Chapter 5 – Macroeconomic and Expenditure Framework

This chapter is under development and will be refined in later drafts

Meaningful poverty reduction will require sustainable economic growth and a stable macroeconomic environment. Macroeconomic stability is an essential precondition to economic growth. The essential conditions for macroeconomic stability are prudence in fiscal management and tight monetary policies. Hence, if the MPRS is to achieve macroeconomic stability, it must carefully balance available resources with expenditure requirements. This Chapter outlines the macroeconomic and expenditure framework that focuses on realistic and quantified targets needed to achieve certain levels of poverty reduction by 2004, whilst remaining within levels of resource use that will ensure macroeconomic stability.

5.1Macroeconomic Stability and Poverty

Macroeconomic instability has in Malawi been associated with low economic growth rates, high inflation rates, unstable normal exchange rates, unstable interest rates as illustrated in Table 1 below.

Table 5.1: Basic Macroeconomic Indicators

	1994	1995	1996	1997	1998	1999	2000
GDP growth rate	-10.2	9.6	8.2	4.9	2.0	4.0	1.7
Average Annual Inflation	34.7	83.1	37.7	9.1	29.8	44.8	29.6
Domestic Saving/DGP	-3.0	-3.0	3.0	0.9	6.0	3.1	3.1
Investment/GDP	29.1	17.0	11.6	12.2	13.3	14.8	15.9
Interest rate (Lending)	31.0	47.3	45.3	28.3	37.7	53.6	53.6
Current Account Deficit/GDP (inc grant)	-13.4	-1.7	-7.7	-10.5	-2.5	-8.3	-4.9
Exchange rate (MK1US$, average	8.7	15.3	15.3	16.4	31.1	44.1	59.5
External Debts/GDP	150.6	139.1	88.6	90.8	142.7	144.0	150.3

Source: IMF

5.1.1 Fiscal and Monetary Imbalances and Poverty

High fiscal deficits have necessitated excessive Government borrowing, which in turn has led to high interest rates and the crowding out of the private sector. Macroeconomic instability has also been reflected through high inflation rates caused by increased money supply. The trends are illustrated in Table 5.2 below.

Inflation is also a regressive and arbitrary tax, which places a heavy burden on the poor. In particular high inflation is damaging to growth as inflation erodes purchasing power most seriously on the poor.

Table 5.2: Source of Increases in the Money Supply 1995-2000

	1995	**1996**	**1997**	**1998**	**1999**	**2000**	**AR.**
Change in M2	1182	2345	-108	2518	2905	2412	1876
Net Foreign Assets	1392	4906	-1747	4489	995	3591	2271
Net domestic Assets	-209	-2561	1639	-1971	1910	-1179	-395
Of which			131	-1660	-251	311	-285
Credit to Govt. (Net)	-276	35	43	-554	1599	129	249
Credit to Statutory bodies	123	152	197	1582	179	1758	658
(Net)		155	1268	-1338	381	-3375	-1016
Credit to private sector	74	-2902	-17	41.1	33.6	20.9	
Other items (net)	-131	60.3	-0.26	4.67	3.62	2.25	
	43.7	6.3	416.6	539.6	802.4	1070	
% Increase in M2	5.41	372.3	16.4	31.1	44.1	56	
Increase in M2 as % of GDP	218.0	15.3	155.0	258.0	244.0	218	
	15.3	218.0	3367	7856	8851	1244	
GDP (Kwacha billion)	106.0	5114					
Exchange rate (MK/US$)	208						
Gross official reserves							
Official reserves in Kwacha							

High interest rates act as disincentive to investment and therefore retard economic growth and worsen poverty as the poor fail to raise credit resources to participate in production. On the other hand depreciating exchange rates erode incomes and purchasing power of the poor through inflationary effects.

