Chapter 5 - Macroeconomic and Expenditure Framework

5.1 Introduction

Macroeconomic stability[66] and efficient utilisation of public resources are essential conditions for economic growth and poverty reduction. Macroeconomic stability requires prudence in fiscal management and tight monetary policies. This demands that Government spends within its means, and therefore that expenditure requirements are balanced with resources available in a stable macroeconomic environment. This chapter outlines the macroeconomic and expenditure framework within which the MPRS will operate. It is crucial to the implementation of the strategy as it balances the expenditure requirements based on costing of the poverty reducing activities outlined in Chapter 4 with resources available.

5.2 Macro-economic Framework

5.2.1 Economic Growth and Poverty Reduction

Economic growth is a necessary but not sufficient condition for sustainable poverty reduction, as without growth, there will be no rise in incomes, and no additional resources available for Government to spend on poverty reducing activities. However, for growth to be effective in reducing poverty, it must involve and benefit the poor (pro-poor or "quality" growth).

In the past, both the quantity and quality of growth in Malawi have been poor. The quantity of growth has been erratic and low on average. The distribution of growth has been highly skewed towards the wealthy. This is clearly demonstrated by a World Bank study in 1998, which demonstrated that assuming past patterns and distributions of growth, the economy would have to grow at 5.3 percent a year just to maintain constant levels of poverty. This compares unfavourably to the average of 4.5 percent growth in the period 1994-2000. However, the study also shows that changes in the distribution of growth would have a far greater impact on poverty reduction. The challenge for Malawi is therefore to improve both the quantity and quality of growth.

5.2.2 Macroeconomic Stability and Poverty

As described in Chapter 3, although there have been periods of relative stability, the economy has generally been characterised by high inflation rates, an unstable nominal exchange rate, and high interest rates. This was caused by poor fiscal and monetary policies, adverse weather conditions and other external factors. For Malawi to attain macroeconomic stability, Government will adopt policies which will improve public expenditure management and reduce government borrowing; control money supply and inflation; maintain a stable and competitive exchange rate; and improve the trade regime and investment environment.

5.2.2.1 Fiscal 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. In addition, excessive

[66] Macroeconomic stability involves low and stable inflation, low interest rates and a stable exchange rate

borrowing has resulted into increased interest payments thus reducing the net resource envelope available to fund government activities, of which some are crucial to poverty reduction. Excessive Government borrowing from the Reserve Bank of Malawi (RBM), commercial banks and private individuals has contributed significantly to macroeconomic instability.

A number of measures to improve fiscal discipline are outlined under Public Expenditure Management in Pillar 4 of the strategy outlined in Chapter 4. In particular this involves improving the budget implementation by creating hard budget constraints (including parastatals), through strengthening political oversight of the budget, improving financial management and expenditure control mechanisms (including stronger sanctions against those that break financial management regulations), and the strengthening of resource forecasting. When planning and implementing the Budget, deficit levels should be dictated by inflation targets.

Also, there is need for stronger monitoring and enforcement procedures against overspending in parastatals. This will be achieved through the Public Enterprise Reform and Monitoring Unit (PERMU) and relevant Parliamentary committees, to be governed by a single, all encompassing Act covering parastatals.

In addition to these fiscal reforms, a number of institutional reform activities will be undertaken. Firstly, efforts will be made to increase the independence of the Reserve Bank of Malawi from government. The current legal framework of the Reserve Bank of Malawi is weak, particularly as regards the institutional framework policy independence. This will be achieved through a review of the Reserve Bank Act, including revising the appointment procedures for the Governor and Deputy Governor, and the current stipulated agreement on borrowing from the RBM.

The current legal framework governing public finances is weak in terms of autonomy of the office of the Secretary to the Treasury. Government will, therefore, revise the legal framework governing the roles of the Secretary to the Treasury and the Budget Director to strengthen their control of Budget implementation and their ability to meet deficit and therefore inflation targets. Finally, the powers of the Public Appointments Committee will be strengthened in order to ensure transparency in appointments of senior officials in government and parastatals, including the Reserve Bank of Malawi.

