

# **Public Finance Management Reform in Malawi**

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**Dick Durevall and Mattias Erlandsson**

Department of Economics  
School of Economics and Commercial Law  
Göteborg University  
Box 640  
SE 405 30 Gothenburg  
Sweden

E-mail addresses:

[dick.durevall@economics.gu.se](mailto:dick.durevall@economics.gu.se)  
[mattias.erlandsson@economics.gu.se](mailto:mattias.erlandsson@economics.gu.se)

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## Acronyms

ABB	Activity Based Budgeting
AG	Auditor General
CABS	Common Approach to Budget Support
DFID	Department of International Development
DPP	Director of Public Prosecutions
FIMTAP	Financial Management, Transparency and Accountability Project
GoM	Government of Malawi
GWAN	Government Wide Area Network
HIPC	Heavily Indebted Poor Country
ID I, II	First or Second Institutional Development Project
IFMIS	Integrated Financial Management Information System
IMF	International Monetary Fund
MEJN	Malawi Economic Justice Network
MEPD	Ministry of Economic Planning and Development
MoF	Ministry of Finance
MPRS	Malawi Poverty Reduction Strategy
MRA	Malawi Revenue Authority
MTEF	Medium-Term Expenditure Framework
NAO	National Audit Office
NORAD	Norwegian Agency for Development Cooperation
OPC	Office of the President and Cabinet
ORT	Other Recurrent Transactions
PER	Public Expenditure Review
PFM	Public Finance Management
PPE	Pro-Poor Expenditure
PSIP	Public Sector Investment Programme
SAL	Structural Adjustment Loan
UNDP	United Nations Development Program

## 1. Introduction

Malawi has implemented a series of structural adjustment programmes since the beginning of the 1980s without much success in terms of economic growth and poverty reduction. One of the explanations for the meagre results of structural adjustment programmes in developing countries is according to Rodrik (2004) inadequate focus on incentives: economists have not taken their economics seriously enough.<sup>1</sup> In this report we study one component of Malawi's structural adjustment programmes, public sector finance management reform (PFM) with an emphasis on the role of incentives in implementation and outcome of these reforms.

Malawi had its first structural adjustment lending in 1981. Since then actual public expenditures have exceeded both original budget estimates and revised estimates during practically all years (World Bank, 1990; 2001a). Not surprisingly, there have been a number of initiatives aimed at improving the budget process, usually initiated by the World Bank and other donors. Even though some of the initiatives have been put into practice, the PFM reforms have not been successful and recently the IMF characterised the budget process as extremely weak (IMF, 2004a). An illustrative example is that during the fiscal year 2003/04 overexpenditure was 3.6% of GDP, when compared to the revised budget.

There are two obvious reasons for why PFM reforms have not achieved the expected results; some reforms have not been implemented properly while others have not worked well. To analyse why the reform processes have not achieved their goals we look at four issues: the preferences and incentive structure of the government, that is, the political will and reform ownership; the incentives of civil servants for capacity building and reform implementation; the complexity and sequencing of reforms; and finally, the role of the World Bank since it has initiated and supported many of the reforms.

PFM is a multifaceted activity and PFM reform is a huge topic, so we will only focus on major reforms. These are the Civil Service Pay and Employment Reform, MTEF (Medium Term Expenditure Framework), PSIP (Public Sector Investment Programme), IFMIS (Integrated Financial Management Information System), Malawi Poverty Reduction Strategy (MPRS) and Pro-Poor Expenditures (PPEs), and the reforms of the watchdogs, the Auditor

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<sup>1</sup> Killick (1996) and Easterly (2001) make a similar point.

General and Anti-Corruption Bureau. There are many other reforms that we will not discuss, partly because it is beyond the scope of this report to cover them all and partly because we judge them as less interesting for understanding PFM reform processes in Malawi. However, in some cases we comment on these reforms. Examples of reforms not discussed in detail are: the Cash Budget System, introduced in 1996; the Public Procurement Act of 2003 and the new Directorate of Public Procurement; the new Internal Audit Unit; debt management; the Decentralisation Implementation Plan; and the creation of Malawi Revenue Authority (see World Bank, 2003a, GoM, 2003a and DFID, 2004 for details).

The main conclusion of the report is that there are at least four flaws of the reform programmes. First, the preferences of the President, by far most important person when it comes to monitoring and accountability, have in practice been ignored. When the President's preferences are not in line with the goals, the reforms are unlikely to be implemented properly. Second, the incentive structure of civil servants needs to be consistent with the objective of reform implementation. Now there are explicit and implicit contracts with the government that are perverse in the sense that they reduce effort and make capacity building very difficult. Third, the sequencing and prioritisation of reforms have not been adequate. For instance, there has to be a reform of the pay structure before reforms that require a lot of capacity building are implemented. Moreover, it is necessary to get the basics right before embarking on complicated reforms. Finally, the World Bank seems to have been too optimistic about the progress of reforms and has not paid enough attention to preferences and incentives within the Malawi government. Another way to summarise our findings is that PFM reforms have focused on improving the technical aspects of the budget system, while largely ignoring the preferences and incentives of the different actors.

In the following section we outline the concepts used in the analysis, and briefly review the principal-agent model applied to the public sector. In Section 3 we describe budget outcomes in Malawi and some of the macroeconomic consequences of large budget deficits. In Sections 4 to 8 we go through various PFM reforms in some detail: these are Civil Service Pay and Employment Reform (Section 4); MTEF (Section 5); PSIP (Section 6); IFMIS (Section 7); MPRS and PPEs (Section 8); and the Auditor General and Anti-Corruption Bureau (Section 9). The report concludes in Section 10 with a discussion of the results and a summary.

## **2. Analysing Public Finance Management Reforms: Some Concepts**

In this section we first describe PFM and comment on some concepts. Then we briefly outline the principal-agent problem and its relevance for the public sector.

PFM is concerned with the management of public funds, where the budget process has a core role. The budget process can be divided up into various stages: long-term planning, annual budget formulation in the executive, passage in Parliament, implementation and oversight. Effective management of public finances means that policy makers can take into account available resources and the implications of policy choices. Thus, a requirement for a well-functioning budget process is proper institutions and decision-making processes. The objective of PFM reform is to implement these, or to improve the existing ones.

Implementation of PFM reforms is in some sense not different from implementation of any other policies; it has to be carried out by civil servants and the end result depends to a large extent on the efficiency of the public sector. However, donors have initiated all major PFM reforms in Malawi, so the outcome also depends on a number of other factors. There are issues such as ownership of reforms and political will, capability, sequencing of different reforms, accountability, etc. In this study we interpret ownership of reforms and political will as being dependent on the preferences and incentive structures of policymakers and top civil servants. This means that the government, or at least the President, and probably some key ministers, have to believe that a specific reform will improve the budget process and work to achieve this. It is unlikely that other actors can enforce such actions upon a government, which is why the concepts ownership and political will are so common in the aid literature. Nevertheless, in principle Parliament or voters can hold the government accountable for not implementing reforms. Civil society can monitor and evaluate the President and his Cabinet, but hardly discipline them. Donors regularly evaluate the progress of reforms and can potentially influence governments by threatening to cancel disbursements of foreign aid. However, experience shows that threats and actual withdrawals of aid may not be very useful in pushing through reforms (Collier et al., 1997).

Capability refers to the ability of the civil service to implement a reform programme. It is dependent on the complexity of the reform and the number of reforms. However, capability is also related to the prevailing incentive structure that civil servants face since it determines

their work effort. This makes the civil service pay structure and work conditions very important.

Sequencing and prioritisation of reforms can also affect the success of reform processes. When there are many reforms and some are interdependent, starting at the wrong end might seriously delay implementation. An illustrative example is the use of forward budgets such as the MTEF, i.e., rolling budgets that run over several years, when it is almost impossible to make reasonable forecasts of future revenues because of fluctuations in donor-funded budget support.

A useful approach to the study of incentives in organisation is the principal-agent theory. In the rest of this section we briefly outline the basic messages of this literature and relate them to the organisation of the public sector. The concepts presented are employed in the analysis to understand Malawi's reforms.

In the economic literature, the 'principal-agent' model has been used to analyse the impact of poor incentives.<sup>2</sup> The principal-agent problem arises because contracts between agents, for example employees and employers, are incomplete, with compliance requiring monitoring. In trying to reach an incentive-compatible contract the principal is constrained by the need to overcome the agent's participation constraint. The contract offered must at least satisfy the agent's 'reservation' utility. Moreover, to discourage shirking and other costly behaviour on the part of the agent, the wage or incentive offered must be such that the threat of dismissal is credible i.e. it is sufficient to instil discipline. However, the principal-agent framework, while insightful, tends to project too simplified a view. Typically, there are hierarchies of 'principals' and 'agents' in the public sector. In a democracy, citizens are the principals of the Parliament, which in turn is the principal of the Cabinet. The Cabinet is itself the principal of the civil service etc. There are also principal-agent relations between the President and his ministers, ministers and their permanent secretaries, and the latter and the staff of the ministries. When institutions are weak, such a formal framework tends to be displaced by informal lines of authority based on patronage, ethnic affiliation and corruption (Wescott, 1996; Kaluwa and Musila, 2000).