5.2 Simulation Model Assumptions

To come up with an appropriate macroeconomic framework, simulations have been made for growth rates of 3 percent, 5 percent, 8 percent and 10 percent. From historical patterns, 3 percent growth over the medium term was noted to be achievable. However, unless there are significant changes to the structure of the Malawi economy and the sources of growth, this growth rate will not be sufficient to achieve sustainable poverty reduction. The 5 percent growth rate was also considered to be attainable. This conclusion arises from the fact that the economy has grown by 4 percent in the recent past. However, the economy would need to develop sufficient economic "shock absorbers" if the economy diversified its sources of growth and attained a consistent macroeconomic environment.

The 8 percent growth rate was also considered realistic in the medium term given that Malawi attained a growth rate of 9.8 percent in 1996. However, to achieve this growth rate would require consistent macroeconomic stability, sustainable economic structural diversification, radical changes in the mindsets of the population, and strong social, technical and political will. The 8 percent growth would then start to significantly reduce poverty in the country.

The 10 percent scenario is based on Vision 2020 and would move Malawi to a middle-income country if sustained over a long period. This would require political commitment at the highest level, complete transformation of mindsets of farmers, entrepreneurs, traditional leaders, public servants and donor representatives. By looking at the potentials of the country, the 10 percent is in fact achievable.

5.3 Framework Targets and Indicators

5.3.1 Economic Growth Rate

For the purpose of the MPRS, a more realistic growth rate would be 5 percent over the next three years. This rate is attainable and would require minimal shocks to the economy to shift from the current growth rate of 1.8 percent. According to the simulation results, the sources of growth would be increased productivity in agriculture, manufacturing and producers of government services.

5.4Other Macroeconomic Targets

The inflation rate commensurate with the 5 percent growth would on average be 18 percent with the GDP deflator moving from 11.11 percent in 2002 to 17.05 percent in 2004 as shown in Table 5.3 below. Within the same time period, the nominal exchange rate would move from MK70.61 to 1 US$ to MK78.59 to 1US$. Revenue (including grants) as a percentage of GDP would decline from 25.7percent to 16.6 percent in 2002 and 2004 respectively. At the same time expenditure as percentage would also decline from 25.2 percent of GDP to 15.9 percent within the same period. Overall balance (including grants) would improve from –22 percent in 2002 to –11 percent in 2004.

Table 5.3: Macroeconomic -Balances – 5% and 8% Growth Scenarios

	5% growth			8% growth		
	2002	2003	2004	2002	2003	2004
GDP at constant prices	15441.20	16213.25	17023.92	15882.37	17152.96	18525.20
GDP at current prices	171496.03	223107.76	290252.03	169135.06	217007.05	278428.73
GDP deflator	11.11	13.76	17.05	10.65	12.65	15.03
Money and Quasi Money	23492.61	30562.71	39760.55	23169.19	29726.99	38140.92
Nominal Exchange Rate	70.61	74.15	78.59	72.03	76.00	80.79
Central Government Revenue	44150.95	46134.90	48249.67	44985.41	47441.30	49423.57
Tax and non-tax Revenue	28315.65	30748.00	32176.87	29150.11	32054.40	33350.77
Grants (Including HIPC)	15835.30	15386.90	16072.80	15835.30	15386.90	16072.80
Total Government Expenditure (excl. stat. Exp.)	43244.83	44731.81	46220.99	43814.01	45347.98	46929.17
Statutory expenditure*	11265.00	11827.78	12418.67	11265.00	11827.78	12418.67
Interest payments (netted out of Statutory Exp.)	6650.00	6899.43	7102.50	6720.90	6989.10	7220.90
Total Government Expenditure**	47859.83	49660.16	51537.16	48358.11	50186.66	52126.94
Overall Balance Excluding Grants	-19544.18	-18912.16	-19360.29	-19207.99	-18132.26	-18776.17
Overall Balance Including Grants	-3708.88	-3525.26	-3287.49	-3372.69	-2745.36	-2703.37
Revenue as % of GDP (Total Including grants)	25.7%	20.7%	16.6%	26.6%	21.9%	17.8%
Expenditure as % of GDP (Excl. Statutory Exp.)	25.2%	20.0%	15.9%	25.9%	20.9%	16.9%
Expenditure as % of GDP (Incl stat.exp)	27.9%	22.3%	17.8%	28.6%	23.1%	18.7%
Overall Balance as % of GDP (Excluding grants)	-11.4%	-8.5%	-6.7%	-11.4%	-8.4%	-6.7%
Overall Balance as % of GDP (Including grants)	-2.2%	-1.6%	-1.1%	-2.0%	-1.3%	-1.0%