5.2.2.2 Monetary Imbalances and Poverty

The ultimate objective of monetary policy is the pursuit of low and non-volatile inflation. This is premised on the fact that high rates of inflation discourage saving and investment, and thereby damage an economy's potential for economic growth. Inflation is also a regressive and arbitrary tax that places a heavy burden on the poor as it erodes their purchasing power. Volatile inflation also introduces uncertainty in the business environment and thereby adversely affecting growth prospects and poverty.

High interest rates, which largely reflect fiscal imbalances, have an adverse effect on economy, particularly on the poor. Changes in interest rates affect real demand in an economy that in turn affects output and prices. High interest rates act as a disincentive to investment and therefore retard economic growth. High rates also reduce the affordability of credit, especially for the poor.

As a result the second objective of monetary policy is to reduce interest rates by improving the efficiency of the financial system. This will be achieved through the review of the regulatory and institutional frameworks and encouragement of new financial institutions and instruments to increase competition.

5.2.2.3 External Sector Imbalances and Poverty

An exchange rate can have an adverse effect on the poor. A depreciating exchange rate erodes incomes and purchasing power of the poor through inflationary effects. Thus Government will strive to attain a stable Malawi Kwacha that is competitive with other foreign currencies, and will avoid the excessive appreciation of the Real Effective Exchange Rate (REER)[67]. The strategic polices which will assist in containing exchange rate pressures include: sound fiscal and monetary polices, low and stable inflation, increased competition in the foreign exchange market and lastly improved market information. These strategies can be achieved through encouraging the development of an interbank foreign exchange market, broadening the participation of the private sector in exchange rate management and a review of the regulatory framework which promotes the growth in non-traditional exports.

The country's deteriorating balance of payments position has been the major cause of exchange rate instability. This has emanated from the unfavourable terms of trade and shortfall in donor inflows. The country has in the past heavily relied on traditional exports like tobacco that have not generated the desired level of foreign exchange. There should therefore be a deliberate policy to encourage the diversification of exports.

5.2.3 Resource Envelope and Macroeconomic Projections

The gross resource envelope envisaged for the MPRSP during the fiscal year 2002/03 will be K41.3 billion. This is based on several assumptions, as shown in Table 5.1 below. For the 2003/04 and 2004/05 fiscal years, the projected resource envelopes are K44.0 billion and K50.3 billion respectively (see Table 5.2 below). The declining trend in the inflation rate is premised on the envisaged tight fiscal and monetary polices.

Table 5.1: Macroeconomic Assumptions for Resource Envelope

Indicator	2001	2002	2003	2004
GDP growth (%)	2.7	3	4.5	5.2
Inflation (%)	27.6	11.5	5	4.4
Exchange rate	70	71	74	78
% of donor pledges honoured		80	90	90

[67]The Real Effective Exchange Rate is a measure of a country's competitiveness, calculated from the nominal exchange rate adjusted by the inflation differential between the foreign and domestic prices

These projected resource envelopes are deliberately based on realistic assumptions. These do not mean that the Malawian economy should not aim for higher levels of growth. Instead, they are realistic estimates based on past experience and technical knowledge. If the MPRSP is fully implemented and there are no negative external shocks, growth and revenues may be higher than projected. In that case, the additional activities that currently fall outside the resource envelope will be implemented.