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<sup>2</sup> See Lazear (1995) for a review of the literature on incentives in organizations.

The monitoring problems in the principal-agent model discussed above arise from lack of transparency. If, for example, the budgetary process of the government is opaque, it is difficult for the Parliament to scrutinise the government's intentions as demanded by the electorate. It simply does not have enough information to do so. Similarly, if public sector job descriptions are poorly specified, imposing disciplinary measures or devising an adequate level of remuneration will be next to impossible. The importance of transparency was powerfully demonstrated in Uganda when the government published the amounts of money it was disbursing to the districts in the local newspapers, making recipients aware of what to expect. With regard to primary schools, financial flows from the central government that reached their targets at the district level rose considerably as a result of the increased level of transparency in the disbursement process (Reinikka, 2001).

Evaluation, or after-the-fact monitoring, is another means of ensuring compliance. There is, however, little point in evaluation when poor performance cannot be punished. In practice, especially where job descriptions are imprecise, it can be difficult to prove that employees are guilty of misconduct. Moreover, given the correlation between punishment, the risk of getting caught and the wage level, creating an effective system of deterrents is difficult. If, for example, the penalty is generally considered too harsh and thus viewed as unfair by onlookers, enforcers will be reluctant to apply it. Similarly, when wages are low, society takes a more lenient view of corruption in the public service. Since softer deterrents do not work either, the answer seems to lie in fundamental reform of the incentive structure of the public service (Tanzi 1998).

### **3. Public Finance Management and Macroeconomic Performance**

A well-functioning PFM system is critical for poverty reduction. There are basically three channels through which the management of public expenditures affect poverty. First, the prioritisation of expenditures can ensure that scarce resources reach activities that are most effective in reducing poverty. Second, the allocation of resources can increase the efficiency of the civil service, thereby improving service delivery. And third, it can contribute to macroeconomic stability by helping to maintain stable inflation and low interest rates, and by stimulating economic growth (GoM and World Bank, 2000). In addition to these three channels, PFM also affects poverty through availability of foreign aid, particularly donor-



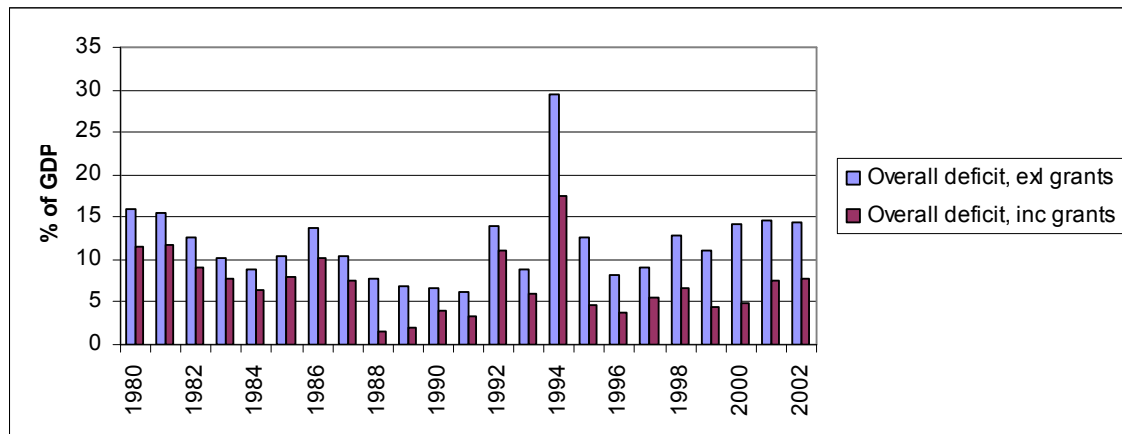
funded budget support. Overspending can lead to sharp declines in budget support and significant losses of government revenue. An illustration of this is that programme aid in Malawi was 5.5% of GDP in 2000/01 and dropped to 0.8% of GDP in 2002/03.

During the last five years, 1999-2003, Malawi's GDP grew by an average of 1.6%, which resulted in a GDP-per-capita decline of over 1% per year. Although external shocks explain some of the decline, many economic commentators link Malawi's poor performance to macroeconomic instability caused by the government's fiscal policies (see IMF 2004a and Whitworth, 2004). The purpose of this section is to describe the development of the Budget and highlight some macroeconomic implications of PFM. Although it would have been interesting to evaluate how PFM has affected poverty through the other channels, this is too complicated and can only be achieved by in-depth studies (see for example, MEJN, 2003).

The most evident signs of a bad PFM system are persistent budget deficits and large differences between approved Budgets and actual expenditures. Both of these phenomena are common features of the budget process in Malawi both under the former regime of one-party rule and life presidency and the current multiparty system. The World Bank's 'Malawi Public Expenditure Review' (1990) pointed out that there was a general tendency of overrunning both the approved and the revised budget ceilings already in the 1980s. There were also large budget deficits, as Figure 1 shows, but these were principally due to external shocks up until 1992. However, in 1994 there was a serious loss of expenditure control, mainly due to the general elections, resulting in a deficit of 17% of GDP including grants.

The change to a multiparty system in May 1994 did not lead to a sustained improvement in fiscal discipline. In fact, budget deficits continued to be high even in the absence of external shocks. Figure 1 shows that they in general were over 5% of GDP after counting grants. The performance during the most recent period, not reported in Figure 1, was very bad; the deficit was 12.1% in 2002/03 and 7.3% in 2003/4 according to IMF estimates (IMF, 2004c).

**Figure 1: Fiscal Deficits as a share of GDP 1980 -2002 (in percent)**



Source: World Bank Africa Database, 2004.

In Malawi the budget is made up of two parts, Recurrent Budget and Development Budget, where the latter includes locally and donor funded public investments and associated recurrent expenditures. Table 1 reports data on approved and actual outturns for the two budgets as a share of GDP over the period of multiparty system, 1994/95-2003/04. In general there are large discrepancies; actual recurrent expenditure was clearly larger than the approved one during all years except one, while the actual development expenditure was smaller during several fiscal years. The main explanation for the variations in development expenditure is unexpected shortfalls in foreign aid, which finances a large part of it.

The numbers reported in Table 1 are aggregates and the differences between budgeted expenditures and outturns are even larger when votes or line items are compared. For instance, in the Recurrent Budget for 2003/04 there were 20 votes with overexpenditure and 39 votes with underexpenditure, but the votes with overexpenditure made up 73% of the Budget. Furthermore, there were five votes with an overexpenditure of 50% or more, and five with at least an underexpenditure of 50% (IMF, 2004c). These discrepancies make the Annual Budget highly unreliable as a tool for policy implementation.

The usual ways of financing budget deficits is through domestic borrowing, foreign borrowing, or money printing. However, in countries with controls on interest rates governments can obtain an implicit tax by borrowing at negative real interest rates. This was an important source of finance for GoM until recently, keeping down the growth of domestic debt.

**Table 1: Approved and Actual Recurrent and Development Expenditure as a share of GDP**

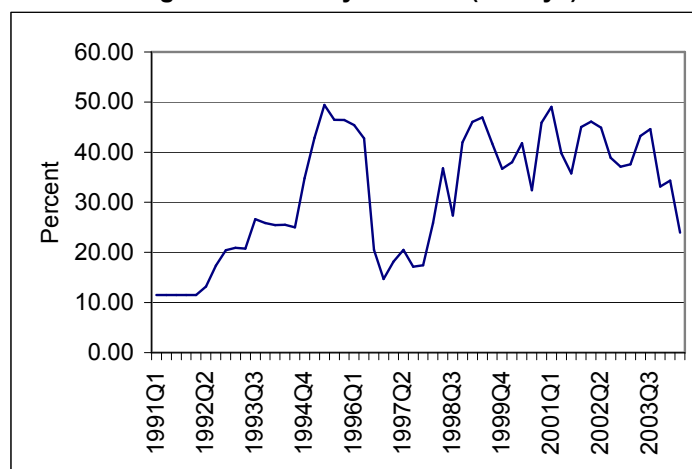
Fiscal Year	<u>Recurrent Budget</u>		<u>Development Budget</u>	
	Approved	Actual	Approved	Actual
1994/95	27.0	34.0	6.8	7.6
1995/96	21.6	24.3	7.0	6.5
1996/97	19.1	18.4	4.9	4.8
1997/98	20.4	22.6	5.1	5.1
1998/99	15.6	18.4	9.4	8.6
1999/00	15.9	17.8	9.3	10.5
2000/01	19.8	22.6	10.6	10.1
2001/02	19.4	24.6	6.9	7.3
2002/03	23.2	32.0	8.2	7.7
2003/04	20.4	33.0	8.1	10.3

Sources: 1994/95 – 1999/00, World Bank (2001a), and 2000/01 – 2003/04, IMF (2001a, 2002 and 2004c).

Figures 2 and 3 show the nominal and real three-month Treasury bill rates between 1991 and 2003, respectively. In Malawi, Treasury bills are the major source of domestic financing of deficits, and Treasury bill rates are the relevant interest rates. The nominal interest rate was clearly controlled until 1992 but for the rest of the period it was very volatile. However, as Figure 3 shows, unstable inflation made the real return on Treasury bills even more volatile.