5.5Resource Envelope

The resource envelope commensurate with a growth rate of 5 percent is shown in Table 5.4 below. In terms of resource requirements, the 5 percent scenario, in 2002, would require government to spend MK43 billion as discretionary expenditure (total expenditure including statutory expenditure would be MK48 billion). The economy would generate domestic revenue resources amounting to MK28 billion (MK44 billion with external resources). Overall, the budget deficit would be 11.4 percent of GDP (excluding external resources) or 2.2 percent of GDP (including external resources)

Table 5.4 Resource Envelope, Use and Gap

Resource Envelope	5% growth			8% growth		
	2002	2003	2004	2002	2003	2004
Direct Taxes	11213.2	12718.8	13254.8	11536.3	13283.2	13805.8
Indirect Taxes	12710.0	13400.5	13820.5	12847.4	13919.2	13968.7
Non-tax Revenues	4392.5	4628.7	5101.6	4766.4	4852.0	5576.2
Grants (other)	11386.4	11236.7	11729.3	11386.4	11236.7	11729.3
HIPC	4448.9	4150.2	4343.5	4448.9	4150.2	4343.5
Total Domestic Resources	28315.6	30748.0	32176.9	29150.1	32054.4	33350.8
Total Resources	44150.9	46134.9	48249.7	44985.4	47441.3	49423.6

Resource Use	5% growth			8% growth		
	2002	2003	2004	2002	2003	2004
Total Government Expenditure (excl. stat. Exp.)	43244.8	44731.8	46221.0	43814.0	45348.0	46929.2
Statutory expenditure*	11265.0	11827.8	12418.7	11265.0	11827.8	12418.7
Total Government Expenditure	47859.8	49660.2	51537.2	48358.1	50186.7	52126.9

Resource Gap	5% growth			8% growth		
	2002	2003	2004	2002	2003	2004
Domestic Resources	-19544.2	-18912.2	-19360.3	-19208.0	-18132.3	-18776.2
Total Resources	-3708.9	-3525.3	-3287.5	-3372.7	-2745.4	-2703.4

5.6 The Costing of Poverty Reduction Activities

The weakness with macro models is that they are unable to give out sector resource requirements to be used for poverty reduction. In order to establish sectoral requirements, the MPRS uses costings of sector activities based on target indicators and unit costs to arrive at required levels of expenditure. The MPRS prioritisation and costing exercise has identified four broad types of expenditure namely Statutory, Overhead, Direct and Enabling expenditure.

Direct Poverty Expenditures (DPE), as shown in Table 1, are expenditures that fund activities that provide services or transfers directly to the poor and these are of the highest priority. These include health, education, agricultural extension, for example. **Enabling Poverty Expenditures** are expenditures that fund activities that enable the implementation of the DPEs and therefore the reduction of poverty. The activities occur at two levels: firstly by enabling specific direct poverty activities for example administration in education and secondly general enablers that are necessary for the implementation of the overall strategy such as public expenditure management, National Assembly, Decentralisation and other reform programmes. In the MPRS, only those enabling activities that are prerequisites for the efficient and effective operation of direct poverty reducing activities have been included.

The **Overhead Expenditures** are those expenditures that are necessary for the administration of state such as Ministry of Defence, State Residences, Office of the President and Cabinet and Ministry of Foreign Affairs. These Overhead Expenditures form core activities of running the administration of state, and are treated separately from Direct Poverty and Enabling expenditures. Lastly, **Statutory Expenditures** are expenditures that must be made and cannot be scaled down such as debt services, pensions and gratuities.