Table 5.2: Gross Resource Envelope

Gross resource envelope	**2002/3**	**2003/4**	**2004/5**
Total Revenue and Grants	41,528.44	44,390.80	49,920.92
Domestic Revenue	27,370.60	31,360.60	34,326.80
of which non-tax revenue	2,686.70	3,090.10	3,402.70
of which tax revenue	24,683.90	28,270.50	30,924.10
Grants	14,157.84	13,030.20	15,594.12
of which project	3,010.24	3,099.51	3,656.25
of which BoP	8,423.20	6,200.82	7,312.41
of which HIPC	2,724.40	3,729.87	4,625.46
Overall financing	- 194.26	- 410.12	356.70
Foreign financing (net)	3,124.38	1,028.18	1,694.75
Borrowing	7,872.88	5,857.38	7,188.75
of which project	5,010.88	3,424.23	3,769.29
of which BoP	2,862.00	2,433.15	3,419.46
Repayment	4,748.50	4,829.20	5,494.00
Domestic financing (net)	- 3,320.64	- 1,443.30	- 1,346.05
Gross resource envelope	41,332.18	43,975.68	50,269.62

The resource envelope (total resources available) is derived from projections of total domestic taxation and non-tax revenue, in addition to conservative estimates of donor inflows. At present, the latter are based on aggregate donor pledges. In order to make the projections more realistic, Government will undertake a survey to ensure that the resource envelope is comprehensively derived so that it can accurately be compared to the costings. In particular, Government will undertake a survey of existing donor and NGO programmes and projects. As the 2000 PER clearly demonstrated, a large proportion of these programmes and projects do not currently appear in the Budget and are not factored into the projection of the resource envelope.

Where ongoing projects involve activities identical or similar to MPRS activities, the financial resources funding the MPRS activities within those projects will be counted as part of the resource envelope. However, projects and parts of projects that do not involve activities contained in the MPRS will be noted and the associated resources excluded from the MPRS resource envelope. Government will continue to welcome the implementation of the project until any review phase or the end of the project life-span. However, any new projects and any mid-term project reviews will be required to take into account the MPRS so that ultimately all programmes and projects involve only MPRS activities.

5.3 Costings Framework

The costings framework consists of three main elements: statutory, statehood and MPRS activities. Where possible, this costing has been done on the basis of targets and unit costs, so that planned expenditure reflects a realistic estimate of the resources needed to meet national objectives. These three elements are combined to compare total costings to gross resource availability. There are also a number of large-scale infrastructure development projects that will not be financed by Government but by private sector and international investors. These are discussed in section 5.4.

The activities included in the costings framework are those MPRS activities that are implemented and financed by or through Government. Whilst the overall thrust of the MPRS applies to Malawi as a whole, and strategies to meet its objectives should be implemented by all stakeholders, the costings are limited to Government.

5.3.1 Statutory and Statehood Expenditure

In addition to the MPRS activities, two other types of activities must be considered before total costs can be compared to the resource envelope. Firstly, projected expenditures on statutory activities must be allocated a share of the resource envelope. These statutory activities are by definition ones that have to be funded and cannot be scaled down, and include items such as interest payments and pensions and gratuities.

Secondly, statehood activities must be included. These activities do not directly reduce poverty, but are essential in any country as the basic activities that enable the functioning of state by promoting and protecting national integrity, security and leadership. Examples include ensuring external security, supporting the President, conducting national public events and gathering and disseminating information to the nation. As with any other set of activities and resource allocation, the use of these resources must be as efficient and effective as possible, and there must be transparency and accountability. Equally importantly, these activities must have a hard Budget constraint – expenditure must not exceed the resource allocation in the Budget, which will be guided by the costings outlined in this Chapter. Any additional expenditure on these activities translates into reduced allocations to the MPRS activities. The MPRS is in part intended to clearly demonstrate these trade-offs, for example by demonstrating the impact that additional unplanned statehood expenditure has in terms of reduced expenditure on health and education activities.

Table 5.3 below presents a summary of statutory and statehood costings. Statutory costs will total around K10 billion in 2002/3, decreasing to K9 billion in 2003/04, and K8.5 billion in 2004/05. This decline is due to falling domestic interest payments as fiscal discipline is improved. The cost of Statehood activities will total K2.4 billion in 2002/03 , reducing to K2.3 billion in 2003/4 and K2.2 billion in 2004/5 These costs are based on the assumption that funding of Statehood activities should be maintained at their actual 2001/2 levels, with administrative and allocative efficiency improving so as to strengthen implementation. The gradual decline is due to the rationalisation of international co-operation and representation activities.