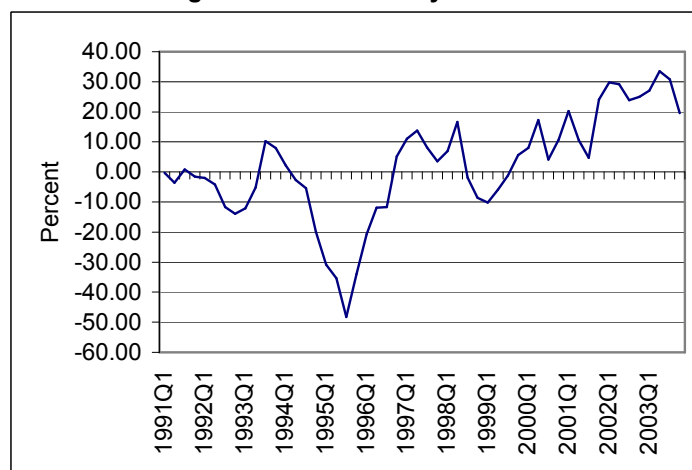
During most of the 1990s the real rates were clearly negative, reaching almost -40%. As a result, domestic borrowing did not lead to large interest payments. However, at the end of the 1990s, real interest rates became positive, reaching over 30% in 2003. In combination with large deficits financed by domestic borrowing this led to a sharp increase in the government's interest bill; it went from 3% of GDP in 2000/01 to 9.2% in 2003/04 (Whitworth, 2004). In the 2004/05 Budget domestic interest rate payments are estimated to be about 20% of total expenditure, and hence, strict fiscal discipline is needed in order to avoid a debt explosion.

**Figure 2: Treasury Bill Rate (91 days)**



Source: International Financial Statistics

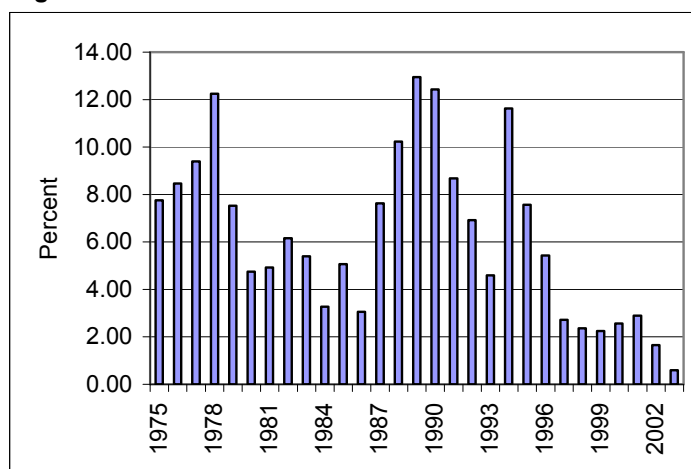
**Figure 3: Real Treasury Bill Rate**



Note: Calculated as the nominal Treasury bill rate minus yearly inflation.  
The source is International Financial Statistics.

It is well known that public deficits can have negative effects on economic growth through crowding out of private investments. In Malawi this effect has been very strong recently. When the government is borrowing at real interest rates as high as 30%, most companies prefer to buy Treasury bills instead of investing in fixed capital formation. Figure 4 shows that private sector investments have been extremely low for several years and that it declined to 0.6% of GDP during 2003, the year when the return on Treasury bills peaked. It is illuminating to compare this with investment levels in other countries; for instance, they were 15% in Uganda and 13% in South Africa in 2002.

**Figure 4: Private Sector Investment as a Share of GDP**



Source: World Bank Africa Database, 2004 and the IMF, 2004c.

#### **4. Civil Service Pay and Employment reform<sup>3</sup>**

As argued above, the incentive structure is an important determinant of the outcome of reforms. This is not true only for the President and his Cabinet but also for the incentive structure of the civil servants. In Malawi, there are many explicit and implicit contracts between the government and its employees that do not provide an incentive structure that promotes efficiency. This could possibly be remedied with effective monitoring and accountability. However, there has been little monitoring of civil servants and they have not been held accountable for their actions. Hence, many reform initiatives have not delivered the expected results.

It seems to be a common opinion that prior to the introduction of a multiparty system in 1994 the Malawi Civil Service (MCS) was quite efficient and the level of corruption was relatively low. However, a closer look indicates that the MCS probably worked well up to the mid-1980s, when a process of deterioration started, even though there was a general tendency to overrun both approved and revised budgets during most of the 1980s (Pryor, 1990, World Bank 1990). One factor that contributed to the deterioration was the decentralisation of the government's payment system in 1987 to line ministries and agencies. It set off a decline in within-year expenditure control and accelerated the breakdown of fiscal discipline in these

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<sup>3</sup> Unless indicated, this section draws on the excellent study by Valentine (2003).

institutions (World Bank 1994).<sup>4</sup> Another factor was the decline in average real compensation in the public sector by over 50% between 1986 and 1987 (Valentine, 2003, p.5). In addition, there was substantial salary compression between 1986 and 1989 when the top-bottom salary differential decreased from 45 to 25 (Durevall, 2003).

After the decline in 1987, real average compensation stayed roughly at the same level until 1994, when it started to fluctuate from year to year although never reaching the values of the first half of the 1980s. It is noteworthy that in 2001 and 2002 real compensation was half of the level in the beginning of the 1980s (Valentine, 2003, p. 5).

Apart from the decline in salaries, a host of other, but related, deficiencies in MCS's compensation system have emerged over time.<sup>5</sup> These can be summarised in the following way:

- Differences in salaries between job grades are too small to provide a reward for experience, skills, responsibility or performance.
- Pay and conditions of service are not good enough to attract and retain personnel with managerial, professional and technical skills.
- Promotions are awarded on the basis of length of service rather than on merit.
- The compensation package is proliferated with allowances and benefits, which weakens transparency of the compensation system.
- There is a lack of rewards and sanctions within the incentive system. No distinction is made between good and poor performers.

The change in the compensation system during the 1980s was a change in the incentive structure of the civil servants, and it influenced the public-sector labour force in various ways. The decline in real salaries led to an unmotivated workforce and reduced work effort. There was reduced commitment to the public service and a weakening of accountability and control procedures. Furthermore, incentives to improve work performance and to accept greater responsibility were reduced. And capacity building became difficult: put sharply, with the current system there are some who make an effort to improve their capacity in order to move

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<sup>4</sup> Another piece of evidence that the deterioration of MCS started well before the change to democracy is Gallagher and Msosa (1995) who reports about the lethargy in the civil service and the inefficient incentive structure, due to many years of neglect.

<sup>5</sup> This and the following five paragraphs are based on Valentine (2003).

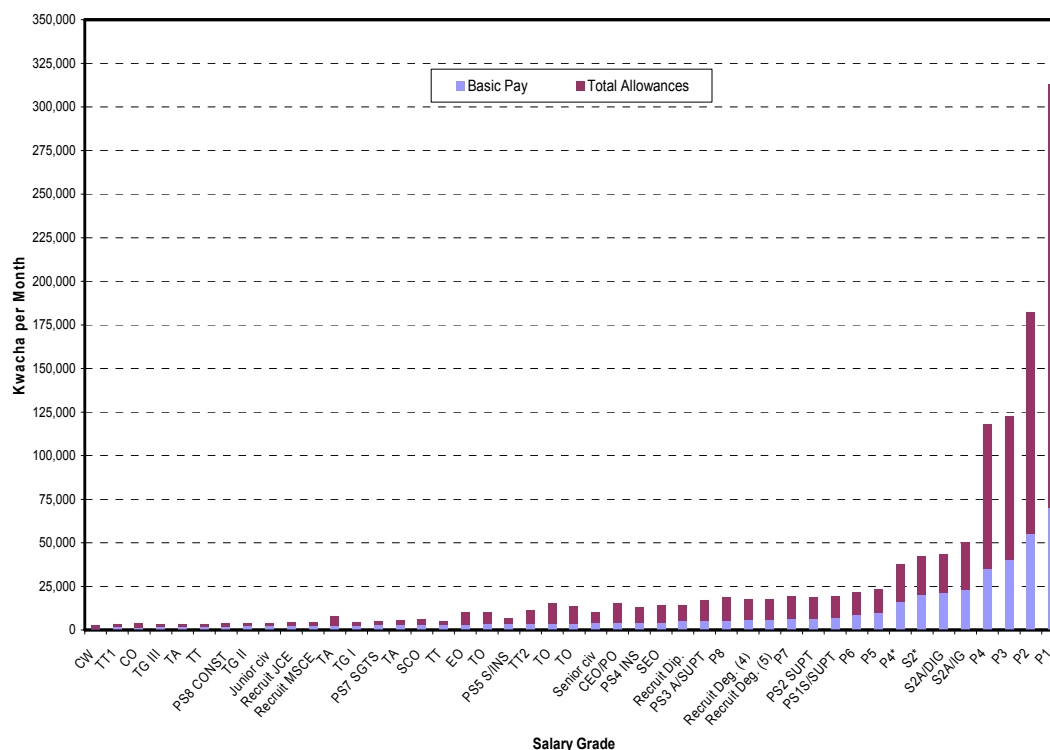
to the private sector and others, with small chances of getting a position in the private sector, who attend work shops and courses only to obtain allowances and free meals.

