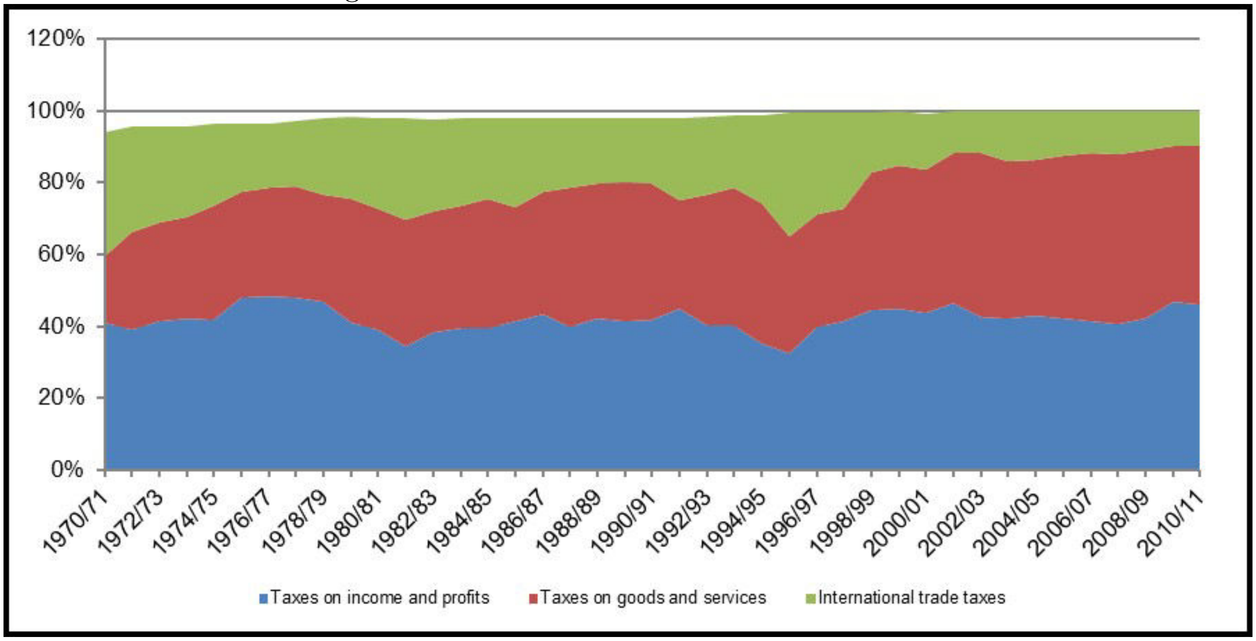
narrowing over the years from 34.6 percent contribution in 1970 to 9.8 percent in 2010 despite the brief increase in 1995.

3.2.1 Income Taxes

The performance of direct taxes has been impressive over the years. The contribution of income taxes towards total tax revenues has been maintained at above 40 percent throughout the period. The income tax dominance over other forms of taxes indicates the country's reliance on direct taxes. However, in recent years, taxes on goods and services (VAT and Excise tax) have also become dominant like direct taxes. As shown in Figure 4, direct taxes stood at about 4 percent of GDP in 1970 as compared to about 2 percent of GDP for goods and services taxes. However, in 2010, both income taxes and goods and services taxes stood at about 9 percent of GDP. The success of goods and services taxes is attributed to reforms which expanded this category's tax base.

Within the group of income taxes, the relative contribution of individual taxes dominates the corporate (company) tax. Although such a trend is also observed in many developed countries, in Malawi the ratio is 2:1 as compared to developed countries where the ratio is 3:1[17]. The tax yield of individual tax components is not as impressive as in developed and other developing countries, perhaps due to a lack of compliance culture from citizens and also inadequate legislation framework which can compel individuals to remit taxes. In addition, the low yield may also be attributed to weak administrative capacity to enforce legislation on payment of taxes from individuals.