Table 5.3 Statutory and Statehood Expenditure

	2002-3	2003-4	2004-5
K million			
Total costings	41,332.2	43,975.7	50,269.6
Statutory	9,984.7	9,023.7	8,516.2
Statehood expenditures	2,358.8	2,276.6	2,236.6
As percent total costings			
Statutory	24.2%	20.5%	16.9%
Statehood	5.7%	5.2%	4.4%

5.3.2 MPRS Costings

The MPRS gives a costed and prioritised description of the set of activities that together have been agreed to maximise poverty reduction given the available resources[68]. These activities were designed in large part through a bottom-up approach – the needs of the poor were defined first and strategies designed by the Thematic Working Groups (TWGs) to help them reduce their poverty. These activities were then costed by the TWGs with assistance from the Technical Committee, where possible on the basis of unit costs applied to relevant targets[69]. The targets and costs were adjusted to remove duplications and ensure accuracy and realism, especially as regards implementation capacity[70]. Once all activities were costed, the total cost of the MPRS activities was derived. The next stage was to reduce most administrative and overhead costs to an estimate of their actual 2001/2 levels for all three years. This was intended to free up resources for the delivery of pro-poor services and to stimulate improvements in administrative efficiency in Government. This will partly be achieved by reducing expenditure on certain low-priority expenditure line items across Government, such as internal and external travel. Finally, lower priority activities were rephased or rescaled so that the total costings were in line with the total resources available. A summary of the resulting costings are shown in Tables 5.4 and 5.6, and a more detailed break-down by objective is produced in annex 2[71].

These summaries of costings are not budgetary allocations, but an indication of how much certain groups of activities will cost. The total numbers for each Pillar were derived from costing the constituent activities and then rephasing where possible as a result of capacity and resource constraints, rather than starting with a total allocation and splitting it between activities or ministries. Further, the costings refer to activities rather than to institutions. In the MPRS, the focus is on defining the strategies that will enable Malawi to meet its poverty reduction goals and objectives within resource constraints. The MPRS regards financial resources in aggregate only and does not define how the various activities will be financed - by

[68] Thus any changes to activities to be implemented cannot be justified merely by demonstration of an impact on poverty reduction – it must be demonstrated that the new activity is more poverty reducing than the activity removed.
[69] For example, in education the total teacher wage bill was derived by multiplying the required number of teachers in a particular year by the cost of paying each teacher in that year. For further details of costing assumptions, please refer to the full matrices and costing models available from the Technical Committee.
[70] For example, although it may be desirable to have a pupil: teacher ratio of 50, this is not possible given the capacity of teacher training institutions and the supply of educated potential recruits.
[71] The break-down of costings by strategy and activity is contained in the separate Action Plan matrix that is available as a technical document.

tax revenue, donor budgetary support, donor project support or debt relief. The MPRS also does not distinguish between the recurrent and development budgets as currently operational in Malawi[72]. The detailed definition of responsible and funding institutions and financing arrangements is the role of the MTEF/Budget process which will translate the MPRS into a detailed funding plan (see Chapter 6).

However, there are important similarities with the Budget that will help to ensure that the MPRS is translated into the Budget. Firstly, the MPRS costing is comprehensive, so that it covers all Government and development partner activities[73]. Similarly, the resource envelope contains all sources of funding, be they domestic taxation, donor grants, loans or HIPC resources. Secondly, the MPRS matrix outlines the responsible institution(s) for each activity, so that the costing of the activities can be easily translated into institutional allocations for comparison with the Budget.