In a situation when basic salaries are so low that it is hard to survive on them, let alone maintain a family, civil servants adopt alternative strategies to increase income. When these become institutionalised, they not only have a strong negative impact on service delivery but they worsen the incentive structure even more. These strategies can be classified as work sharing, cost sharing, revenue sharing and resource sharing. Work sharing means that personnel share the workload, allowing one worker to be absent or pursuing his own business while the others do the job. An example where this seems to take place is in hospitals in Malawi where some medical staff are reported to leave work early. Cost sharing implies that civil servants ask for payments for free public services, such as medicines, or request payments in excess of formal fees. Revenue sharing is misappropriation of revenue from user charges, which probably is very common since non-tax revenues from line ministries and agencies are highly unpredictable and sometimes extremely low. Resource sharing is when public resources, such as vehicles, are stolen or used for personal gain.

Since a system with too low salaries obviously is unsustainable, GoM has responded in various ways. One response has been to introduce a proliferation of allowances and fringe benefits. Over time this has raised personal compensation, particularly for top-level civil servants. The widespread use of allowances has partially offset the decline in salaries but at the same time it has created a system that lacks transparency, is inconsistent, and distorts the incentive structure.

The importance of allowances for the compensation structure is illustrated in Figure 5, which depicts the distribution of average monetary compensation for the MCS in 2003 into basic pay, i.e., wages and salaries, at the bottom, and allowances, at the top. During 2003 only 35% of the wage bill was made up of salaries and wages while 66% was allowances. For those that were not on performance contracts, i.e., all but the top-four levels, the allowance share varied between 69% and 74% (Valentine, 2003, p.42).

**Figure 5: Distribution of Average Monetary Compensation for the MCS, February 2003**



Source: Valentine (2003), who obtained the data from Accountant General Department.

Although some allowances are unrelated to performance, such as housing allowance, others are duty facilitating. Among these we have travel allowance, per diem allowance, sitting allowance, and attendance fees. In general these are too high and often work as top-ups on salaries. One example is allowance for domestic travel, where the allowance for a couple of nights is equal to one month's pay for many civil servants. Civil servants in grade P4 and above, on the other hand, can improve their income substantially by travelling abroad. These allowances are likely to distort the incentive structure away from public sector efficiency. Instead of working in his or her office, the civil servant prefers to travel, sit in meetings or attend workshops. Moreover, department heads are reported to actively use allowances to make civil servants work more; for instance, overtime work is sometimes paid with travel allowance without any travelling taking place. This implies that rules are broken and it is an example of how low salaries generate a culture where regulations are not enforced.

Since the mid-1980s there have also been several plans of carrying out civil service pay and employment reform, often with support of the World Bank. Some of these initiatives are the Herbecq Commission (1986), the Chatsika Commission (1995), the Functional Reviews of



Ministries (1996-1998), the Job Grading and Salary Restructuring (1997-1999), the Performance Contract Scheme (2000) and Medium Term Pay Policy Reform (2003). None of these has been implemented properly so far; performance contracts for top-level civil servants were introduced in 2000 but without proper performance evaluations, and the Medium Term Pay Policy Reform started in the fiscal year 2004/05 so it cannot be evaluated yet.

It is not easy to disentangle the reasons for the failure to implement the pay reforms. Some of them were ill conceived according to Valentine (2003), but they also worked against the incentives of the ruling elite. The basic reform dilemma is that there are too many employees given the total MCS wage bill, which currently is about 7% of GDP. To raise salaries, there has to be retrenchment. But Malawi does not appear to have too many civil servants when compared to other countries. Moreover, the vast majority of the civil servants work in the educational and health sectors and it is politically almost impossible to cut back on these, particularly when poverty reduction is a policy goal. The main structural problem is instead that there are too many civil servants in well-paid top-positions and too few middle-level professional and technical staff. Moreover, the middle-level staff is significantly worse off than their counterparts in the private sector, while top-level civil servants are quite well-paid; in the beginning of the 1990s incomes of top level civil servants were only slightly below those in the private sector after monetization of allowances, and after the introduction of performance contracts in 2002 they are probably better off (World Bank, 1994, and Valentine 2003). Hence, a change in the pay structure would have had a negative effect on those in top positions, and since they are part of the ruling elite, the reforms have not been implemented.

In this context it is interesting to note that the Performance Contract Scheme (2000) was adopted quickly. The World Bank put forward the idea of performance contracts in an attempt to remedy some of the weaknesses of the pay structure. The objective was to change the incentive structure for those in top positions by offering three year-contracts with very attractive salaries and performance evaluations before contract renewal. This was supposed to provide incentives for Controlling Officers not to overrun their budgets and withstand ministers' desire for overspending. However, the performance evaluations were not in the interest of the majority of those in government and senior public officials, and nobody took on the role as principal. As a result only the contracts were used while the evaluations were carried out perfunctorily since there was no incentive to control expenditures; somewhat less than 600 people were awarded contracts and out of these only two have left and they did it

voluntarily. The salaries of those who managed to get a contract increased dramatically; in 2003 they got 6.8% of the total wage bill while only constituting 0.4% of all civil servants. Compensation of Malawi top-salary earners is at par with Botswana, a country that has 18 times higher GDP than Malawi, and far above those in the region with similar GDP (Valentine, 2003).

An important issue is how the World Bank has viewed pay reform in Malawi. As noted by the World Bank (1990), many of the problems mentioned above were present already in the mid-1980s. Nevertheless, the World Bank pointed out that in 1986 the government reduced anomalies in salary ranges and increased salaries in the higher grades. This was considered as a serious attempt to overcome the problem of insufficient incentives (World Bank, 1990, p.6). In spite of the so-called attempt, there was a wage freeze in 1988/89 and later a retrospective increase from January 1989. The World Bank (1990) expressed some concern with the small increase for top-level civil servants, but the other salaries were considered by and large competitive; a conclusion that seems dubious when considering the sharp decline in real compensation in the mid-1980s (see Figure. 1 in Valentine, 2003). Nevertheless, there was no new pay increase until September 1992, which came after the first civil-service strike since independence. Hence, there is little evidence of a change in pay policy during this period.

A wage and salary review in 1993 showed that when considering both salary and non-monetary benefits, there were small pay differentials between the most senior civil servants and their counterparts in the private sector (World Bank, 1994a). On the other hand, professionals and middle-level managers earned significantly less than those in the private sector, an issue that would be addressed in the five-year Institutional Development Project II (ID II) (World Bank, 1994b). The achievements of ID II are described in World Bank (2002). It is pointed out that tools had been developed that help in diagnosing institutional and incentive problems, which had undermined civil service performance. They would also enable the government to take decisions on incremental reform of civil service systems such as provision of housing allowances and benefits, introduction of performance contracts, or far-reaching wage reform (World Bank, 2002 pp. 8-9). However, there is no mention of any actual changes in the pay structure. Interestingly, one of the major factors affecting the outcome of ID II was high labour turnover due to poor incentives, which made retention of trained personnel difficult (World Bank, 2002, p.15).

The most recent World Bank institutional development project, FIMTAP, does not cover pay reform (World Bank, 2003). However, the World Bank notes that although the government had not carried out a large-scale administrative reform, several improvements had taken place: monetisation of housing allowances, hiring of accounting professionals on contract, outsourcing of some activities and introduction of performance contracts. As evident from Valentine (2003), these changes did not correct the incentive problem in the MSC.

The study that developed the Medium Term Pay Policy Reform was commissioned by the GoM (Valentine, 2003). Its implementation is planned to take several years; the first step was taken during the fiscal year 2004/05. It consisted of a reduction in number of job grades and salary scales, an incorporation of allowances into salaries, a 25% salary increase across the board, and a sharp increase in minimum wages (GoM, 2004b). Unfortunately the start was not very successful and there have already been some strikes and reform reversals. Since allowances became taxable, many civil servants got a significant reduction in after-tax income; possibly too large since civil service income tax increased from 25m Kwacha to 186m Kwacha per month.<sup>6</sup> Moreover, the reduction in the number of job grades have had unpopular consequences; some that had been in too high grades before for income reasons were automatically promoted while others with 20 years of experiences were put in the same grade as newly employed.

Since pay-policy reform has been on the agenda since the mid-1980s without being implemented, it would be a great step forward if the current government implemented it. Pay-policy reform is complicated, but as evident from other countries, such as Tanzania and Uganda, it certainly can be achieved. What matters is political will; other obstacles can be overcome though it may take time.

## **5. The Medium Term Expenditure Framework**

Implementation of a Medium Term Expenditure Framework (MTEF) has become a standard reform to achieve forward budgeting within public finances. The introduction of Poverty Reduction Strategy Papers (PRSPs) has revitalized the reform, since the MTEF constitutes an

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<sup>6</sup> In conversation, Mr Matanda, Deputy Accountant General, Accountant General's Office.

ideal instrument for implementing the PRSP through the government budget. In Malawi, the work of implementing a well-functioning MTEF has been going on ever since the launch of MTEF I in 1995. This far, Malawi's MTEF has failed to deliver.