Figure 3: Contribution to Gross Tax Revenue



Source: Authors based on MRA and IMF data

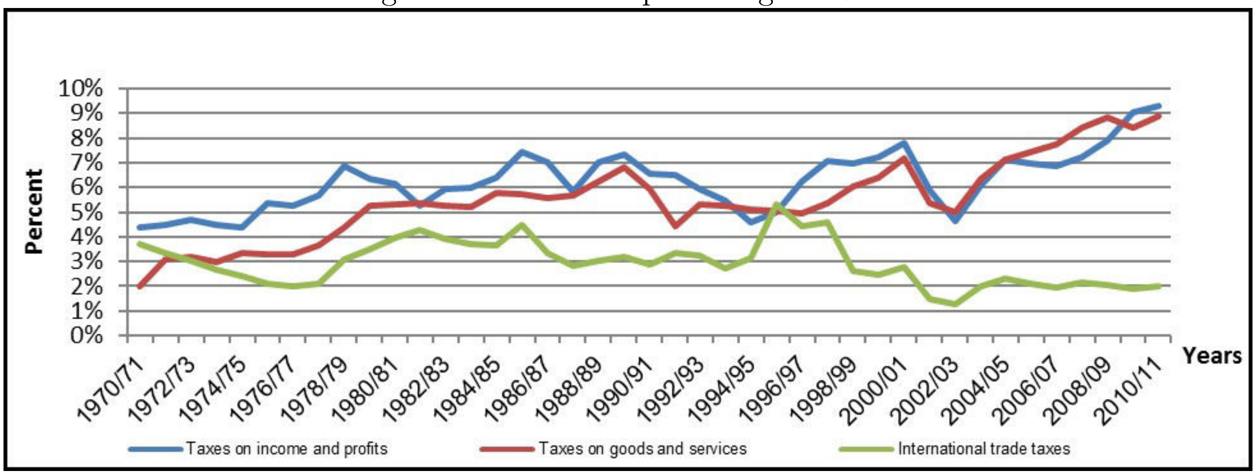
3.2.2 International Trade Taxes

The importance of trade taxes to total taxes has been diminishing over the period under consideration. Figure 3 shows that international trade taxes declined to as low as 9.8 percent of total revenue in 2010 from 34.6 percent in 1970. Furthermore, Figure 4 shows that international taxes collection was about 2 percent of GDP in 2010 from 4 percent of the GDP in 1970. The drop in importance of international trade taxes is largely on account of the country's participation in both regional and multilateral trade arrangements which have

[17]Revenue Statistics 2014 - OECD

resulted in the reduction of average tariff rates from 28.7 percent in 1990s to 12.7 percent in 2010. This conforms to the world trend where the contribution of international trade taxes to the total revenues is diminishing. In the case of developed countries, the contribution of international trade taxes to total tax revenues is less than 0.3 percent of GDP (Karingi & Wanjala, 2005). As the country is moving towards more free trade, the contribution of international trade taxes towards total tax revenues will continue to drop.

Figure 4: Taxes as a percentage of GDP



Source: Authors based on MRA and IMF data

3.2.3 Taxes on Goods and Services

The significance of taxes on goods and services has over the years increased tremendously. Their contribution to total tax revenue increased from about 10 percent in 1970 to 47.4 percent in 2007. As a percent of the GDP, the component has moved to about 9 percent of GDP in 2010 from about 2 percent of GDP in 1970. The increase reflects the widening of the tax base especially after embracing the reforms in the late 1980s. The value added tax (VAT) has become a major component and its performance has been satisfactory since extending to the wholesale and retail stages in 2001. With the diminishing contribution of international trade taxes; taxes on goods and services, particularly VAT is being regarded as the future tax for the country's revenue mobilization. Table 3 shows the performance of the

VAT as compared to other taxes. The trend shows that the tax peaked to about 6 percent of GDP in 2010 from around 1 percent of GDP in 1970 though it was earlier referred to as Surtax. On the other hand, excise tax remained below 1 percent of GDP up until 2000 when the tax peaked up to more than 1 percent of GDP.

Table 3: Tax Type as a Percentage of GDP

Year	Company Tax	Personal Tax	Surtax/VAT	Excise Tax	Customs Duties
1970/71	2.24	2.14	1.12	0.86	3.69
1971/72	2.44	2.05	2.25	0.85	3.35
1980/81	3.73	2.41	4.60	0.74	3.98
1981/82	2.90	2.36	4.59	0.76	4.27
1982/83	3.37	2.56	4.35	0.86	3.91
1990/91	3.94	2.09	5.34	0.53	2.88
1991/92	3.81	1.99	3.84	0.52	3.34
1992/93	2.85	2.42	4.77	0.48	3.24
2000/01	2.76	3.33	5.35	1.82	2.78
2001/02	1.83	2.64	3.97	1.37	1.48
2002/03	1.38	2.18	3.86	1.16	1.29
2003/04	1.78	3.02	4.51	1.83	2.01
2004/05	1.95	3.97	4.95	2.19	2.30
2005/06	2.03	3.91	5.24	2.21	2.09
2006/07	2.02	3.75	5.59	2.17	1.97
2007/08	2.13	4.14	5.96	2.48	2.15
2008/09	2.67	4.24	5.93	2.89	2.06
2009/10	3.22	4.58	5.76	2.64	1.92
2010/11	2.49	4.93	6.09	2.78	1.98