Table 5.4: MPRS Costing Summary by Pillar

	2002-3	**2003-4**	**2004-5**
Total Costings	41,332.2	43,975.7	50,269.6
Total MPRSP	28,988.7	32,675.3	39,516.9
Pillar 1	8,013.6	9,421.1	9,331.9
Pillar 2	13,860.4	15,356.6	17,188.3
Pillar 3	1,209.0	1,824.8	2,308.0
Pillar 4	4,040.1	3,783.7	3,952.8
Cross-Cutting	1,667.4	2,010.6	2,465.8
Implementation, Monitoring and Evaluation	198.2	278.6	270.2
Activities to be identified	-	-	4,000.0
As percent total costings			
Total MPRSP	70.1%	74.3%	78.6%
Pillar 1	19.4%	21.4%	18.6%
Pillar 2	33.5%	34.9%	34.2%
Pillar 3	2.9%	4.1%	4.6%
Pillar 4	9.8%	8.6%	7.9%
Cross-Cutting	4.0%	4.6%	4.9%
Implementation, Monitoring and Evaluation	0.5%	0.6%	0.5%
Activities to be identified	-	-	8.0%

[72] Although the MPRS costings are divided into recurrent and investment costs, this split does not correspond to the Recurrent/Development Budget distinction, which in reality is a split between programmes and donor funded projects, both of which have elements of recurrent and investment costs.
[73] Apart from Statehood, Statutory and some large-scale infrastructure development projects, which are treated explicitly elsewhere in this section.

5.4 Large scale Infrastructure Development

As mentioned above, a number of large-scale infrastructure development projects have been treated separately, since they will not be funded by Government resources[74]. Whist these projects are not priorities for poverty reduction, they are important for the development of Malawi. They will not be financed by Government, which will concentrate its resources on the MPRS activities. However, Government will actively seek private sector and international investors to finance the projects, where necessary using innovative financing arrangements (such as Build-Operate-Transfer). In certain areas (such as core road construction), certain international development partners with particular expertise will be invited to invest.

These projects fall under three main categories: telecommunications, electrification and roads. The main telecommunications project covered here is the expansion of rural telecommunications (expected to be largely funded by the private sector). In the electricity sector, the projects include the interconnection of electricity grid systems with Mozambique, the rehabilitation of existing transmission and distribution power systems and the expansion of main grid electricity supply capacity. Finally, in roads, the projects include the reconstruction and expansion of the core road network, including the Karonga-Chitipa road. More details of these can be found in Annex 3.

Finally, Table 5.6 presents a more detailed summary of costings within each pillar, at the goal and sub-goal level (reflecting the headings and sub-headings in Chapter 4). The costings reflect the MPRS priorities, with K7.3 billion allocated to basic education, K4.6 billion to essential healthcare, K1.6 billion to safety nets, and K2.6 billion to supporting agricultural livelihoods in 2002/03. The further details of the costing and resulting expenditure allocations can be found in annex 2 and the separate costing data source, together with a breakdown of costs into recurrent and development expenditures.

Table 5.5 Detailed Costings by Goal and Sub-Goal (Millions of Malawi Kwacha)

	2002-3	2003-4	2004-5
Pillar 1 - Sustainable Pro-Poor Growth	8,013.56	9,421.09	9,331.92
Goal 1.1 - Sources of pro-poor growth	3,064.36	3,787.16	3,575.28
Sub goal 1.1.1 - Increasing agricultural incomes	1,771.43	2,393.54	2,264.85
Sub-Goal 1.1.2 - Natural Resources	773.24	837.95	840.55
Sub-Goal 1.1.3 - Develop MSMEs	196.00	248.00	175.00
Sub-Goal 1.1.4 - Manufacturing and Agro-Processing	78.01	81.00	89.00
Sub-Goal 1.1.5 - Tourism	192.50	187.50	172.50
Sub-Goal 1.1.6 - Small Scale Mining	53.18	39.18	33.38
Goal 1.2 - Creating an Enabling Environment for Growth	4,949.20	5,633.92	5,756.64
Sub-Goal 1.2.1 - Macroeconomic Stability	-	-	-
Sub-Goal 1.2.2 - Credit and Micro-Finance	25.91	59.50	19.04
Sub-Goal 1.2.3 - Rural Infrastructure	2,428.04	2,793.10	3,019.61
Sub-Goal 1.2.4 - Other Enabling Infrastructure	1,785.57	1,805.57	1,856.07
Sub-Goal 1.2.5 - Domestic and external trade	57.85	264.15	77.20

