NATIONAL BUDGET BRIEF

2020/21
MALAWI

Living the Promise to Leave No One Behind

KEY MESSAGES AND RECOMMENDATIONS

Malawi's economy and revenue base have not grown fast enough to match the rising expenditure needs. The past budgets have exacerbated this hiatus by overshooting revenues and incurring expenditure overruns on recurrent budgets, resulting in higher than expected fiscal deficits, mainly financed through costly domestic borrowing. This has increased the cost of the debt service and the chances of debt distress.

Recommendation: The Government is encouraged to address the imbalance between revenue and expenditure, by ensuring the sustainability of the latter through a medium-term strategic approach, to protect its capacity to finance its own policies and service provision in case of a debt crisis. Debt and fiscal deficits, though unavoidable, should also be resorted to under a medium- and long-term debt strategy, aimed at lowering the cost of borrowing and harnessing International Financing Institutions (IFIs) resources as much as possible.

While recurrent budgets are subject to overruns, budget for development projects, especially those funded by donors, regularly underperform, by 32% (MK206.9 billion against MK333.3 billion) in 2019/20. This is linked to a combination of project management, procurement and absorption capacity challenges.

Recommendation: In its efforts to strengthen budget credibility by adopting a multi-annual approach and further leveraging upon the available development finance, the Government should also investigate and address any possible inefficiencies, absorption capacity challenges, and red tape in procurement and management of development projects.

The Government maintained the average level of allocations in the areas of health, education, water, sanitation and hygiene (WASH) as well as social protection. However, investments in child protection remain very low, at 0.02% of total budget.

Recommendation: The Government is encouraged to focus on the sustainability – and to the extent possible on the increase – of the current social sector allocations, considering their critical role in human capital accumulation, leveraging on available donor funding and targeting own resources towards the improvement of the systems and the capacity of human resources. This would ensure systems would continue functioning, delivering services and maintaining infrastructures even in case of reduced external resources. It would also create a base for further Government engagement in the sectors when additional domestic resources were to become available.

Compared to 2019/20, total budgetary provisions to Local Councils have declined in real terms by 4%, from MK289 billion to MK272 billion in 2020/21. Allocations for some devolved social sectors, such as water and gender, are still too low to allow districts to meaningfully deliver on devolved services in the context of a growing population.

Recommendation: The planned review of the National Decentralization Policy and the assessment of the Fiscal Decentralization Strategy will prove critical in supporting a reform of the local governance architecture that can deliver on the decentralization agenda across all sectors, responding to rising needs for service delivery at local level through an effective and efficient fiscal transfer system.

1. Introduction

This budget brief is one of several which explore the extent to which national budgets respond to developmental needs of children in Malawi. The brief analyzes the size and composition of the 2020/21 National Budget, with a special focus on allocations to key social sectors that benefits children. The brief also offers insights into the efficiency, effectiveness, equity, and adequacy of past spending. The brief isolates a set of recommendations on how the Government of Malawi (GoM) can increase and improve the quality of public spending on social sectors, including by enhancing efficiency, effectiveness and equity in the utilization of available resources

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The analysis underpinning this brief is drawn from a review of several budget documents and reports from key public finance actors. The budget documents reviewed include Financial Statements, Annual Economic Reports, Public Debt Reports, Appropriation Bills, Detailed Budget Estimates (DBEs), and Program Based Budgets (PBBs). In addition, the analysis also benefitted from reports from the World Bank, such as the 11th Malawi Economic Monitor (MEM), the International Monetary Fund (IMF) – such as the October 2020 World Economic Outlook (WEO), the IMF Country Report No. 20/168 for Malawi, the World Bank-IMF Debt Sustainability Analysis (DSA) (May 2020) as well as the IMF Article IV of 2018, the Reserve Bank of Malawi (RBM) and the Open Budget Survey (OBS) Reports from the International Budget Partnership (IBP).

2. Macroeconomic Context

The 2020/21 National Budget was prepared in a very challenging macroeconomic environment mainly because of COVID-19. The budget, which is the first drafted under the current Government, is themed "Living the Promise". The budget was formulated in line with the priorities of the third Malawi Growth and Development Strategy (MGDS) III to contribute to the shift towards sustainable and inclusive growth; macroeconomic stability; and sound financial management. There are three major assumptions underpinning the 2020/21 budget, namely: (i) real GDP growth rate of 1.9% and 4.5% in 2020 and 2021, respectively, (ii) average inflation rate of 9.9%; and (iii) a policy rate of 13.5%. The policy rate was revised downwards to 12% by the Reserve Bank of Malawi (RBM) in October 2020.

The global and domestic effects of the spread of COVID-19 are projected to sharply slowdown economic growth in Malawi in 2020. COVID-19 is projected to disrupt Malawi's previously steady growth trajectory, as shown in Figure 1. Several macroeconomic forecasts for Malawi are predicting a sharp slowdown in GDP growth if not a contraction for 2020 and 2021. The Government forecasts Malawi's economy to slow down from 5% in 2019 to a projected 1.9% in 2020. These downward estimates are consistent with forecasts from the World Bank and IMF. The World Bank, for instance, forecasts Malawi's GDP growth in 2020 to sharply decelerate from a pre-COVID-19 estimate of 4.8% to 2% under a baseline scenario[1]. However, as the COVID-19 crisis deepen, the

1 The baseline scenario is based on three major assumptions, namely that (i) Malawi will not experience a full nationwide lockdown, (ii) the Malawian economy will only face a severe external demand shock and tightened financial conditions, and disruptions to domestic activity in 2020 but not in 2021 and (iii) while the agriculture sector would have only a limited impact, growth of services and industry would diminish considerably.

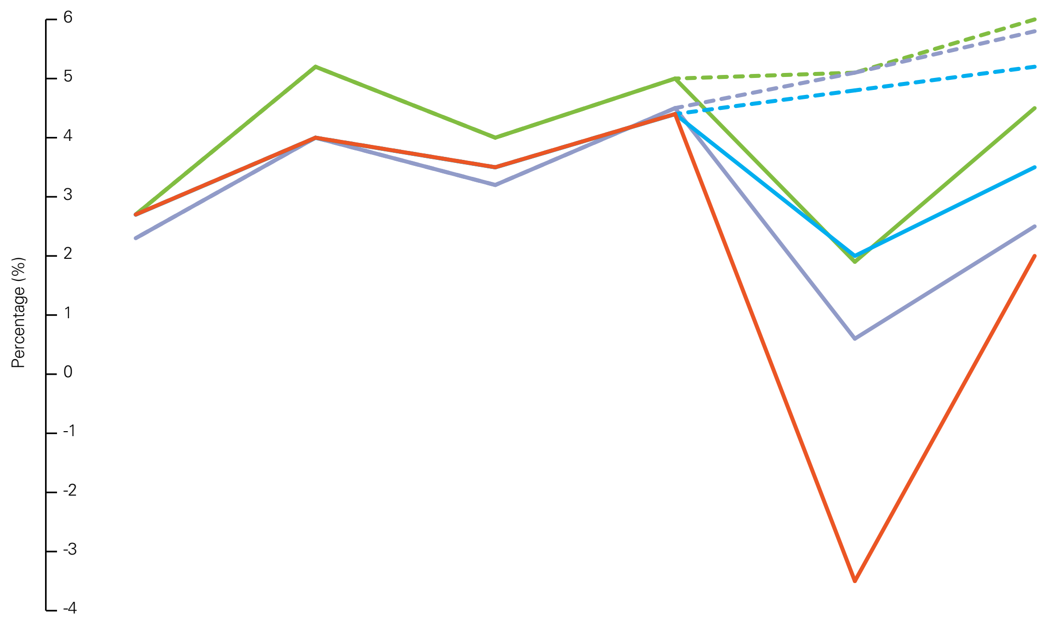
economy could contract by 3.5% under a worst scenario[2]. Similarly, the IMF estimates Malawi's economic growth to sharply decelerate to 0.6% in 2020 and 2.5% in 2021, from respective pre-COVID-19 estimates of 5.1% and 5.8%.

2 The worst case scenario is based on three major assumptions (i) an extensive in-country spread of the COVID-19, (ii) a protracted global health crisis, (iii) only the agriculture sector would still be growing, while manufacturing and services would face a significant decrease, which will in turn combine to cause a severe contraction in disposable income and private consumption.

Malawi's short and medium-term economic recovery path thus faces fundamental uncertainty, with strong downside risks, linked to both external and internal factors. Currently, and rebus sic stantibus, the IMF (2020) forecasts economic growth to average 6.4% during the 2022-25 period, with long-term growth expected to stabilize at around 5.5%[3]. The Government projects a modest rebound in 2021, with the economy expected to grow by 4.5%.