5.6.1 Direct Poverty Reduction and Priority Poverty Reduction Expenditure

Table 5.5 below presents sectors and activities in the sectors that are directly related to poverty reduction. The sectors in the Table 5.5 were arrived after considerable debate during the consultation process, particularly at the District level. It is these sectors and activities where government will increase its expenditure on a priority basis. The efficient utilisation of the resources in these direct poverty reducing activities supported by the enabling activities will transform both economic and poverty status of the country.

Table 5.5:Categorisation of Direct Poverty Reduction Expenditure by Activity

Sector	**Specific Activities**
Agriculture and Irrigation	Agricultural extension, Market information dissemination, Irrigation development, Development of Farmers' Clubs and Co-operatives
Education	Primary Education, Secondary Education, Teacher Training, Teaching and Learning Materials
Water and Sanitation	Management, maintenance and construction of boreholes and piped water, Sanitation, Dam construction and maintenance.
Nutrition	All activities related to food and nutrition

Technical and Vocational Education	All activities related to technical and vocational training except expenditure on the Ministry of Labour
Environment	All activities related to protection and management of environment
Health and Population	All activities related to Essential Healthcare Package
Community Services and Gender Empowerment Home Affairs	Community Services Expenditure Adult Literacy Expenditure Pre-School Expenditure All activities related to Police and Prisons
Transport and Public Works	All activities related to maintenance and construction of rural feeder roads and main roads

5.6.2 Priority Poverty Reducing Activities

During the Budget season of 2001/2002, the consultation process identified some activities that were priority for poverty reduction. The government increased its expenditure allocations to these sectors in response to popular demand emerging from stakeholders. The Priority Poverty Expenditure (PPEs) are summarised in the Findings to Date Document.

In Table 5.6, we note that the PPEs are activities within DPE areas. Government will allocate funds in accordance with the priorities emerging from the MPRS. The link between the DPE areas and PPEs is given in Table 5.6 below.

Table 5.6: Direct Poverty Expenditure and Priority Poverty Expenditure

DIRECT POVERTY REDUCTION EXPENDITURE	**PRIORITY POVERTY EXPENDITURE PPEs**
Basic Education (Primary, Secondary, Adult, Technical, Special Education)	Teaching and learning Materials Teacher Training Teachers salaries and house allowance
All Agriculture activities except reform of the Ministry.	Agricultural extension system and associated reforms Expansion of community based irrigation Creation of farmers associations and co-operatives
Water and Sanitation	Increase allocations to construction and maintenance of boreholes
Nutrition	Food security and nutrition Introduction of nutrition education programmes
Technical and Vocational Training	No PPE as cross cutting
Environment	No PPE as cross cutting
Roads	Maintenance and construction of rural feeder roads

All Police Services Including Community Policing	Increase allocations to community policing programmes across all districts
HIV/AIDs	No PPE as cross cutting
Gender	No PPE as cross cutting
All Health activities	Drugs Health worker training Health Worker salaries and conditions

5.7 Medium Term Expenditure Framework

As part of the MPRS process, Thematic Working Groups developed detailed strategies and costings of these strategies. The Expenditure Framework includes the costings for the Direct Poverty Expenditures based on the specific activities that Government would implement to reduce poverty if necessary resources were available. The costings are based on unit costs and the achievement of long-term country targets comparable to long term global targets[1]. Details of the strategies, activities and costs are included in Annex 2.

5.7.1 Direct Poverty Expenditures

Table 5.7 shows the overall costings for Direct Poverty Expenditures derived from the unit cost of achieving a specific objective within a given time. For ease of presentation, the activities are grouped under their implementing Ministries. The costings indicate that Government needs to spend 34bn, 35bn and 36bn MK respectively for the years 2001/2002, 2002/2003 and 2003/2004.