The basic idea behind the MTEF concept is quite simple and goes back to the core of economics: The MTEF should facilitate the best possible allocation out of limited resources. To deliver this, the framework consists basically of two parts:

- (i) An estimation of the total resource envelope available for the full public sector. There are quite a few methods that can be used to estimate this envelope, but in principle it consists of a macroeconomic model that makes forward predictions of government revenues and expenditures over the time period covered by the MTEF.
- (ii) A mechanism to allocate available resources between government sectors in a way that is most in line with the policy priorities of the country. This procedure by necessity creates intra-sectoral trade-offs. In practice, this resource allocation consists of "bottom-up" reviews that take place within each sector of the public sector, where the line ministries specify their budget requirements. Given the resource envelope, a central authority then decides the inter-sectoral allocations.

Two vital operational characteristics of an MTEF are that it is supposed to work for several years (in Malawi, three years), and that the long-lasting separation between the Recurrent and the Development Budgets is supposed to come to an end.

### **5.1 The History of Malawi's MTEF**

When reading recently published documents about PFM reforms in Malawi, one gets the impression that these started with the change to democracy in 1994. This is not always the case. The World Bank attempted to implement the core component of the MTEF, forward budgeting, already in the 1980s when it was made part of the conditionality of structural adjustment lending (SALII and SALIII). Technical assistance was provided by the World Bank to achieve this (World Bank, 1989).

Yet, there was little progress in the implementation of forward budgeting. As stated by World Bank (1989, p.7): the calculations of three-year resource envelopes did not reflect the actual trends in revenue; the recurrent costs associated with development expenditures were not reflected in the forward budgets; and the forward budgets did not embody criteria that could

be used for prioritisation of expenditures. To remedy these weaknesses, ID I (World Bank, 1989) aimed at speeding up the budget reform, by, among other things, suggesting a re-organisation of the divisions in Ministry of Finance (MoF). However, the project failed because of a lack of continuity and quality of staffing in the MoF (World Bank, 1997).

In spite of the lack of progress in implementing forward budgeting, the World Bank did not doubt its merits. This was made explicit in the World Bank's Staff Appraisal Report on ID II from 1994, which emphasised the need for improved budget planning. It stated "the single most important institutional reform needed is to implement a system of forward budgeting." Further, it was noted that forward budgeting had been stressed in numerous reports over the past 10 years preceding 1994 (World Bank, 1994, p. 11). The report also pointed out the urgent need for linking the Development Budget and the Recurrent Budget.

Subsequently, the MTEF Phase I commenced in 1995. The main components of this reform were reallocation of expenditures to priority activities, the preparation of Activity Based Budgets (ABB), and an integration of the Development and Recurrent Budgets (GoM, 2000). A review of MTEF was carried out in 2000. It found that some reallocation of resources towards priority activities had taken place in the period 1995 to 1999, but this was not due to the MTEF. Further, the integration of the two budgets had not taken place; neither had the substantial off-budget expenditures come to an end (GoM, 2000). Further, some critical "success factors," that are crucial for the successful implementation of the MTEF were identified. In short, these were:

- Active sponsorship by the President and the Cabinet: Low levels of engagement and involvement by the Cabinet characterized the early years of the MTEF. According to Fozzard and Simwaka (2002) this was an unintended result of the bottom-up approach, originally seen as the strength of Malawi's MTEF. However, the consequence was that the focus on the overall resource envelope was downplayed, and it entered the process at too late a stage. Moreover, the executive role of ministers in some line-ministries, where Principal Secretaries are Controlling Officers, distorted the incentives to abide by medium-term budget targets (World Bank, 2001a, p.17)
- Improvements in accountability, transparency and auditing: Without a functioning accountability framework, the other parts of the MTEF are unlikely to be effectively implemented. In particular, there is a potential conflict inherent in imposing an ABB on top of a budgeting and accounting process that is based on inputs and a cash-budget

system. The failure of recognizing that ABB in essence implies a total reconstructing of the budget process made the MTEF a burdensome complement to the existing budget process.

- Strengthening the organisational effectiveness of the MoF, and ensuring close co-ordination across the central agencies: In order to be successful, the MTEF process has to include an authority that discriminates between the projects that come up as results from the “bottom-up” reviews within the line ministries. Without such an authority, the necessary trade-offs are likely to be absent, or at least sub optimal. Also, the integration of the Development and Recurrent Budgets has to be organized by a function that has resources available to make the estimations of the future recurrent costs of today’s investments.
- Bringing donors into the MTEF/budget process: With the aim of an integration of the Development and Recurrent Budgets, it is important that all donor activities are coordinated within the government budget. Still, due to the weaknesses of the government budget, many donor projects were funded off budget. Donors are also important in the sense that donor support that has failed to appear, which has made government revenues hard to predict. This severely reduces the predictability of the yearly resource envelope available for government activities.

Many of the weaknesses of the MTEF identified in (GoM, 2000) appear to still apply four years later. There is currently an MTEF Phase II (GoM, 2003a) in the pipeline but implementation has not begun yet.

Some people interviewed asserted that an MTEF is actually in place in Malawi today, while others claimed the opposite. Although it might be hard to judge whether or not the MTEF plays a role in today’s budget work, it would be an exaggeration to say that Malawi has a well-functioning MTEF. In fact, it seems quite clear that the main elements are either not in place or function well below the required level. To start with, as pointed out by Le Houerou and Taliercio (2002) two preconditions for a MTEF are good macro-economic modelling of the available resources and a solid foundation for budgetary management. Malawi does not fulfil any of those requirements. Furthermore, the MTEF might have hindered the necessary step of within-one-year fiscal discipline by diverting resources; the MTEF is not a proper instrument for correcting the most urgent problem, chronic overspending. Thus, one reason for the delayed implementation of the MTEF might be improper sequencing of reforms. As

stated by the World Bank/IMF joint report on HIPC countries: “While improved capacity in budget formulation may be less difficult to achieve in the short run, it may prove ineffective unless accompanied by reforms in budget execution and reporting, rather than budget formulation” (World Bank/IMF, 2001c). The sequencing problem is also acknowledged in the World Bank’s outline of FIMTAP (World Bank, 2001b, p. 7) where it is argued that an MTEF cannot be implemented without having a working within-year budget process.

Another explanation for the delayed implementation is a lack of capacity and will among the people within the MoF, the Ministry of Economic Planning and Development (MEPD), and the line ministries. Although medium-term programs have been prepared, they have basically been an extrapolation of annual incremental increases. Furthermore, the MTEF contains elements of feedback, in the sense that the forecasts for coming years must be based on actual outcomes previous years. The lack of transparency and, above all, accountability has made this element of the MTEF hard to implement.

## **6. The Public Sector Investment Programme (PSIP)**

A long-standing characteristic of Malawi’s budget process is that Recurrent and Development Budgets are prepared separately. Since the Development Budget contains recurrent expenditures, and public sector investments require both subsequent and recurrent outlays, this can jeopardize the budget process. An additional feature is that that much donor project funding is omitted from the budget, while having future recurrent cost implications.

To address some of these problems, the Public Sector Investment Programme (PSIP) was started in the beginning the 1980s in connection with the introduction of structural adjustment lending. However, the PSIP was discontinued in 1997 under the assumption that it would be replaced by the MTEF (GoM, 2004a, p.vi). As a result, for several years MoF had little information about ongoing investment projects in line ministries and few of them were included in the Development Budget. This damaged the budget process since resources were allocated to line ministries without considering how many of their employees were paid by donor-funded projects, how many vehicles they had access to, and what activities were financed by donors. As a result, there were misallocation of resources and a reduction in transparency. The PSIP, was revived in 2004 to overcome these flaws in the budget process.

Now, the PSIP is viewed as a part of an integrated framework together with the MTEF (GoM 2004a, p.5).

The objective of the PSIP today is to maintain a comprehensive list of all public projects in form of a five-year rolling plan. Line ministries prepare projects while the MEPD screens them. The projects are ranked, based on how well they fit into the government's development strategy explicitly stated in the MPRS and Malawi Economic Growth Strategy. Only those projects that qualify should be included on the list. Further, the PSIP should guarantee a clear connection between the Development and Recurrent Budgets since only those projects and programmes in the PSIP will receive funding. It is also an essential first step in getting the allocation of donor resources to better reflect MPRS priorities and in making the budget a comprehensive statement of public expenditure.

The PSIP was not fully reflected in the 2004/05 Development Budget; many major PSIP projects were missing, while a number of non-PSIP projects were included. The failure to incorporate the PSIP in the Budget is understandable given the fact that the PSIP was being revived after a seven-year gap and that it is still not finalised. However, inadequate communication between MoF and MEPD appears to have contributed to the problem, and successful establishment of the PSIP will only be possible if it is treated as a joint venture between the respective divisions in MEPD and MoF (CABS Review, 2004).

## **7. IFMIS – An Integrated Finance Management Information System**

IFMIS is a computer based information system that enhances effectiveness and transparency of the financial management system. For the GoM, IFMIS should provide timely and accurate financial information and a standardised integrated financial management reporting system for managers within the government, and it should provide the Accountant General with a GoM-wide upgraded computerised accounting system, and lead to significant improvement in financial control (World Bank, 2003, p.19). Hence, a well-functioning IFMIS would be a cornerstone of PFM in Malawi. An indication of the importance of IFMIS is that the rollout in at least four ministries is one of the HIPC floating completion point conditions.