3 See the IMF Country Report No. 20/168, published in May 2020.

Figure 1
GDP Growth Trends in Malawi, factoring the effects of COVID-19[4]



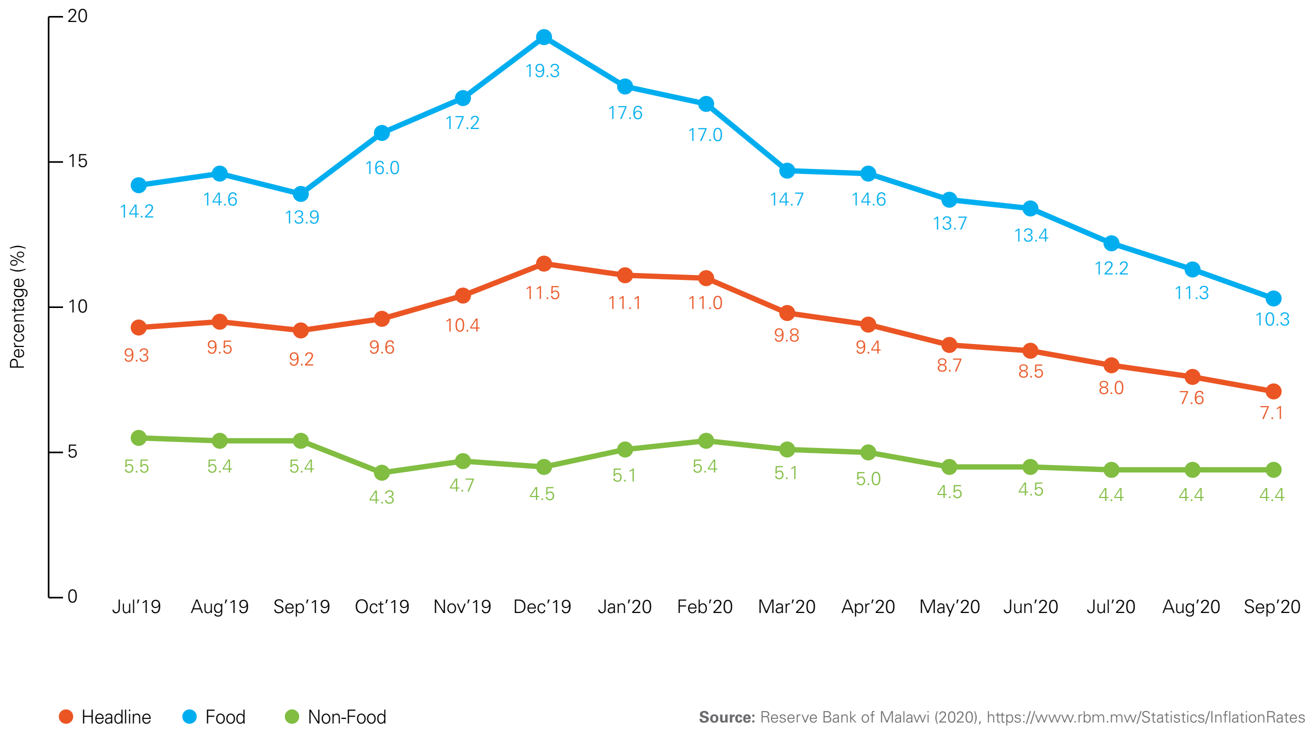
	2016	2017	2018	2019	2020	2021
WB Pre COVID-19	2.7	4.0	3.5	4.4	**4.8**	**5.2**
WB Post COVID-19 (Baseline)	2.7	4.0	3.5	4.4	**2.0**	**3.5**
WB Post COVID-19 (Worst)	2.7	4.0	3.5	4.4	**-3.5**	**2.0**
IMF Pre COVID-19	2.3	4.0	3.2	4.5	**5.1**	**5.8**
IMF Post COVID-19	2.3	4.0	3.2	4.5	**0.6**	**2.5**
GoM Pre COVID-19	2.7	5.2	4.0	5.0	**5.1**	**6.0**
GoM Post COVID-19	2.7	5.2	4.0	5.0	**1.9**	**4.5**

Source: Government, IMF (October 2020 WEO) and World Bank Global Economic Prospects (June 2020)

4 Given the evolving nature of the COVID-19 pandemic in Malawi, the IMF and World Bank forecasts for 2020 and 2021 will be frequently updated based on new information as well as changing (local and global) circumstances.

Inflation and exchange rate are projected to remain stable in 2020/21. Since 2018/19, the Government has managed to maintain inflation in the single digit, averaging around 9%, with the monthly inflation trend generally stable, as shown in Figure 2. For 2020/21, inflation is expected to average 9.9%, with annual average rates for 2020 and 2021 of 10.5% and 9.3%, respectively. After peaking to 19.3% in December 2019, food inflation has been declining, as shown in Figure 2. Non-food inflation has averaged 5% over the past 18 months (March 2019 to September 2020). On the external front, the Malawi Kwacha has remained stable against the US Dollar, projected to average 1:750 in 2020/21. This exchange rate stability is linked to a relatively stable gross official reserves (at 3.1 months of imports, as at end June 2020). With regards to monetary policy, the RBM has continued to tighten its stance, revising the interest rates down from 14.5% to 13.5% in 2019 and further to 12% in October 2020.

Figure 2
Inflation Trends in Malawi



Source: Reserve Bank of Malawi (2020), https://www.rbm.mw/Statistics/InflationRates

KEY TAKEAWAY

➤ **Malawi's short-to-medium term macroeconomic outlook is severely weakened due to the COVID-19,** which has implications on the realization of the assumptions upon which the 2020/21 National Budget is based on.

3. Socio-economic Context

Malawi has one of the youngest populations in Africa, with children constituting over half (51%) of the 17.56 million population[5] (84% of which live in rural areas). With a population growth of 2.9%, Malawi ranks among the top 40 countries with the fastest annual population growth rates in the world. If the current population growth trend continues, Malawi's total population could reach 30 million by 2030, with child population almost doubling to 16.2 million (World Bank, 2018). This creates a potential for a demographic dividend but can be a missed opportunity if not appropriately harnessed or even a threat to Malawi's graduation from poverty.

Poverty remains widespread in Malawi. The latest available data shows that 51.5% of the population were living under the national poverty line in 2015/16, as compared to 50.5% in 2010/11[6]. Poverty is higher in rural than urban areas, at 59.6% vs. 17.7%, in 2015/16. The percentage of ultra-poor people declined from 24.5% to 20.1% between 2010/11 and 2015/16. Multidimensional child poverty also remains high, at 60.5%[7]. As a result, the country's poverty incidence, and human development indices are among the worst in sub-Saharan Africa (SSA). As of 2018, Malawi's human development index (HDI), valued at 0.485, ranked number 172 out of 187[8] countries. The rank for gender equality[9] was the same as for HDI, at 172/187, which reflects high gender-based violence, frequent early marriages, and poor maternal health. Table 1 summarizes selected key social development indicators for Malawi.

5 National Statistics Office (NSO) (2018) Malawi Housing and Population Census Report, 2018.

6 National Statistics Office (NSO) (2018) Integrated Household Survey (IHS) 4.

7 National Statistics Office (NSO) (2018), Child Poverty Report Analysis 2018.

8 http://hdr.undp.org/en/countries/profiles/MWI

9 http://hdr.undp.org/en/data

Table 1

Selected Key Social Development Indicators for Malawi

Indicator	Value and disaggregation, as appropriate	Source
Population (% of children)	17.56 million	National Statistics Office (NSO) (2018)
Population growth (%)	2.9	NSO (2018)
Moderate poverty rate (rural, urban) %	51.5 (59.6; 17.7)	NSO (2018)
Ultra-poverty rate (rural, urban) %	20.1 (23.8; 4.1)	NSO (2018)
Multidimensional child poverty rate (rural, urban) %	60.5 (70; 25)	NSO (2018)
HDI (Rank)	0.485 (172/189)	Malawi Human Development Report (2019)
Human Capital Index (HCI)	0.41	World Bank (2020)
Proportion of population with access to basic water, sanitation and hygiene services (%)	69;26; 9	UNICEF and WHO (2020), Joint Monitoring Programme (JMP)
Secondary enrolment rate (boys, girls)	16 (16; 16)	Education Management Information System (EMIS) (2020)
Transition rate from primary to secondary (%) (boys, girls)	38 (37; 38)	EMIS (2020)
Primary enrolment rate (boys, girls)	90% (87%; 92%)	EMIS (2020)
U5 child mortality (deaths per 1,000 livebirths)	63	Malawi Demographic Health Survey (2015/16)
Child Marriage rate	42%	Traditional Practices Survey (2019)
Stunting	37%	Malawi Demographic and Health Survey (MDHS) (2015/16)

COVID-19 risks to erase the significant socio-economic progress made over the years by Malawi. Preliminary estimates from the World Bank, for instance, forecasts urban moderate poverty to increase, ranging from 1.6% under a baseline scenario to around 5% (compared to 2.2% in the rural) under the worst-case scenario. In a context of already weak systems, access to health and nutrition services, including for children, adolescents and young women is being affected significantly. In the water sanitation and hygiene (WASH) sector, the COVID-19-induced socio-economic impact is becoming evident as many users, particularly those within the poorest quintiles, are systematically disconnected from the water networks because of their inability to pay for the services, potentially undermining adequate preventive hygiene. In the area of protection, there are elevated risks of domestic violence, including against children, and rising cases of child marriage due to the socio-economic effects of the COVID-19. If not addressed, these challenges could hamper the country's efforts to achieve the Sustainable Development Goals and the objectives of MGDS III.

KEY TAKEAWAYS

- **The demographic boom will require improvements in human capital development investments, especially in the areas of health, nutrition and education.**
- **The COVID-19 could potentially result in acute and long-lasting socio-economic impacts that, if left unchecked, might significantly weaken the long-term developmental prospects for Malawi.**
- **Cognizant of the above, upscaling public investments in social assistance programs is more important than ever** – to help cushion vulnerable households against the socio-economic effects of the COVID-19 – with the overall aim of safeguarding the significant socio-economic gains that Malawi has achieved so far.