While the Direct Poverty areas are accorded a higher priority within the Expenditure Framework, these sectors will be required to apply the priorities identified during the process as the basis for allocating resources during the implementation of the budget.

[1] Progress towards the international development goals, A Better World for All 2000

Table 5.7 Direct Poverty Reduction Costings

		1. Budget Estimates			PRSP Costings		
		2001/2002	**2002/2003**	**2003/2004**			
	Ministry	**Estimate**	**Projection**	**Projection**	**2001/2002**	**2002/2003**	**2003/2004**
Pillar							
	Agriculture	2,542,785,814	2,630,604,452	2,603,262,769	2,452,389,809	2,652,029,641	2,573,945,155
Pro-Poor Growth	**Water Development**	2,140,153,274	1,369,396,552	1,046,937,293	1,538,221,082	1,471,694,222	1,422,621,570
	Roads	1,796,000,000	3,416,962,076	954,145,000	2,951,172,000	2,951,172,000	2,951,172,000
	Natural Resources	843,323,301	647,876,235	666,902,816	991,744,918	1,059,933,709	1,053,281,729
	Tourism Parks and Wildlife	71,222,913	81,408,423	88,113,531	186,154,017	156,356,993	152,090,626
Safety Nets	**Gender, Youth and Community Services**	454,530,728	391,521,457	356,258,900	2,520,713,505	2,522 ,990,803	2,526,239,587
	Ministry of People with Disabilities	26,869,110	31,123,507	32,604,170	15,288,669	26,869,110	31,123,507
	Safety Nets	0	0	0	1,975,806,800	2,063,187,800	2,218,485,969
Human Capital	**Labour and Vocational Training**	34,193,882	43,049,742	43,688,752	498,630,654	552,252,982	637,695,571
	Education	5,904,177,500	4,461,922,455	4,600,275,580	11,080,492,830	11,947,060,319	11,991,553,598
	Health and Population	5,361,065,352	5,164,520,730	4,609,332,959	7,135,876,579	7,194,522,382	7,618,631,609
	Nutrition	0	0	0	461,861,001	502,796,667	572,380,501
Governance	**Police**	681,792,997	906,990,648	931,282,466	2,830,775,222	2,875,761,888	2,919,501,888
	Prisons	240,402,184	349,895,759	266,107,821	346,192,769	330,192,757	330,192,757
	Total Direct Poverty Reduction	20,096,517,055	19,495,272,036	16,198,912,057	34,985,319,854	36,306,821,274	36,998,916,067

5.7.2 Enabling Poverty Reduction Expenditures

In the costing of the MPRS, it was assumed that the cost of Enabling activities are the same as the projections contained in the Medium Term Expenditure Framework budget documents that include the approved Estimates for 2001/2002 and projections for 2002/03 and 2003/04. This also applies to the Overhead Category of expenditures. This, however, does not mean that Government should continue to implement these activities as before. Rather, it implies that Government must review and reprioritise its actions within those resource constraints by refocusing on providing an enabling environment for the direct poverty activities.

Table 5.8: Overhead Expenditures

	2001/02	2002/03	2003/04
STATE RESIDENCES	306,878,991	446,540,713	467,864,637
OFFICE OF THE PRESIDENT AND CABINET	696,087,913	975,781,079	896,010,273
STATUTORY CORPORATIONS	15,381,071	21,878,193	22,681,949
OFFICE OF THE VICE PRESIDENT	54,834,188	57,539,215	59,958,690
FOREIGN AFFAIRS AND INT. COOPERATION	976,090,252	2,086,961,836	2,083,167,775
SPECIAL ACTIVITIES	3,406,327,500	0	0
SUBVENTIONS TO STATUTORY ORGANISATIONS	1,116,000,000	1,171,800,000	1,230,390,000

5.8The Results of Prioritisation of the Expenditure Framework

Table 5.9 below shows the percentage allocations to the three broad types of expenditures, indicating that the direct poverty expenditures receive the highest allocation of the current Estimates for 2001/02 – 2003/04, while this percentage increases once the Costings for the Direct Poverty are added to the Expenditure Framework.