[74] A large number of infrastructure projects remain in the MPRS, notably rural feeder roads and rural electrification

Sub-Goal 1.2.6 - Taxation	651.83	711.60	784.72
	-	-	-
Pillar 2: Human Capital Development	13,860.36	15,356.57	17,188.26
Goal 2.1 Improving quality and access to education	8,710.19	9,623.25	10,782.64
Sub-goal 2.1.1 - Basic education	6,015.84	6,592.47	7,454.75
Sub-Goal 2.1.2 - Secondary School education	2,144.35	2,480.78	2,777.89
Sub-Goal 2.1.3 - Higher Education	550.00	550.00	550.00
Goal 2.2 Better Technical, Vocational and Entrepreneurial Education and Training	468.25	488.51	567.46
Goal 2.3 Improved Health Status	4,568.55	5,104.74	5,663.16
Sub-Goal 2.3.1 - Preventative Healthcare[75]	-	-	-
Sub-Goal 2.3.2 - Essential Healthcare	4,184.48	4,720.67	5,279.09
Sub-Goal 2.3.3 - Tertiary Healthcare	384.07	384.07	384.07
Goal 2.4 - To prevent and control Protein, Energy, Malnutrition and micronutrient deficiencies	113.36	140.06	175.00
	-	-	-
Pillar 3 - Improving the Quality of Life for the Most Vulnerable	1,209.02	1,824.78	2,307.96
Goal 3.1 - Safety Nets	1,127.30	1,734.89	2,209.08
Sub-Goal 3.1.1 - Productivity Enhancing Interventions	838.71	1,187.97	1,319.03
Sub-Goal 3.1.2 - Welfare Support Interventions	288.59	546.92	890.04
Goal 3.2 - Improving disaster management	81.72	89.89	98.88
	-	-	-
Pillar 4 - Governance	4,040.15	3,783.72	3,952.77
Goal 4.1 - Political Will and Mindset	-	-	-
Goal 4.2 - Improved safety, security and access to justice	2,001.19	2,225.60	2,413.90
Goal 4.3 - Ensuring responsive and effective public institutions	2,038.95	1,558.12	1,538.86
Sub-goal 4.3.1 - Improved Public Expenditure Management	411.77	335.82	302.38
Sub-Goal 4.3.2 - Public Service Reform	140.30	122.42	122.78
Sub-Goal 4.3.3 - Corruption and Fraud	111.21	118.46	126.51
Sub-Goal 4.3.4 - Decentralisation	811.18	420.69	425.49
Sub-Goal 4.3.5 - Democratisation	441.34	441.34	441.34
Sub-Goal 4.3.6 - Human Rights	123.15	119.38	120.36
	-	-	-
5 - Cross cutting	1,667.41	2,010.57	2,465.78
Goal 5.1 Ensure national response to the HIV/AIDS pandemic	663.70	676.45	668.08
Goal 5.2 Reduce gender inequalities	68.02	74.32	60.51
Goal 5.3 Ensure environmental sustainability	294.00	334.00	372.00
Goal 5.4 - Create a Science and Technology driven economy	641.70	925.80	1,365.20
	-	-	-
Monitoring and Evaluation of MPRS	198.16	278.59	270.20
Goal: Ensure implementation of the MPRS	198.16	278.59	270.20

[75] The costs of preventative healthcare are included under Nutrition (Pillar 2), Water and Sanitation (Pillar 3), Education (Pillar 2) and the Essential Healthcare Package.