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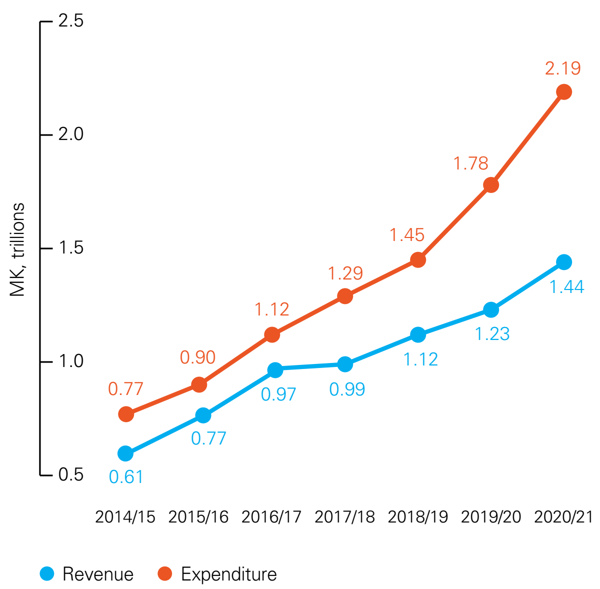
4. Aggregate Spending Trends and Priorities

For the first time over the past five fiscal years, the proposed total revenue and grants for 2020/21 was lower (by 9%) than its previous year's approved level of MK1.57 trillion. This reflects the contracting revenue base, largely due to the COVID-19 economic impact.

The 2020/21 National Budget (MK2.19 trillion) is 23% higher than the MK1.78 trillion 2019/20 National Budget. The total budget is equivalent to 30.6% of GDP. Over the years, expenditures have been rising at a faster rate than revenue, widening the fiscal deficit, as shown in Figure 3. For the first time over the past five fiscal years, the proposed total revenue and grants for 2020/21 was lower (by 9%) than its previous year's approved level of MK1.57 trillion. This reflects the contracting revenue base, largely due to the COVID-19 economic impact. In real terms, the growth in total expenditure (10.7%) in 2020/21 is twice that of total revenue (5.4%).

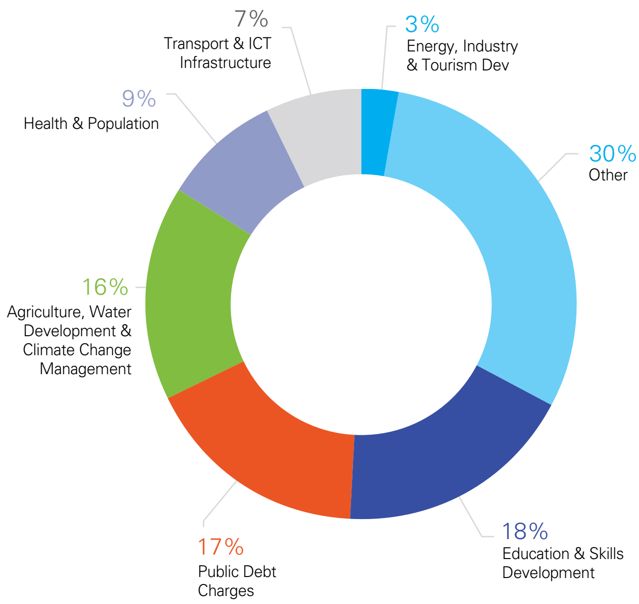
Over half of the 2020/21 National Budget (MK1.15 trillion), was allocated to the five MGDS III key priority areas (KPAs). Figure 4 shows that the education and skills development KPA received 18% of the total budget, followed by the agriculture, water development and climate change management KPA (16%), health and population (9%), transport and ICT infrastructure (7%) and energy, industry and tourism development KPAs (3%). The remaining 47% of the budget (MK1 trillion), was allocated to other development areas that directly impact implementation of the KPAs. Of note includes statutory expenditures in the form of public debt charges (17%) and Pensions and Gratuities (5.4%). The high level of public debt charges is a serious concern as it reduces the fiscal space available for the Government to invest in key sectors.

Figure 3
Trends in Nominal Total Expenditure and Revenue



Source: Government Budget Documents, 2015/16-2020/21

Figure 4
Breakdown of the 2020/21 Budget by MGDS III Key Priority Areas (KPAs)



Source: 2020/21 Draft Financial Statement

Notable expenditure increases were realized in health and WASH sectors. The health sector was allocated a total of MK205 billion, 22% more than in 2019/20. The WASH budget more than tripled from MK27 billion in 2019/20 to MK90 billion in 2020/21. The increase in the health and WASH sector budgets is consistent with the rising expenditure needs to respond to the COVID-19. For instance, a total of MK11.17 billion was allocated to the COVID-19 health response, at both national and local level. In terms of WASH response, the environmental health/sanitation in health facilities programme was allocated MK763 million, 3.6 times the 2019/20 level.

Nutrition and child protection programmes remain visibly underfunded. Allocations to nutrition specific programmes declined from MK7.8 billion in 2019/20 to MK6.1 billion (0.28% of the total budget) in 2020/21, because of lower on-budget donor contributions. The Government's own contribution to nutrition, through the Department of Nutrition and HIV/AIDS (DNHA) however increased by 23% to MK475 million. The 2020/21 allocation is only 17% of the basic MGDS III cost estimates (MK35 billion) and 14% of resources needed to ensure a comprehensive nutrition package (MK44bn), using cost estimates from the Copenhagen Consensus. Visible allocations to child protection remain very low at about 0.02% of the total budget.

The increase in the health and WASH sector budgets is consistent with the rising expenditure needs to respond to the COVID-19.

KEY TAKEAWAYS

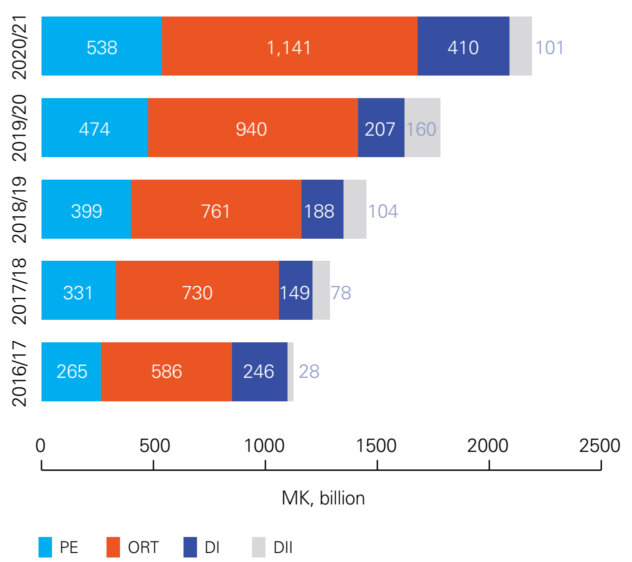
- **Expenditures keep rising at a faster rate than revenue, causing deepening fiscal deficits.**
- **Raising debt service is a cause of concern,** as it reduces Government's fiscal space and crowds out resources that could potentially be invested in other, more productive ways.
- **The Government has significantly increased allocations to key social sectors, such as WASH and health, as part of the response to the COVID-19.** However, budgets for traditionally neglected areas of child protection and nutrition remain visibly low.

5. Composition of Government Budgets

Spending on basic social services remains a priority for the Government, with the social sectors receiving about 34% of the National Budget allocations. This is in line with the general spending trend of the past years that saw the allocations to the social sectors averaging 34% since 2016/17. The education sector keeps on being the largest sector in terms of budgetary allocations. However, with 18% of the National Budget allocated to education in 2020/21, Malawi has missed the Dakar Target (20% of the national budget to be allocated to education) for the first time since 2016/17.

The health sector is the fourth largest in terms of budgetary allocations, representing 9.3% of the National Budget. Yet, it remains well below the Abuja Declaration spending target of 15% of the national budget to be spent on health. The WASH sector received a significant 4.1% of the allocations in the 2020/21 National Budget. Social welfare related programmes (social protection, child protection and ECD) received 2.8%. Debt service accounts for 17% of the total allocations in the 2020/21 National Budget.

Figure 5
Trends in the Composition of Total Expenditures



Source: Draft Financial Statements, 2015/16-2020/21

About 76.6% of the 2020/21 National Budget finances recurrent expenditures, 52.1% of which being allocated to Other Recurrent Transactions (ORT), including public debt charges, and 24.5% to Personal Emoluments (PE). The ORT budget, of MK1.14 trillion, mainly covers public debt charges (MK376 billion), goods and services (MK308.9 billion), social benefits (MK266 billion), grants to other Government Budgetary Units (MK177 billion) and other statutory expenditures, such as arrears payments (MK12.5 billion).

The PE budget is divided in MK523.7 billion allocated for wages and salaries and MK14.3 billion for Government's social contributions. Compared to 2019/20, the PE budget increased by 13.5% and 2% in nominal and real terms, respectively. The increase in the PE budget is to cater for general salary increment (MK42.7 billion), Government contribution to the Contributory Pension Scheme (MK14.3 billion), annual wage creep (MK8.1 billion) and MK8.0 billion for recruitment of additional health personnel, to support the COVID-19 response.