IMFIS consists of a common database and several sub-systems that vary between users.<sup>7</sup> The core sub-systems are accounting, budgeting, cash management, debt management and related core treasury systems. Some countries include other sub-systems such as revenue collection, procurement management, asset management, human resource and payroll systems, and pension and social security system. There are plans to use most of these sub-systems in Malawi but they need to be adapted to the local environment, and in some cases interfaces with exiting IT systems have to be created.

The idea of computerisation is very appealing when considering the complexity of financial resource management in a country, and the problem of corruption. IFMIS reduces the workload of civil servants, makes bank reconciliation automatic, and provides for a number of ways of detecting excessive payments, fraud and theft. Thus, since the end of the 1980s, the World Bank has funded IFMIS projects in at least 27 countries around the world at a cost of about US\$ 1.1 billion. Implementing and maintaining IFMIS is, however, not a simple task since it involves the MoF, the MEPD and all line ministries. According to World Bank's own evaluations, over 60% of its IFMIS projects have not worked well.

In Malawi, the World Bank initiated the implementation of IFMIS by providing support for it under its ID II project (1994-1999). After 1999, various donors provided support and technical advice, and in 2003 IFMIS was included in the World Bank project FIMTAP (World Bank, 2003b). External financing for IFMIS is essential since it is a very costly project: a rough estimate of the expected cost is 1.3 billion Kwacha, or slightly less than 1% of GDP.<sup>8</sup>

The complexity of the task of implementing and running IFMIS can be illustrated by looking at hardware requirements. For Malawi this includes 50 servers: one central IFMIS server, a local IFMIS server in each ministry with several PCs connected via a separate Local Area Network, and a local IFMIS server connection to the Government Wide Area Network (GWAN). Moreover, since power shortages are common in Malawi, uninterruptible power supply units and generators are needed. In addition, there are considerable human resource

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<sup>7</sup> This and the following paragraph draw on the review of IFMIS by Dorotinsky (2003).

<sup>8</sup> This calculation is based on the average cost for the World Bank of implementing IFMIS in 15 countries. The data are from Dorotinsky (2003).

requirements because of capacity building across the entire government. There has to be a programme for training of trainers and end users, a unit with a full-time IFMIS manager, five full-time accountants and IT specialists, and internal and external audit staff with IT expertise. And since IFMIS will substantially alter the work of many people, a change management process needs to be addressed. Other requirements are described in GoM (2003a) and World Bank (2003a).

Although the IFMIS project started in 1995, implementation problems delayed the start of the pilot phase to 2000. It was finished by 2003, and considered successful. The rollout of IFMIS started in Ministry of Health and Population but the World Bank soon discovered serious flaws in the computer programme. For instance, it was possible to issue the same check 15 times, indicating that somebody had tinkered with the system. Moreover, some parts were missing such as the Budget module.<sup>9</sup> Hence, almost ten years after the start of the project, IFMIS was still not running.

With hindsight it is easy to understand why implementation has been so slow. When IFMIS is working well, it effectively removes the discretionary power from the Controlling Officers to re-allocate resources and overspend, and it makes it easy to detect many types of corruption. Hence, since such a system runs against the interest of political principals and senior bureaucrats, it has not received much support. The study by Rakner et al. (2004) provides evidence in line with this conclusion. They argue that individual incentives within the executive branch undermine the formal processes and institutions at each stage of the budget process, which includes PFM reforms. A similar argument is put forward by a review on Malawi for NEPAD's African Peer Review (MEPD, 2004). Moreover, when describing Malawi's budget reform experience, the World Bank, (2001a, p.17) argues that there was weak political commitment to the objectives of budgetary reform and that in certain line ministries the managerial power of ministers distorted incentives to follow sound financial management. The World Bank Country Financial Accountability Assessment (2003) does not take such a strong stand but its evaluation of the weaknesses of the eight-year long IFMIS implementation process clearly indicates that the government was not particularly keen on seeing a well-functioning IFMIS.

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<sup>9</sup> In conversation with D. Mphande, Senior Public Financial Management Expert, the World Bank.

Although the World Bank is aware of the role of preferences and incentives for successful implementation of complex reforms such as IFMIS, it does not seem to have put sufficient weight on this when taking decisions on IFMIS (see World Bank, 2001a). In the Staff Appraisal Report for ID II from 1994 there is no mention of political will, and the political risk is assumed to be small because of the apolitical character of the project (World Bank 1994b, pp.34-35). In 1996, the World Bank (1996, p.3) claimed that the GoM had firmly demonstrated its commitment to policy reform, but this probably only involved the Minister of Finance (Botchwey et al., 1998); the President showed no interest in public sector reform.<sup>10</sup> In 2001, as a result of the slow progress of the implementation of IFMIS and other reforms, the World Bank (2001b) pointed out that commitment and political will are key to institutional reform. Furthermore, it again claimed that there was significant high-level support for IFMIS; a surprising statement since there had not been a change of government and Malawi's track record was clearly bad (see GoM, 2000 and World Bank, 2001a). The belief in the government is once again made explicit in January 2004 when the World Bank expressed concern about the risk that after the general elections in May 2004 the new government would be less committed to reform than the sitting one, a strange statement considering how little political will it had actually shown during the previous ten years (World Bank, 2004, p.25). Hence, the World Bank does not even seem to have tried to act as a principal even though its own evaluations of the reforms indicated that it should have taken a tougher stance.

Apart from the absence of adequate preferences and incentive structures in the government and technical difficulties, the IFMIS project has at least two other major weaknesses. First there is a lack of staff with IT knowledge, and training or hiring cannot easily remedy this. The current salary structure and terms of employment in the MCS are not attractive and flexible enough to keep staff at the technical and professional level when there are employment opportunities in the private sector. This has affected the IFMIS project and according to the Deputy Director of the Accountant General's Department, who is heading IFMIS, all of those who had been trained to run IFMIS had left by November 2004.

Second, IFMIS is implemented in an environment where there is a lack of fiscal discipline. As emphasised by Dorotinsky (2003), IFMIS only works well if the database is updated timely

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<sup>10</sup> In conversation with P. Lungu, Office of the President and Cabinet.

and correctly, but there is no reason to believe that will be the case in Malawi with the current incentive structure. To take an example, monthly expenditure returns from line ministries are often late and/or unreliable, so why expect data entrance into IFMIS to be any better? Another example is the Personnel, Payroll and Pensions Advance Integrated (PPPAI) project that was initiated in 1998/99 to computerise Personnel and Payroll systems. Although widely used, there have been serious problems because information on civil service attrition and new hiring had not been updated on a timely basis (Valentine, 2003). Furthermore, according to World Bank (2003) PPPAI had not eliminated the problem with ghost workers and there were opportunities for double payments and other deficiencies.

In spite of all the difficulties encountered in Malawi and other countries, the World Bank is determined to implement IFMIS. Funding is provided by FIMTAP, and a FIMTAP office situated in the Office of the President and Cabinet is handling the process. Computers have been purchased and a consultant, hired to review the current version of IFMIS, presented his report at a meeting early November 2004. The World Bank is now confident IFMIS will be running before the end of 2005.<sup>11</sup>

## **8. Malawi Poverty Reduction Strategy and Pro-Poor Expenditures**

Although the Malawi Poverty Reduction Strategy (MPRS) and Pro-Poor Expenditures (PPEs) are not really PFM reforms, they are implemented through the budget and have implications for the budget process. There are also forces going in the the opposite direction; the budget process influences the implementation of the MPRS and PPEs.

The overall goal of the MPRS is to achieve “sustainable poverty reduction through socio-economic and political empowerment of the poor.” To achieve this, a strategy has been built around four pillars: sustainable pro-poor growth, human capital development, improving the quality of life of the most vulnerable, and good governance. In addition there are some cross cutting issues. There is a wide range of targets listed in the MPRS paper for the period 2002-2005. Some notable key targets are a reduction of the incidence of poverty from 65% of the population in 2002 to 59% in 2005, a reduction of the extreme poverty headcount from 28.8%

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<sup>11</sup> In conversation, Mr D. Mphande, Senior Public Finance Management Expert, the World Bank.

to 20%, and an increase in life expectancy from 39 to 43 years. Other core targets include improvements in literacy rate, and in infant and mortality rates (see GoM, 2002).

One of the weaknesses of the MPRS is that even when the budget outturn is close to the approved budget, which is unusual, we can only get a very crude estimate of expenditures on MPRS activities. To explain this, we can divide the budget into four components, Statutory and Statehood Expenditures, Development Budget, Other Recurrent Transactions (ORT), and Personal Emoluments. Statutory and Statehood expenditures are not part of MPRS expenditures so they can be ignored. The Development Budget, which in principle should only be public investment, can easily be based on the MPRS. However, until recently there was no coordination of GoMs investment projects and no screening took place to make sure they were in line with the MPRS. This has improved recently with the revival of the PSIP, as described in Section 6. As a result, there was a significant improvement for the fiscal year 2004/05, though there is still more work to be done before the Development Budget is primarily based on the MPRS. One factor that thwarts such a development is the habit of donors to sidestep the MoF and deal directly with line ministries or agencies.