4 Findings on the Tax Policy Formulation

Tax policy formulation in Malawi is a multi-sector approach. There are a number of key institutions that influence tax policy formulation particularly the Ministry of Finance, Economic Planning and Development, the Ministry of Industry and Trade, and the Malawi Revenue Authority. There are other institutions including International Monetary Fund (IMF) and World Bank which are mainly consulted on revenue targets, policy proposals and technical analysis. In principle, the Ministry of Finance, Economic Planning and Development is responsible for developing tax policy and determining the tax policy changes. We find that previously, the analysis of the impact of tax policy changes on other sectors of the economy was not fully coordinated until 1993 when the Tax Policy Unit in the Ministry of Finance, Economic Planning and Development was established. The Unit has evolved to Revenue Policy Division and is charged with the responsibility of coordinating formulation of tax policies, overseeing its implementation and assessing their impact on all the sectors of the economy. The Division is also responsible for forecasting the revenue impact of the policy changes. On one side, Malawi Revenue Authority through its Policy Planning and Research Division participates in tax policy analysis and formulation by developing policy proposals based on the feedback the institution receives from the taxpayers and submits the technical analysis of such proposals to the Ministry of Finance, Economic Planning and Development for consideration/inclusion in the policy formulation. In principle, tax policy formulation is made through a number of continuous formal and informal consultations with the private sector, other Government agencies and MRA. Since 2000, as part of the national budget formulation process, Government through the Ministry of Finance, Economic Planning and Development engages individuals, businesses personnel, professional associations, academicians and civil society to get their input on tax policy and administration changes and general public expenditures. Over the past few years, Government has increasingly initiated more formalized consultation process through key professional institutions such as the Institute of Charted Accountants in Malawi (ICAM), the Economics Association of Malawi (ECAMA), the Malawi Confederations of Chambers of Commerce and Industry (MCCCI) and Farmers Associations among others. The primary objective of consultations is to generate ideas and encourage dialogue on institutional, regulatory and policy reforms that need to be undertaken to promote the development of the private sector and the economy. There are also other times when MRA engages with the public through various fora to get feedback on the impact of tax policies on businesses. These kinds of meetings have also helped shape the tax policies of the country. We observe that conspicuously missing on the tax policy formulation is the role of Political Parties and Parliamentary Committees responsible for Budget and Finance, Trade and Commerce, coordinated Civil Society Coalition and Local Governments. Unlike the private sector whose views on tax policy formulation are presented by MCCCI, civil society organizations present their proposals in an uncoordinated fashion. Parliamentary Committees and Political Parties have also little interest in tax policy formulation as their main interest is on the actual government expenditure. It is therefore not surprising that often times they do not participate in stakeholder forums with the private sector when presenting tax policy proposals. This, in most cases, compromises the quality of the tax policies as Government can only implement policies that represent views of few sectors of the society thereby leaving out important needs of the general public. However, this lack of full involvement of political parties and parliamentary committees in tax policy formulation is not only unique to Malawi but across African countries as observed by Fjeldstad and Heggstad (2011). It was observed that Political Parties and Parliamentarians have limited understanding of complex budgetary issues including taxation due to weak research support, limited resources and information rendered to such institutions. If Political Parties had strong research and advisory units within their institution, they could have better technical capacity and skills to understand tax policies hence constructively contribute in the policy formulation. We also find that there is no cooperation and consultation between tax policy coordinating units in the Ministry of Finance, Economic Planning and Development and MRA with the Local Government authorities where the decentralized structures of Government are well established, especially in the rural areas. This limited interaction poses challenges to compliance enhancement initiatives such as taxpayer education and cost of compliance for both administration and taxpayer as there is duplication of information requirements. It should be noted that formulation of sound taxation system requires greater cooperation and linkages between different parts of the Government and the private sector so as to formulate tax policies which are coherent and well managed, (Fjeldstad & Heggstad, 2011). On the other hand, we find that Government has not fully utilized Civil Society Organizations (CSOs) as a possible channel of increasing awareness and education on tax issues. Establishing such cooperation is helpful as the general public can easily embrace tax issues if the CSOs can take the lead in educating communities on the importance of paying taxes for the economy as well as for the general public.

5 Conclusion

The paper focused on analyzing tax policy changes and the impact of the policies on revenue performance. It also analyzed the key influencers and drivers of tax policy changes and their role on tax policy formulation. The analysis has traced that the tax policy reforms had different sets of objectives to achieve at a particular period. In addition to the overriding policy reform objective was simply to improve revenue generation. Other objectives included simplifying the tax system, improving equity, improving investment, widening the tax base, reducing tax evasion and liberalizing trade. It has been clearly demonstrated that the policy reforms have had an impact on revenue generation as the revenues grew as percentage of GDP. Worth noting is the substantial increase in revenues as a percent of GDP following major policy changes, which indicates that the increase in revenues was as a result of the widening of the tax base. However, further analysis is required on the magnitude of the responsiveness of the taxes to these policy changes. The analysis has also shown that direct taxes have been dominating the contribution to total taxes and have been closely followed by goods and services taxes. On the contrary, trade taxes contribution has been diminishing over the years. The study has also established that the country has a history of volatile revenue flows which calls for serious efforts to diversify the revenue structure. It is therefore recommended that the revenue structure should largely be domestically driven for long term stability and sustainability. Further goods and services revenue sources (VAT) which is now the most dependable revenue source and has the potential to become the country's main revenue source should be strongly safeguarded. The analysis has also revealed that the tax policy formulation process is not strongly consolidated as some sectors are not actively participating. However, the establishment of a sound taxation system requires greater cooperation and linkages between different sectors of the society and Government so as to achieve tax policies which are coherent and well managed. Finally, it has also been observed that Government has not fully utilized other sectors of the society as the channel of increasing awareness and education on tax issues. This paper recommends establishment of such cooperation to help Government in educating the communities on the importance of paying taxes thereby improving tax compliance levels.

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