The majority of development projects in 2020/21 will be funded by donors (DI). A total of MK511.2 billion was allocated for development projects (DI and DII) in 2020/21, 1.4 times higher than the 2019/20 allocation. Donors are expected to finance 80% of the development budget to the tune of MK410 billion (DI), almost double the 2019/20 amount. The incidences of donor support for development projects are high across key social sectors. For example, about 97% and 77% of WASH and Health developments budgets in 2020/21 will be funded by donors, respectively. Government's contribution to the development budget (DII), estimated at MK100.9 billion, is 37% lower than the 2019/20 allocation but higher than the average DII allocation over the period 2016/17-2019/20 (~MK92 billion).

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KEY TAKEAWAYS

- **The financing of the social sectors has been a constant priority over the past years, although some sectors benefited more than others and the investment of Government's own resources is uneven amongst the different sectors.** Against a backdrop of shrinking fiscal space, maintaining investments in the social sectors will require adopting a medium-term perspective geared at making these sustainable.
- **Development (infrastructural) expenditures are mainly dependent on donor funding, including in some key social sectors such as WASH, health, education, and social protection.**
- **The structure of the Malawian budget, with high statutory obligations and recurrent expenditure levels, is unlikely to fundamentally change in the coming years, with high debt servicing costs crowding out resources and reducing the room for fiscal consolidation.**

6. Budget Credibility and Execution

Revenue has regularly underperformed in the recent past, largely driven by tax revenue shortfalls. Figure 6 shows that the Government has consistently revised downwards its revenue projections at mid-year since 2017/18, with actual year-end revenue receipts consistently falling short of their revised targets. In 2018/19, for instance, total revenue, which was originally pegged at MK1.249 trillion, was revised downwards by 6% (MK76 billion) at mid-year, and nevertheless underperformed by 4.5% (MK53 billion) to reach MK1.121 trillion at end-year.

The underperformance has mainly been due to lower-than-anticipated tax revenue collections (Figure 7), the main source of Government revenue. The consistent gap between actual, initial and even revised estimates suggests a tendency in Government to overshoot the revenue forecasts during budget formulation. A tendency that worsened over time and was particularly evident in 2019/20 when even a downward revision of 6% for tax revenues did not come close to the actual amount, as shown in Figure 7.

Figure 6
Trends in Total Revenue Performance

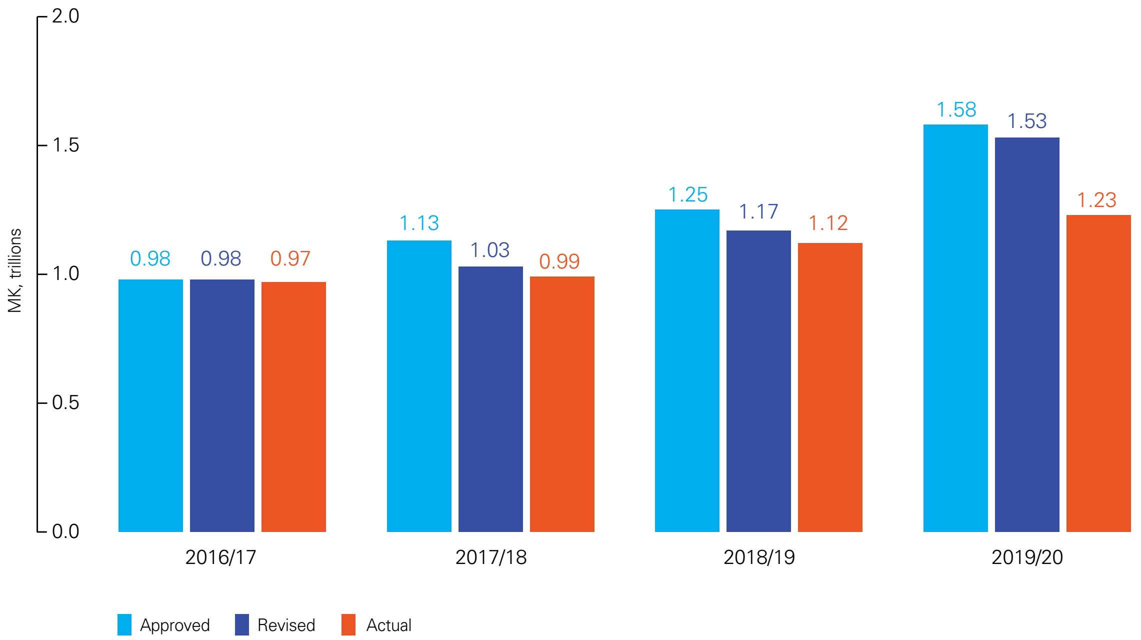
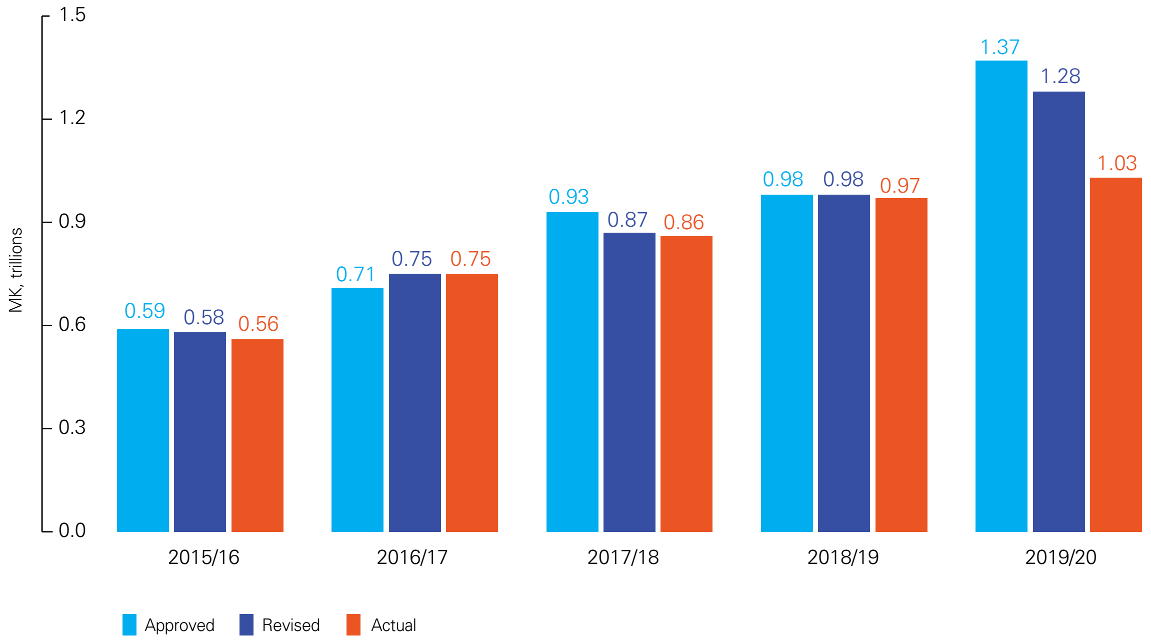


Figure 7
Trends in Total Tax Revenue Performance



Source: Government Financial Reports, 2016/17-2019/20

Grants have also consistently underperformed in the recent past. In 2019/20, grants underperformed by 27%, as only MK127 billion was disbursed, compared to the revised estimate of MK175 billion (Table 2). The underperformance was largely linked to non-disbursement of capital grants from foreign governments (such as Norway and Ireland), a trend which has persisted over the past three fiscal years. In contrast, 80% of capital grants from International Organizations[10] were disbursed. A total of MK21.96 billion was also received in current grants from International Organizations against a nil revised estimate. The influx of current grants in 2019/20 is probably linked to on-budget donor support for the COVID-19 response.

10 These include the World Bank, African Development Bank (ADB), European Union (EU) and International Fund for Agricultural Development (IFAD).