Table 5.9: Percentage Expenditure Allocations by Broad Category

Category	**% of Estimates**			**% of total Costings**		
	2001/02	**2002/03**	**2003/04**	**2001/02**	**2002/03**	**2003/04**
Direct Poverty Reduction	57.60%	54.76%	55.97%	70.44%	69.43%	74.40%
Enabling Poverty Reduction	23.54%	31.85%	27.54%	16.41%	21.52%	16.01%
Overhead Expenditures	18.86%	13.39%	16.48%	13.15%	9.05%	9.58%
Total	**100.00%**	**100.00%**	**100.00%**	**100.00%**	**100.00%**	**100.00%**

Table 6 below presents the percentage allocation of expenditures for both the current 2001/02 – 2003/04 Estimates and the MPRS costings. These percentages illustrate that the Human Capital pillar is receiving the highest share of the Total Estimates for the period 2001/02 – 2003/04, whilst the Growth and Governance pillars receive the second highest shares.

When the additional costs of the Direct Poverty Strategies are added to the estimates, the shares of the Human Capital Development increase further from 32 percent of the current estimates for 2001/02, compared to 38 percent of the MPRS costings. The percentages for Growth decline slightly as do the Governance shares, while the percentage of Overhead expenditures decline from 18 percent of the 2001/02 Estimates to 13 percent of the total costings for the same year. Within the Governance pillar, the share on Direct Expenditures for Police and Prisons increase significantly, as do the shares for the Safety Nets Pillar.

5.9Funding Gap

In Table 5.10 we note that the MPRS costing framework shows that after domestic resources and currently pledged donor grants and loans there is still a significant resource gap that is needed to achieve certain levels of the poverty reduction under the prevalent macroeconomic prescriptions.

The overall funding gap for the same medium term period is MK-6.15 bn, MK-7.27bn and MK-2.76bn.. For the next three years government will need to solicit extra domestic revenue or foreign grants in order to bridge the funding gap. The costing framework will exactly match the budget framework if the funding gap between these two frameworks is fully financed. If the funding gap is not fully financed lower priority areas and expenditures will be scaled down.

Table 5.10 Funding Gap

Macro Balances	**5% Growth Scenario**			**8% Growth Scenario**		
	2001/02	**2002/03**	**2003/04**	**2001/02**	**2002/03**	**2003/04**
Total Discretionary Expenditure	43,244,830,000	44,731,810,000	46,220,990,000	48,358,110,000	50,186,660,000	52,126,940,000
2001/02 - 2003/4 Estimates	34,868,587,540	35,577,854,039	28,914,370,069	34868587540	35577854039	28914370069
Additional Resources Available	8,376,242,460	9,153,955,961	17,306,619,931	13,489,522,460	14,608,805,961	23,212,569,931
Direct Poverty Costings	34,985,319,854	36,306,821,274	36,998,916,067			
Enabling Estimates	8,200,470,570	11,322,080,967	7,955,384,688			
Overhead Expenditures	6,571,599,915	4,760,501,036	4,760,073,324			
Total Costings and Estimates	49,757,390,339	52,389,403,277	49,714,374,079			
Gap	**-6,512,560,339**	**-7,657,593,277**	**-3,493,384,079**	**-1,399,280,339**	**-2,202,743,277**	**2,412,565,921**

5.10 Macroeconomic and Budget Pillars for MPRS

For Malawi to attain the desired macroeconomic framework for MPRS, the Government would be required to attain a fiscal deficit level of less than 1.5 percent of GDP, monetary and external sector policies for the next three years. Specifically, government would have to adopt policies which encourage public expenditure management and reduction in government borrowing; control money supply and inflation, maintain flexible exchange rate and improve the trade regime and the investment environment. Some of the policies are summarised in the matrix in Annex 2.