Currently it is not possible to accurately track voted recurrent expenditures, ORT and personal emoluments, to activities listed in the MPRS. The reason is that spending is classified as being part of a programme, sub-programme and as a line item. The line items specify costs for inputs, such as fuel, used by a line ministry but they do not include information for what purpose the inputs are used. The line items are linked to the programmes and sub-programmes but these are not related to the activities in the MPRS.

In the HIPC review (World Bank, 2004a) there is an attempt to evaluate whether budget allocations were in line with the MPRS during the fiscal year 2002/2003. This could be done because each ministry was instructed to use the MPRS as a guiding framework and link each of its planned activities to a MPRS activity. Only information of the planned use of ORT could be obtained: there was no information about Personal Emoluments or the Development Budget. Nevertheless, in this way estimates of the ORT shares allocated to MPRS activities could be measured. The exercise showed the shares were broadly in line with the MPRS for ORT. However, there are two weaknesses of this analysis that merit mentioning. First, it is well known that the budget outturn differs widely from approved estimates of expenditures so we do not know to what extent actual expenditures were based on MPRS. Secondly, the

results may not be due to policy since there is no clear connection between policy decisions and budget implementation. To properly link the Budget to the MPRS, output-based budgeting is required, that is, it should be based on activities. Furthermore, Scek (2004) notes the need to link the priorities in the MPRS with the spending priorities in line ministries. Since the MPRS paper does not contain any details about spending priorities within the line ministries, this is not possible. Moreover, there are administrative and communication problems because the MPRS is handled by the MEPD, while the Budget Department in the MoF prepare the budget.

One explanation for the positive results of the HIPC review is the PPEs. The concept of PPEs comes from Enhanced HIPC conditionality where the savings from servicing foreign debt should be used for poverty reduction. The PPEs can be seen as a component of MPRS but they differ by being identified as the use of HIPC resources for drugs, nursery training, teaching materials etc., while there are no specific targets. It is easier to implement the PPEs than MPRS activities, but there is, nevertheless, a great deal of uncertainty about how the money actually is used. Since the HIPC decision point in 2000, GoM has allocated resources to PPEs as specified by the HIPC conditionality, in spite the general lack of budget discipline. This has led to redirection of resources towards MPRS activities.

The implementation of MPRS is followed up by Annual Reviews. A review that covered the first half of the 2002/03 fiscal year was released in April 2003. It was criticised by other stakeholders as not being participatory and did not include vital information, which was readily available in other ministries. The Final Report of the 2002/03 Annual Review was completed during 2004, and this time the team included officials from the government, civil society and the private sector. Nevertheless, the report was not available at the time of writing this report.

According to the MPRS, 102 indicators should be monitored. These are divided up into four groups, input, i.e., government expenditures, outputs, such as pupil-teacher ratios, outcome, for example, examination pass rates, and impact, that is changes in welfare. Not surprisingly, data collection has constituted a serious challenge for the reviews. This is especially true for impact indicators, which can only be obtained from surveys such as the Demographic and Health Survey and the Integrated Household Survey and Poverty Analysis.

The 2004/05 Budget draws on the Staff Monitored Programme (SMP) and there is little scope for allocating resources according to the MPRS because of the large interest bill and the need to reduce domestic debt. The difficulty of forming a budget in line with the MPRS can be appreciated by taking into consideration that during the fiscal year 2003/04 non-discretionary expenditure was estimated to be almost 70% of total domestic expenditures, out of which the interest bill contributed with 28.4 percentage points (see Whitworth, 2004).

To conclude, although the MRSP was designed carefully, there have been problems translating its priorities into the budget. The main reason is that the activities listed and their costing in the MPRS are not clearly linked to budget programmes, making it difficult to allocate resources accurately. Another reason is that the MPRS does not distinguish between the Recurrent and the Development Budgets, and the latter is only partially covered in the budget. These problems were noted by the IMF and World Bank (2002) evaluation of the MPRS, but it emphasised that GoMs programme classification of the budget and its long experience in developing medium-term estimates would make the next step unproblematic, i.e., linking activities to sub-programmes. However, this has not turned out to be the case.

## **9. Watchdogs: The Auditor General and Anti-Corruption Bureau**

In this section we describe two institutions that have a core role in economic governance: the Auditor General (AG) and the Anti-Corruption Bureau (ACB). The objective of the AG and ACB is to make agents accountable for their actions. To achieve this, the AG is dependent on a well-functioning Public Accounts Committee, while the ACB cooperates with the Director of Public Prosecution.

### **9.1 The Auditor General**

The Auditor General (AG) has a crucial role in evaluating the use of public expenditures and in implementing accountability. In Malawi, the National Audit Office is an independent institution and AG reports directly to Parliament. It should audit all the Malawian institutions relying on taxpayers' money, including the parastatals.

Until 2003, when the Public Audit Act was passed, the 1994 Constitution and the Finance and Audit Act from 1962 provided the legal basis for the AG. Although formally independent from the executive, the AG's Office was located in the MoF building and AG's Annual

Reports were handed over to the Minister of Finance, who was responsible for passing them on to the Public Accounts Committee. Since the AG audited the MoF, this was not a good system. Moreover, the AG was financed through the budget as any other activity, making it possible for the executive to undermine its oversight role by under-funding.

After the introduction of a multiparty system the independence of the AG was strengthened by a symbolic move of the office out of the MoF building to a new building in Lilongwe. Nonetheless, as during the one-party regime, the AG's Annual Reports continued to be seriously delayed and largely ignored. The delays were partly due to resource shortage but also to the Accountant General who was very slow in preparing the yearly financial statements that the AG audits.

One way of evaluating whether the change to democracy and the adoption of a new constitution led to an increased emphasis on PFM governance, is to analyse the budget allocation to AG's Office. In Table 2 we report the actual allocations for a period before 1994, and two periods after 1994. When measured as a share of GDP, resource allocation to the National Audit Office did not increase after the shift to democracy so there is no indication of a policy change.

**Table 2: Total Recurrent Allocation to Auditor General's Office**

Period	Average share of GDP %
1988/89- 1992/93	0.033
1996/97 - 1998/99	0.026
2001/02- 2003/04	0.032

Note: The GDP data are for fiscal years as reported by the IMF. Source: various Budget Documents.

The Public Audit Act in combination with the Public Finance Management Act, also passed in 2003, should help to speed up the auditing. According to the Finance Management Act, the Accountant General should prepare the financial statements for the fiscal year ending in June not later than October 31<sup>st</sup>. The AG shall then examine these and provide a written report attached to the financial statements to the National Assembly expressing his opinion by December 31<sup>st</sup>. The financial statements, together with the report of the AG, are then passed on to the Public Accounts Committee. The new acts seem to have had an impact since the Accountant General sent the financial statements for the fiscal year 2003/04 to AG in the



beginning of November 2004, so there is a chance that he can express his opinion before the end of 2004. This would be very fast by regional standards where 12 months is acceptable. It is noteworthy that the acts presume that IFMIS is implemented, which it is not, and the Malawi Financial Accountability Action Plan (GoM, 2003a) has a target where the audited record is presented to the legislature within twelve months of the end of the fiscal year.

In recent years the AG has had some success in clearing its backlog: As far as previous accounts are concerned, the financial statements for 2000/01 have been audited and the Parliament Public Account Committee hopes to finalise its work by the end of 2004. In addition, AG has expressed his opinion on the financial statements for 2001/02 and 2002/03. These are printed and will be submitted to Parliament at its next sitting, which is in 2005.

The general impression is that AG's reports are detailed and disclose critical remarks to ministries and government institutions. But when the Annual Reports are ready several years after the ending of the fiscal year, as in the past, it is very difficult to hold Controlling Officers responsible for mismanagement. Hence, getting rid of the backlog and producing timely reports is essential for AG. However, his effectiveness in enforcing accountability has also been frustrated by the absence of disciplinary actions, follow-up investigations and prosecutions. It is telling that even the Secretary to the Office of the President and the Cabinet, the highest civil servant in Malawi, does not bother to respond to AG's enquires about the reasons for excess expenditure (GoM, 2003b). It would thus be a very strong signal of policy change if Controlling Officers started to respond adequately to AGs enquires, and if they were held responsible for their acts under the new government.

The Public Audit Act strengthens the independence of the AG in so far as his funding should be determined by Parliament, and not go through the normal budget process. Moreover, the AG should receive sufficient funding to carry out its tasks: there should be no within-year erratic funding or less funding than what is budgeted, which has been normal in the past. The new legislation also provides for independent staffing and compensation. At the time of writing the AG had submitted a proposal to Parliament with a description of new salary scales, etc, but it had not been approved yet. Hence, the AG still suffers from a shortage of staff, in particular trained auditors: in November 2004 there were 210 vacant posts in the National Audit Office out of a total of 320 posts. AG plans to fill 70 of these but it is difficult

since he has to follow standard MCS procedures, which takes over 6 months, and pay very low salaries.

## **9.2 The Anti-Corruption Bureau**

In 1994 a new constitution was written which expressed a firm commitment to good governance. As a result, institutions such as the Ombudsman, Electoral Commission, Compensation Tribunal, and the Anti-Corruption Bureau (ACB) were formed. Out of these the ACB is the most relevant for PFM.