Table 2
Performance of Grants by Source and Type, in MK millions

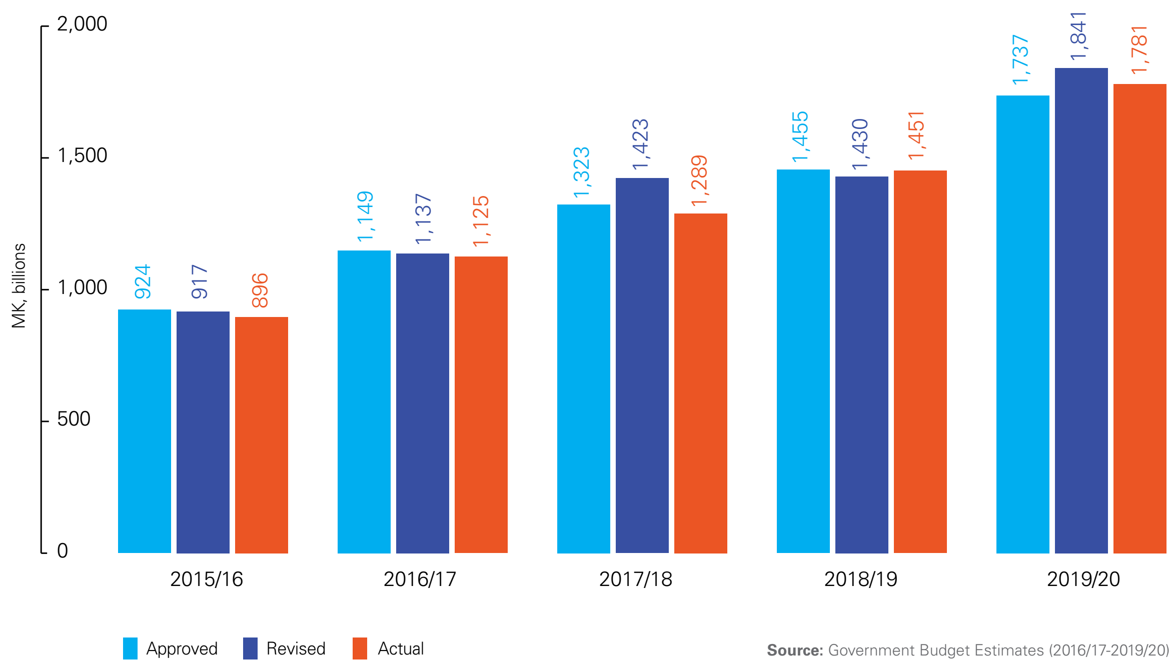
Grant Source	Type		2018/19		2019/20	
			Amount	% Outturn[11]	Amount	% Outturn
Foreign Governments	Capital	Approved	26,588	**0**	42,698	**0**
		Revised	26,588		43,935	
		Actual	-		-	
International Organizations	Current	Approved	60,000	**51**	-	
		Revised	-		-	
		Actual	30,705		21,956	
	Capital	Approved	110,492	**76**	107,360	**80**
		Revised	110,492		131,115	
		Actual	84,432		105,157	
Total Grants		Approved	197,081	**84**	150,058	**73**
		Revised	137,081		175,049	
		Actual	115,136		127,113	

Source: Government Financial Statements, 2019/20-2020/21

11 The % outturn compares the actual with the revised figure.

Total expenditures have generally shown better predictability than revenues and grants over the years. Since 2015/16, expenditure outturns have marginally departed from their approved estimates, as shown in Figure 8, with the exception of 2017/18. For the other years, the deviations are broadly in line with the international standards under the Public Expenditure and Financial Accountability (PEFA) framework which provides for ±5% variance for a credible budget.

Figure 8
Trends in the Performance of Total Expenditure



Source: Government Budget Estimates (2016/17-2019/20)

The ORT budget is generally fully honored and utilized. Expenditure overruns on the PE budget are largely linked to in-year adjustments on wages and salaries. In 2019/20, for example, the PE budget exceeded (MK473.6 billion) its approved level (MK455.7 billion) by 4% due to a 5% (MK22.2 billion) upward revision at mid-year, meant to cater for salary adjustments for the civil service.

The development budget, especially the donor-funded part (DI), has significantly underperformed over the years. In 2019/20, for example, the donor-funded development budget was underspent by 32% (MK206.9 billion against MK333.3 billion). These challenges are also experienced in social sectors. In 2019/20, for example, the health sector development budget was underspent by 61% (MK7.9 billion against MK20.9 billion).

Low absorption capacity by some MDAs of donor funds has been cited by the Government as contributing extensively to the underperformance of the development budget. The recent MGDS III progress review revealed that although budgetary allocations to some KPAs have been lower than targeted, since the onset of the MGDS III in 2017/18, some sectors (health and population, energy and mining) have failed to absorb the allocated funds against planned activities and programs. Thereby, partly contributing to poor sector performance and consequently leading to sub-optimal development outcomes. Issues connected to lack of coordination, bureaucracy and donor programming were also cited as a cause of poor performance in the absorption of grants.

KEY TAKEAWAYS

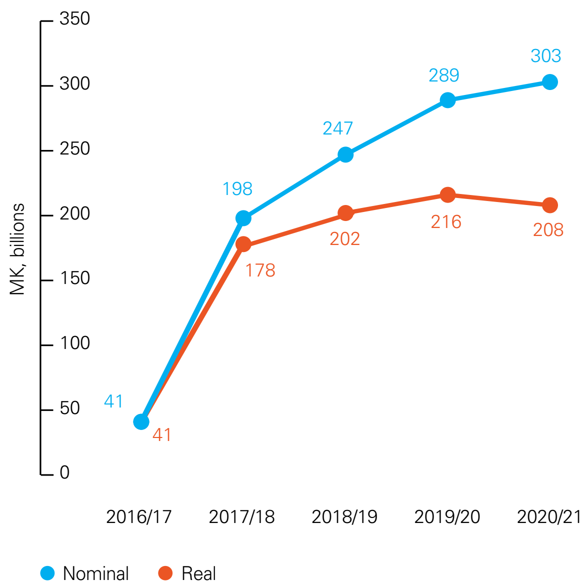
- **The budget formulation process needs to be improved by strengthening macroeconomic and revenue forecasting and assessments of fiscal risks,** whilst ensuring proper planning and measuring of expenditure needs (particularly factoring in salary increases and the potential underperforming of foreign grants) and allow for a sounder borrowing strategy.
- **The adoption of credible budget projections would ensure the budget process is connected to a multi-year perspective,** integrating wider policy reforms, improving the overall budget transparency and fostering fiscal discipline.
- **These would also facilitate the implementation and coordination of credible strategies for revenue mobilization (domestic, but also international aid) and debt management,** necessary to tackle the budget deficits and the shrinking fiscal space in a structured manner.

7. Decentralization and Sub-National Spending

The total allocation to Local Councils (LCs) has declined in real terms. A total of MK303 billion was provided for the purposes of transfers to Local Councils in 2020/21, up from MK289 million in 2019/20, as shown in Figure 9. Compared to the 2019/20, the allocation in 2020/21 is 5% higher in nominal terms but is 4% lower in real terms. As a share of the total budget and GDP, the total district budget has declined from 16% to 14% and 4.8% to 4.5%, respectively. An additional MK7.4 billion will be provided as performance-based grants under the Governance to Enable Service Delivery (GESD) Project, funded by the World Bank. These funds are budgeted for under the National Local Government Finance Committee (NLGFC).

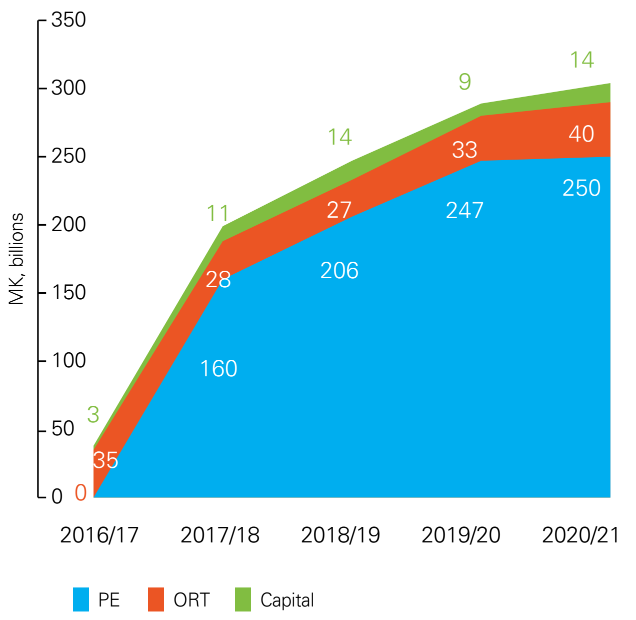
As a share of the total budget and GDP, the total district budget has declined from 16% to 14% and 4.8% to 4.5%, respectively.

Figure 9
Evolution of Spending at Local Level



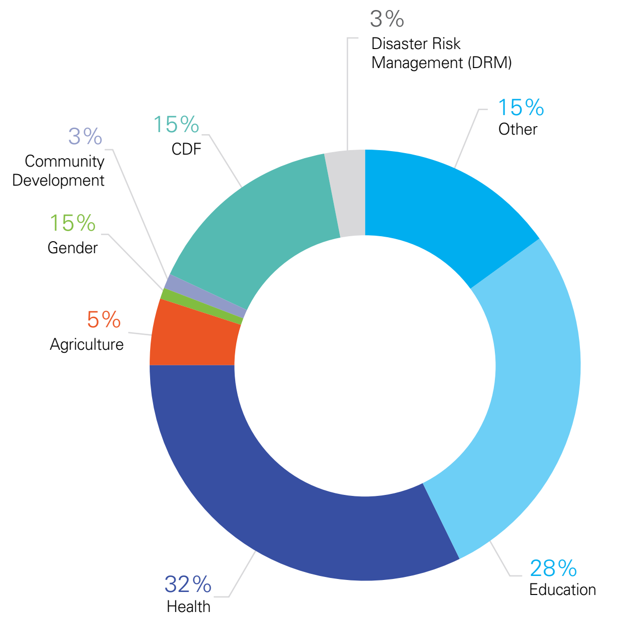
Source: Government Budget Estimates (FY2016/17 to 2019/20)

Figure 10
Trends in the Composition of Nominal Transfers to Local Councils



Source: Government Budget Estimates (FY2016/17 to 2019/20)

Figure 11
Sectoral Composition of the Total District ORT Budget, for 2020/21



Source: PBB for 2020/21

Transfers to Local Councils are mostly allocated to cover wages and salaries (PE) for district staff (82%). This is in line with the trend over the past years that saw PE absorbing around 80% of the total transfers to LCs (Figure 10). A total of MK250.2 billion was budgeted for PE in 2020/21, which is 9% lower than the 2019/20 level (MK247 billion), in real terms. The allocation for ORT, of MK40 billion, represents 13% of the total district budget. Allocations for local development projects, amounting to MK13.5 billion, remain a meagre part (4%) of the LCs budget. The total ORT and capital budget (MK53.2 billion) translate to 4.5% of the net national revenue (NNR). As per the Decentralization Policy (1998), the Treasury is mandated to unconditionally set aside resources equivalent to 5% of the NNR for the purposes of the development of Local Councils.

Education and health together receive about 87% of the total transfers to Local Councils in 2020/21, with education being by far the largest recipient at 60% of the transfer. In 2020/21, the education sector was allocated a total of MK181.4 billion (94% for PE and 6% for ORT), up from MK160 billion in 2019/20. The health sector was allocated a total of MK82.7 billion, up from MK71.8 billion. The allocation to the health sector is mainly composed of salaries and wages for district health staff (MK54.1 billion), followed by MK16.3 billion for drugs to district hospitals. A total of MK2.72 billion was allocated as ORT to the health sector for COVID-19 purposes, in addition to the general ORT allocation of MK9.45 billion. A sectoral breakdown of the total district ORT budget shows that the health sector will receive 32% of the total ORT transfers, followed by the education sector (28%), constituency development fund (15%) and agriculture (5%), as shown in Figure 11.

Outside education and health, ORT transfers to other social sectors are too low to support adequate service delivery. In 2020/21, for example, the gender and community development sectors were each allocated a total of MK250 million (about 0.7% of the total district ORT budget). This implies that, on average, each District Council will receive about MK9 million (less than USD12,000) to implement gender and social related programmes such as gender equality, women economic empowerment and child protection services. The water sector ORT budget was pegged at MK223 million, translating to an average allocation of MK8 million per district per fiscal year (less than USD11,000). These budget allocations are not linked to resource needs at local level.

Resources for other social sector functions are still not devolved. This means that resources are still being managed at the central level, yet the majority of the services are delivered at the local level. For instance, the ECD budget under the Ministry of Gender, Community Development and Social Welfare (MoGCDSW) is still not devolved, despite the majority of ECD services being offered at the local level. Going forward, the Government is encouraged to accompany devolution of functions with commensurate resources to capacitate the districts to effectively deliver on the delegated services.

KEY TAKEAWAYS

- **The decentralization framework is outdated (the Local Government Act and the Decentralization Policy are over 20 years old) and most parts of it are not implemented, especially when it comes to fiscal decentralization.**
- **This has negative repercussions in terms of governance and division of labor between the national and the subnational level,** which in turns impacts service delivery at subnational level and undermines inter-institutional trust.
- **The above, coupled with an outdated Fiscal Decentralization System, negatively affects the funding of the sub-national level.** Fiscal transfers are not commensurate to local needs and challenges and sub-national revenue collection capacity (and rights) are not sufficient to complement them.
- **There is thus need to review the Decentralization Framework to create an enabling legal and policy environment for the decentralization systems to properly work.** The Decentralization Policy and the Fiscal Decentralization System should be reviewed in parallel to ensure that the devolution of functions to the different levels of Government is followed by a commensurate devolution of fiscal capacity and/or resources.

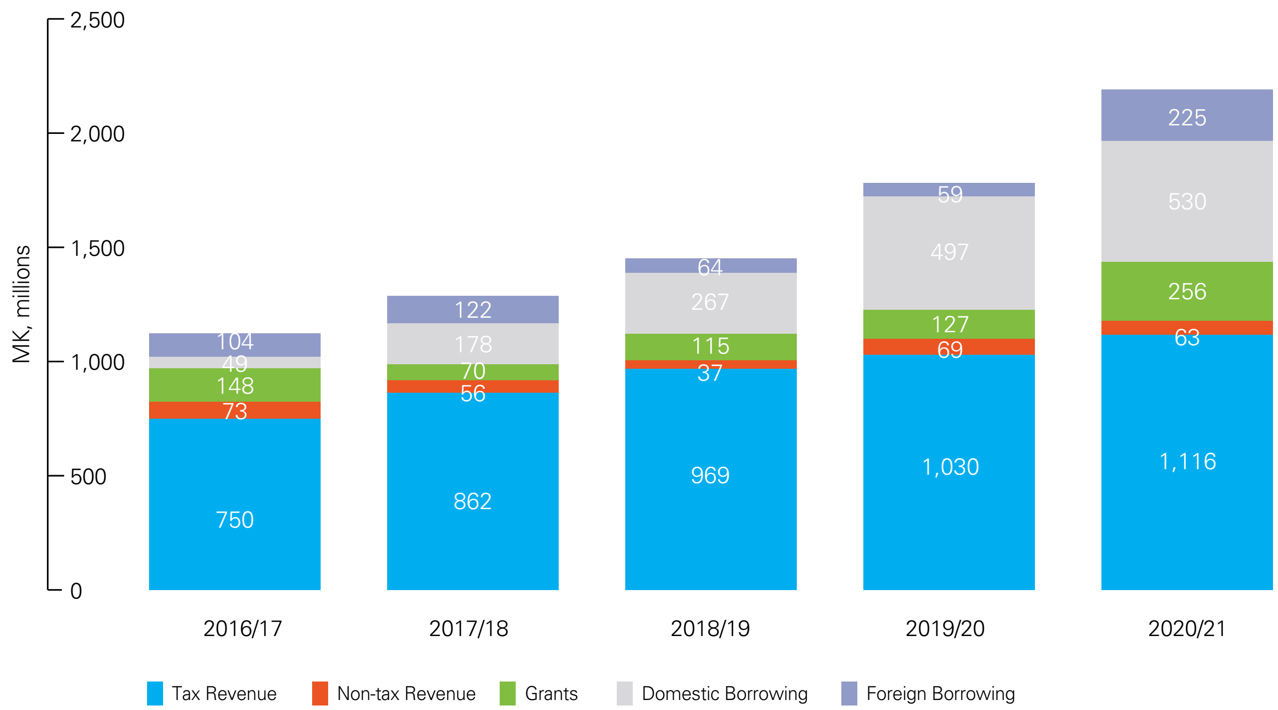
8. Budget Financing

The National Budget is largely financed by domestic revenue, mainly taxes. Domestic revenue has contributed an average of two-thirds to the financing of the total budget over the past five years. The recent past has, however, seen the share of domestic revenue to total financing of the budget declining from 73% in 2016/17 to reach a five-year low of 54% in 2020/21. In contrast, the share of domestic borrowing has risen to over 20% and now constitute the second largest contributor to the financing of the total budget. On the other hand, grants have been contributing an average of 10% to the financing of the total budget while foreign borrowing has been contributing about 7%.

Domestic revenue collection is expected to reach MK1.18 trillion (16.5% of GDP) in 2020/21. Accounting for inflation, currently at 9%, the estimated domestic revenue is 3% lower than its preliminary outturn for 2019/20 of MK1.09 trillion. This reflects the expectation for a reduced revenue generation capacity in the domestic economy, following the impact of the COVID-19 pandemic. About 94% (MK1.11 trillion) of the domestic revenue is expected to come from taxes, which roughly matches the outturn for 2019/20 of MK1.03 trillion, in real terms. The remainder MK63.1 billion is anticipated to come from non-tax revenue, 8% lower than the MK68.5 billion of 2019/20, as shown in Figure 12.

Grants are estimated to a five-year peak of MK255 million (3.6% of GDP) in 2020/21, about twice the amount of 2019/20. Overall, grants are expected to contribute 12% to the financing of the total budget in 2020/21, against the 7% share held in 2019/20. The doubling of grants is largely linked to a surge in current

Figure 12
Trends in the Sources of Financing the Budget

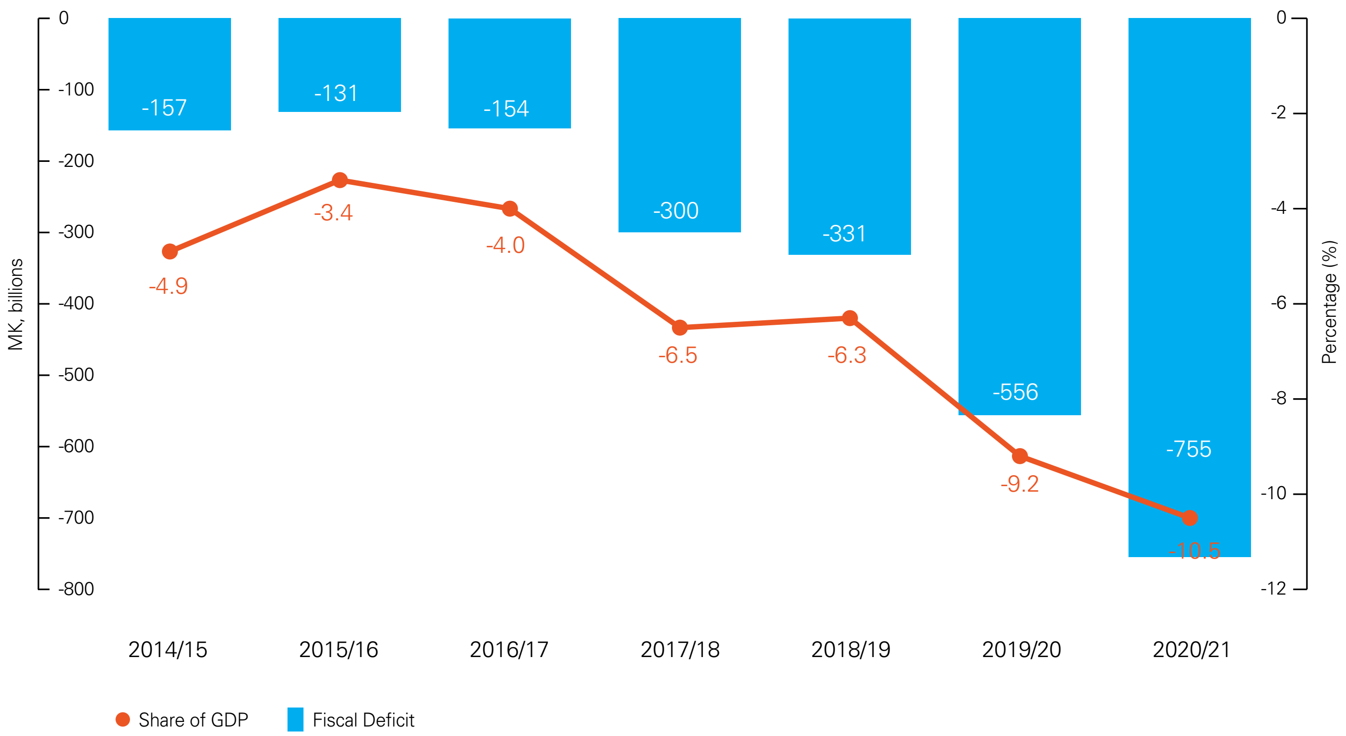


Source: Government Budget Documents, 2015/16-2020/21 grants from international organizations, which are estimated to more than quadruple from MK21.9 billion in 2019/20 to MK94.8 billion in 2020/21. This is linked to program support for the COVID-19 response. A total of MK126 billion is expected to be received in the form of capital grants from international organizations, which is 20% up from MK105 billion realized in 2019/20. On the other hand, capital grants from foreign governments are estimated to amount to MK34.7 billion.

Against a backdrop of reduced revenues and increased expenditures, the 2020/21 budget deficit of MK556 billion stands 36% higher than the 2019/20 deficit (Figure 13). As a share of the GDP, the budget deficit is expected to widen from 9.2% in 2019/20 to 10.5% in 2020/21. Government plans to finance the budget deficit mostly through domestic borrowing, which is expected to contribute about 70% (MK530 billion or 7.4% of GDP) to the financing of the budget deficit for 2020/21, in line with recent trends. The share of domestic borrowing to the total budget has been significantly increasing to reach an all-time peak of 28% in 2019/20.

As a share of the GDP, the budget deficit is expected to widen from 9.2% in 2019/20 to 10.5% in 2020/21. Government plans to finance the budget deficit mostly through domestic borrowing, which has been significantly increasing to reach an all-time peak of 28% in 2019/20.

Figure 13
Evolution of the Fiscal Deficit



Source: Government Budget Documents, 2015/16-2020/21

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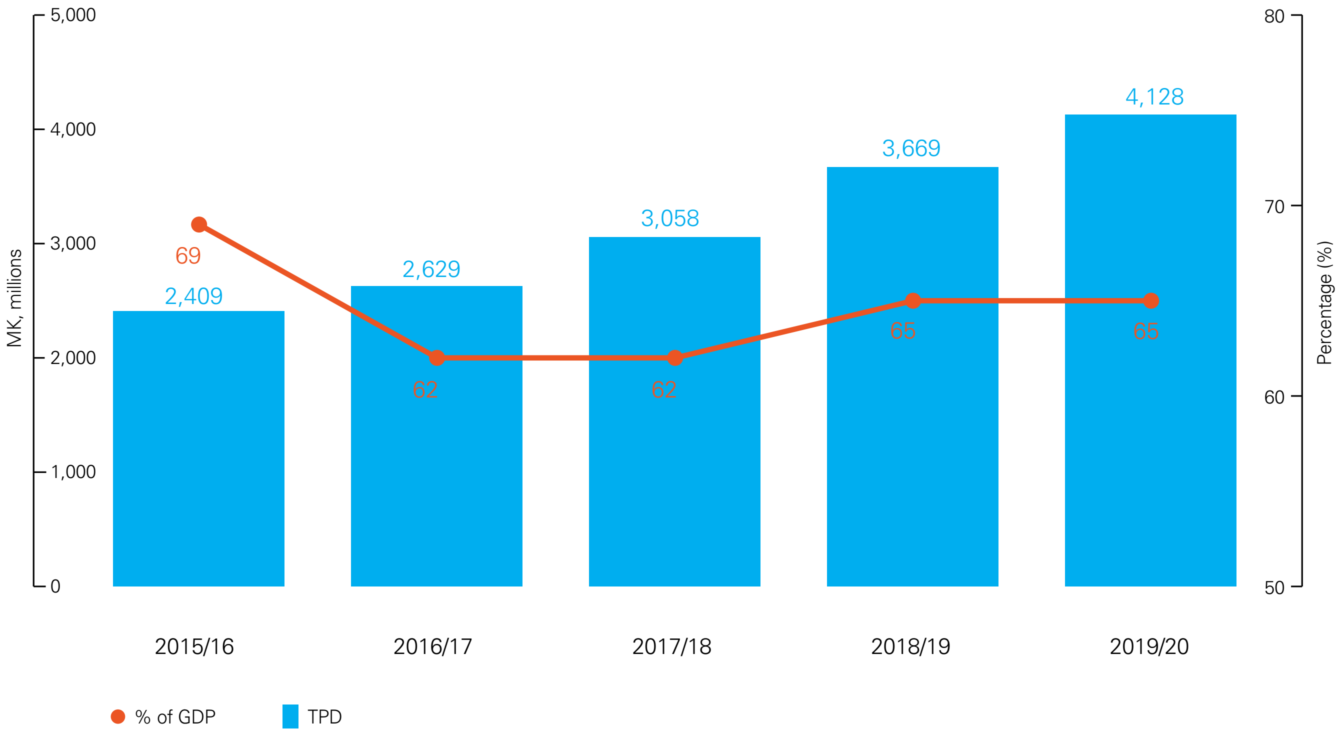
The planned level of foreign financing is anticipated to almost quadruple in 2020/21. The Government plans to borrow a total MK224.7 billion externally to help finance the deficit in 2020/21. As shown in Figure 12, this represents a significant increase from a five-year low of MK58.9 billion borrowed externally to finance the 2019/20 budget deficit. In relative terms, the share of foreign financing has notably increased between 2019/20 and 2020/21, passing from 10% to 30%. This might be linked to several issues. First, the dampening effect of the COVID-19 on the domestic lending market. Second, a probable shift towards rebalancing the financing of the deficit, in light of the high-cost debt servicing charges from the huge domestic borrowing accumulated over the past five fiscal years. Third, a lot of the support for the COVID-19 coming in the form of loans.

The growing and consistently large fiscal deficits have markedly increase Malawi's public debt stock in recent years. Total public debt (TPD) stock[12] swelled by 70% to reach MK4.1 trillion in 2019/20, from MK2.4 trillion in 2015/16, as shown in Figure 14. According to the Government, the stock of public debt as a share of GDP has levelled off at around 65% between 2018/19 and 2019/20. These figures notably differ from those reported by the IMF. Available data from the May 2020 Bank-Fund Debt Sustainability Analysis (DSA), show that the stock of public debt as a share of GDP has levelled off at around 60% of GDP between 2018 and 2019. However, the share is expected to soar by seven percentage points to reach 66.5% in 2020, before widening by a further three percentage points to reach 69.9% by 2021.

12 The figures for debt stock used in this paper were obtained from the Government of Malawi 2018/19 Annual Public Debt Report, which can be found on www.finance.gov.mw. Noteworthy is that these figures may slightly differ from those contained in the Joint World Bank-IMF Debt Sustainability Update of May 2020

Figure 14
Evolution of the Fiscal Deficit



Source: Government Budget Documents, 2015/16-2020/21

Total public debt (TPD) stock swelled by 70% to reach MK4.1 trillion in 2019/20, from MK2.4 trillion in 2015/16, as shown in Figure 14. According to the Government, the stock of public debt as a share of GDP has levelled off at around 65% between 2018/19 and 2019/20.

The recent past has seen the public debt portfolio gradually shifting from external to domestic financing. As of 2019/20, public domestic debt[13] (MK2.37 trillion) constituted 57% of the public debt stock, as compared to 43% for external debt, amounting to US$2.19 billion (about MK1.7 trillion), as shown in Figure 15. In relation to GDP, the share of domestic debt stood at 37% by June 2020, as compared to 28% for external debt. These shares differ from those reported in the May 2020 Bank-Fund DSA, which revealed that external debt as a share of GDP fell from 32.8% in 2017 to 29.6% in 2019, while the GDP share for domestic debt rose from 23.9% to 29.9%, over the same period. The DSA projects domestic debt to reach 35.1% of GDP in 2020, compared to 31.4% for external debt. The shift in the composition of public debt suggests an increasing trend by the Government to monetize the growing fiscal deficits through domestic borrowing as well as the securitization of domestic arrears (IMF, 2018).

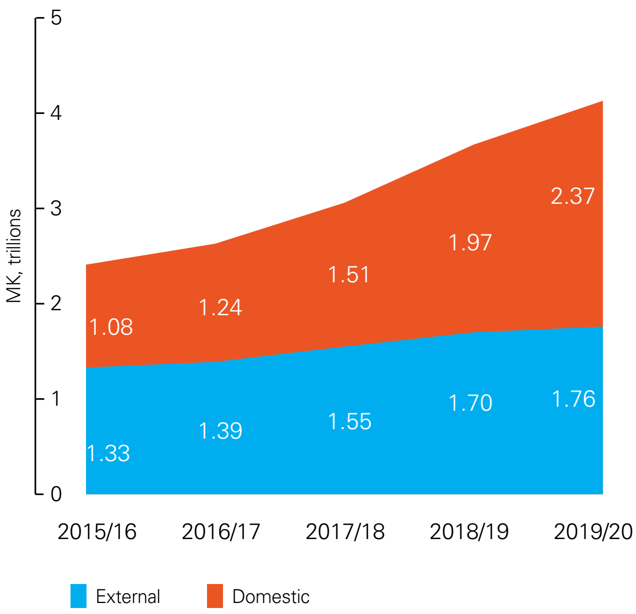
13 In line with international standards, the domestic debt values are at face value (principal plus interest). Accordingly, the Government revised its domestic debt figures to reflect the face values since fiscal year 2015/16.

The cost of debt servicing soared in recent years, following the increase in the debt stock and the shift towards domestic borrowing. The 2018/19 Annual Public Debt Report[14] revealed that in 2018 and 2019, the cost of interest payment for domestic debt, as a share of GDP, was respectively 6.7 and 12.7 times higher than for external debt, as shown in Table 3. The Government acknowledge that high interest rates, largely emanating from domestic borrowing, is one of the three main factors causing the increase in debt to GDP ratio in the past four years. The other two factors are the large fiscal deficit, as already explained, and exchange rate depreciation. Since 2016/17, interest expenses have been consuming for up to 20% of Government revenue. According to the Joint Bank-Fund Debt Sustainability Analysis (2018), this reflects the much higher servicing cost of Malawi's domestic debt, compared to external debt which is predominantly on favorable concessional terms.

14 Ministry of Finance, Economic Planning and Development (September 2019), Annual Public Debt Report for the 2018/19 Financial Year, www.finance.gov.mw.

Figure 15

Trends in Composition of Public Debt (2015-2018)



Source: MoFEPD Annual Debt Reports, 2017/18-2019/20

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As of 2019/20, public domestic debt (MK2.37 trillion) constituted 57% of the public debt stock, as compared to 43% for external debt, amounting to US$2.19 billion (about MK1.7 trillion).

Table 3
Selected Cost of Debt Indicators for Malawi

Cost of Debt Indicator	External Debt (a)		Domestic Debt (b)		Total Debt	
	2018	2019	2018	2019	2018	2019
Interest payment (% of GDP)	0.3	0.3	2	3.8	2.3	4.2
Weighted Average IR (%)	1.1	1	6.9	13.3	4.1	7
Ratio of Cost of Domestic Debt to External (b/a)	6.7	12.7				

Source: MoFEPD (2019), 2018/19 Annual Public Debt Report

Cognizant of the implications of the rising public debt, the Government is exploring the possibility of establishing a Debt Retirement Fund (DRF). Once established, the idea is that proceeds from the DRF will be ring-fenced and entirely used to retire the public debt until such a point when public debt levels are within sustainable levels. Upon achieving sustainability, the DRF could be turned into a Malawi Sovereign Wealthy Fund, which could be used to roll out fiscal stimuli packages to support economic activities and the welfare of citizens in times of socio-economic crisis such as those arising from the current COVID-19 pandemic and other forms of natural disasters, which Malawi continues to face.

KEY TAKEAWAYS

- **The COVID19 has reduced domestic revenue prospects, mainly through reduced taxable activities, further limiting available fiscal space for the Government to adequately invest in social sectors.**
- **With external funding flows to Malawi expected to further dwindle due to COVID-19, the Government will need to explore ways to finance its spending priorities without jeopardizing its fiscal position.**
- **The growing debt stock and the shift in its composition, with higher amounts of domestic debt being subscribed at high interest, are worrisome developments in that they could cause a debt crisis.** Malawi is already considered at high risk of domestic debt distress by the joint IMF and WB Debt Sustainability Assessment. The current discussions geared towards finding solutions for the debt situation, such as exploring the Debt Retirement Fund, are welcome developments.

9. Policy and Systems

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9.1 Public Finance Management Reforms

The Government has initiated several reforms to improve public finance management. In 2020/21, the Government is expected to finalize the review of the Public Finance Management (PFM) Act of 2003. The revised PFM Act is expected to strengthen accounting, budgeting, revenue and expenditure management, internal controls and other areas of public finance management. The Government has also started rolling out the New Integrated Financial Management Information System (IFMIS) in 2020/21, which is expected to be fully rolled out by the end of the fiscal year. The New IFMIS is expected to play a pivotal role in improving the efficient and effective accounting and financial reporting functions in Government.

To improve domestic revenue, the Government is also developing a Domestic Resource Mobilisation Strategy, which will among other areas focus on broadening the tax base, improving tax and non-tax systems, enhancing tax compliance and strengthening institutional capacity. At local level, the Government through the support of the World Bank, plans on introducing performance-based grants where resources will be disbursed based on districts' adherence to regulations and prudent financial management.

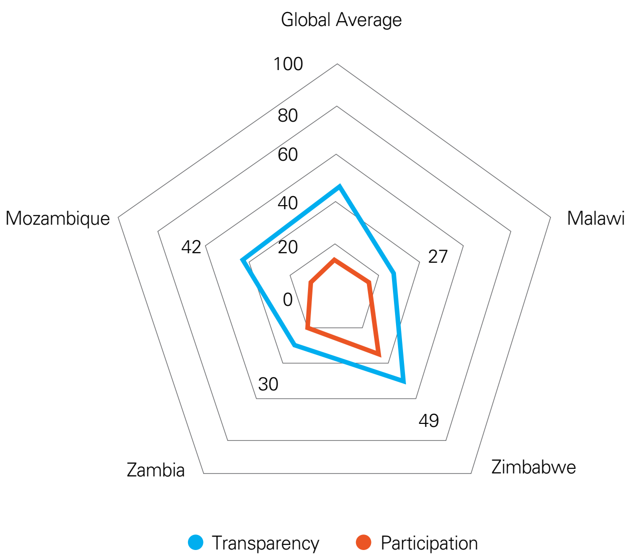
Under the Public Sector Management Reforms Unit (PSMRU), headed by the Office of the Vice President, the Government is planning swift public sector reforms. These are expected to strengthen governance structures of all parastatals and enhance prudent financial management. The Government also plans to establish a Treasury Single Account in 2020/21. This will act as a unified structure of bank accounts where Government resources are pooled and treated as fungible. The Government is also planning to engage international credit rating agencies for a sovereign credit rating to help Malawi access international financial markets, crucial for the purposes of financing huge infrastructural development.

9.2 Budget Transparency[15]

Malawi's budget transparency levels remain very low. According to the Open Budget Survey (OBS) (2019), Malawi scored 27 (out of 100) on the OBS, which is almost the same as the score of 26 in the 2017 OBS. The 2019 score ranks Malawi number 95 out of a total 117 countries on the OBS. The 2019 OBS score for Malawi is low compared to regional peers – Zambia (30), Mozambique (42) and Zimbabwe (49), as shown in Figure 16. At 15 (out of 100), the score for public participation has not changed since 2017. The legislature (58) and supreme audit institution (48) in Malawi, together, provide limited oversight during the budget process, with a composite oversight score of 54 (out of 100).

15 This part of the OBS measures public access to information on how the central government raises and spends public resources. It assesses the online availability, timeliness, and comprehensiveness of eight key budget documents using 109 equally weighted indicators and scores each country on a scale of 0 to 100. A transparency score of 61 or above indicates a country is likely publishing enough material to support informed public debate on the budget

Figure 16
Budget Transparency in Malawi in relation to Neighbors



Source: International Budget Partnership (IBP) (2020)

Ongoing efforts by the Government to strengthen budget transparency should help improve scores in the upcoming OBS in 2021. To improve its budget transparency score, the International Budget Partnership (IBP) has recommended the Government to (i) publish a Pre-Budget Statement, an Enacted Budget, In-Year Reports, Audit Report and a Year-End Report online in a timely manner, (ii) include debt and macroeconomic information in the Executive's Budget Proposal and (iii) improve the comprehensiveness of the Audit Report and Citizens Budget.

The Government is making efforts to improve its transparency. In 2020/21, the Government included the debt and macroeconomic situation in its Budget proposal in line with the international standards. The Government has also committed to publishing the key budget documents online in a timely manner. Several efforts are also underway to improve public participation and budget oversight. For instance, public hearings organized by the Parliament to allow the public and civil society to present key issues and recommendations during on the 2020/21 budget proposal prior to its approval.

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KEY TAKEAWAYS

- **Government is showing commitment to substantive PFM reforms that would capitalize on the quick gains made since the last PEFA (2018)** in terms of legal and regulatory to tackle some structural issues in terms of budget credibility, basic functionalities, procurement systems and civil service quality and effectiveness.
- **Government has embarked in several initiatives meant to improve the overall level of transparency in budgetary matters.** If sustained, these initiatives could help improve donor confidence in the country's PFM systems, facilitating the roll out of direct budget support and the access to other forms of financing.

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