In 1995, the Corrupt Practice Act was passed in Parliament, providing the legal basis for the establishment of the ACB: earlier there had been a penal code for corruption offences but they were considered a misdemeanour. The Director and Deputy Director of the ACB were appointed by the President early in 1997 and operations started in March 1998. The mandates of the ACB were to investigate and prosecute offences of corruption, to educate civil society to empower them to stop corruption, to prevent corruption and to examine private and public institutions. The Director of ACB reports annually to Parliament and the Public Accounts Committee can summon the ACB.

The ACB quickly gained a reputation of being efficient. Within a couple of years there were 22 cases before court with over 100 people accused, out of which two were ministers. Its activities also contributed to the dismissal of four ministers and several senior civil servants. This efficiency was due to several factors. First, according to a former adviser to the ACB, Mr Paul Russell, the ACB had had continuous support from the President but without any interference. Second, the institution was set up from scratch so the staff could be handpicked. Third, there were competent leadership, including expatriate expertise. And finally, the incentive structure for the employees in the organisation promoted hard work and accountability. All employees are on three-year contracts and they earn several times as much as comparable civil servants in other institutions. Monitoring and evaluation of performance is done formally every year and this information is then used to determine salary increases. When contracts expire after three years, they can be renewed or not.

Yet, the popularity of the ACB did not last and soon there were aggressive media attacks for lack of action. In 2000, the World Bank (2000) believed that limited capacity in the courts had slowed the progress. However, as time passed without the ACB succeeding to get any high-

level conviction, the President's support came into question. One obstacle was the Director of Public Prosecution (DPP) who without a good explanations refused consent to prosecute high level cases on several occasions. Moreover, the Director of the ACB appears to have given in to pressure from the President.<sup>12</sup>

After the change of government in May 2004, new Directors with support from President to fight corruption aggressively replaced the old ones. This resulted in ACB's first high-level conviction in August 2004. There seems to be no doubt about the determinedness of the ACB or the new DPP; media is full of stories about their activities. However, both the ACB and DPP suffer from under-funding, in particular the DPP, and this is inconsistent with the government's anti-corruption policy. There is also a need for caution about over-optimism. It is possible that the new President's anti-corruption drive is part of a power struggle within the UDF, and that it will peter out as his opponents are neutralised.

## **10. Summary and Concluding Remarks**

Malawi has a long history of public finance management reform. It started already in the beginning of the 1980s and since then a large number of activities have been suggested, initiated and implemented. The reform process still continues and as clearly illustrated by the Malawi Financial Accountability and Action Plan (GoM, 2003a) there are many ongoing reforms and new ones in the pipeline.

After 20 years of reform, Malawi has a good legal and institutional framework for public sector financial management (World Bank, 2003a). There is a Cash Budget System in place, new acts that regulate public finance management, make the Auditor General independent, and provide for a well-functioning public procurement, and there are new regulations for internal auditing. Moreover, there are parliamentary committees for the Budget and the Public Accounts, an anti-corruption bureau, and much more. In spite of this, IMF (2004a) characterises the budget process as extremely weak. Overspending has occurred during almost all fiscal years since 1980, and significant with-in year reallocations of expenditures between the votes have been common, particularly during the last 10 years. The Cash Budget System, introduced in 1996, does not work well and irregular cash releases encourage the build up of

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<sup>12</sup> In conversation with current Director of the ACB, Gustave Kaliwo.

arrears even though this is not allowed. As a result, the public finance management regulations are circumvented and there are opportunities for inappropriate diversion of resources (IMF, 2004c). Moreover, even if regulations were enforced, limitations in the budget process make it difficult to implement the poverty-reduction policy outlined in the MPRS. This is because there is no proper mechanism ensuring that allocations of recurrent expenditures go to prioritised activities.

A number of policy documents argue that several of the weaknesses of the budget process would be remedied by the implementation of two major reforms, MTEF and IFMIS (see GoM, 2000, GoM, 2003, World Bank, 2003a). The work to switch to forward budgeting and prioritisation of activities, which is the essence of an MTEF, began in early 1980s, but in 2004 there was de facto no functioning medium-term framework.<sup>13</sup> And the IFMIS projects, initiated in 1996, is far from completed. An interesting question is why implementation of these reforms has been so slow.

One point of view is that the purpose of PFM reforms is to increase the efficiency of the budget process, which should lead to improved public sector service delivery, poverty reduction, and higher economic growth. This should be in the interest of the Malawi authorities that ought to do what they can to carry out the reforms. If this is the case, the explanation for the slow progress is either capacity constraints or that the reforms are too complicated. However, since several years have passed since the start of the reforms, capacity should not be the problem, and since other developing countries use both MTEF and IFMIS, there has to be other explanations.

Another reason is absence of political will and ownership. Although GoM supported the reforms verbally, and some measures were taken to enhance the credibility of this support, there are many indications of a lack of political will. Both the MTEF and IFMIS reduce the discretionary power of public officials and senior civil servants to re-allocate resources and overspend, which is against their interests. This conclusion is in line with the findings of Rakner et al. (2004) who argue that perverse incentives in the executive branch of the government undermine each stage of the budget process. The pre-study for NEPAD's African Peer Review (MEPD, 2004) presents arguments in the same spirit, and the detailed

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<sup>13</sup> According to IMF (2004c) Malawi has a largely perfunctory medium-term framework.

description of reforms in World Bank (2001a) seems to reach the same conclusion though it is not as straightforward as Rakner et al. (2004). Another piece of evidence in favour of this argument is that reforms that generate resources have been implemented: the reform of the tax system has been very successful, including the creation of the Malawi Revenue Authority, and government revenue has grown rapidly during the last five years.

Yet another indication of the lack of political will is provided by Auditor General's Annual Reports on the Public Accounts. There are reports of over-expenditures for a number of ministries and agencies. However, enquires by the Auditor General are largely ignored by Controlling Officers. Among the Controlling Officers we find the Secretary to the President and the Cabinet, that is, the head of Malawi Civil Service, and the Secretary to the Treasury. When they ignore the Auditor General year after year, other Controlling Officers can do the same without any risk. Moreover, with such a system it is obvious that the President, and, most likely the Minister of Finance, are not committed to fiscal discipline.

In many countries the president is the by far most important person when it comes to monitoring and accountability; he or she has to take on the role as principal for there to be successful reforms. This seems to be the case in Malawi as well. During the two terms, 1994-1999 and 1999-2004, the President did not act as a principal for the reform programmes, and there was no other actor who could hold him accountable for this. Voters, civil society, Parliament, donors, and watchdogs, such as the ACB, are weak relative to the sitting President and his Cabinet, and only in very clear-cut cases do they seem to have some clout, such as when the President attempted to change the constitution to let him run for a third term.

There is also some truth in the lack-of-capacity explanation but it best understood in connection with the incentive structure of civil servants. There are a number of reports about the difficulty of the public sector to attract, motivate and retain competent staff.<sup>14</sup> The problem is there are many explicit and implicit contracts between the government and its employees that do not provide an incentive structure that promotes efficiency. In such cases there has to be effective monitoring and evaluation, and people have to be held accountable for their actions, but that is unusual. Hence, public sector efficiency is low and this affects

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<sup>14</sup> Malawi Country Assistance Evaluation (World Bank, 2000) emphasises the staffing problem in the public sector.

reform processes negatively. Moreover, capacity building is very difficult in such an environment. Because of low salaries, civil servants either show no interest in training or they leave for the private sector after having completed it. The main reason for the lack of qualified staff is not shortages in Malawi but inadequate salary structure and career possibilities in the civil service.

Since the incentive regime in the Malawi Civil Service has been defective for many years, the question is why it has not been reformed. The reason is that pay and employment reform has not been in the interest of the government or senior civil servants. It is most likely that at least top civil servants would have suffered from income losses of such a reform (see Valentine, 2003, Section 4, and World Bank, 1994b). Considering this, it will be interesting to follow the implementation of the Medium Term Pay Policy Reform, which started during the fiscal year 2004/05. Proper implementation will constitute a strong indication of the government's commitment to public sector reform.

Yet another explanation for slow implementation of reforms is that sequencing has not been adequate. There are many examples of this. Most importantly, a reform of the pay structure is needed before reforms that require a lot of capacity building can be implemented. Moreover, it is necessary to get the basics right before embarking on complicated reforms. For instance, there is no point in doing three-year budgets when the approved Annual Budgets bear little relation to the outturns. And what is the point in preparing future budgets when the resource envelope cannot be predicted with any accuracy because of volatile inflows of foreign aid? Furthermore, to implement the Malawi Poverty Reduction Strategy properly there has to be a strong link between planned expenditures and the expected outputs but the Cash Budget System prevents this because of irregular monthly cash releases.

The donors also have a role to play in the reform processes. Apart from being un-coordinated and initiating many reforms, which are well-known problems, they also tend to be too optimistic about the commitment and political will of the government and underestimate limitations in capacity building. Although we have not systematically analysed donor documents to substantiate this claim, our reading of World Bank reports on projects in Malawi indicate that this is a problem. As a result, donors have advocated reforms aimed at improving the technical aspects of the budget system, while to a large extent ignoring that the incentive structure was major the problem. The Malawi Country Financial Accountability

Assessment (World Bank, 2003a, p. 7) illustrates the problem clearly when noting that the cash budget so far had failed to create a shift in attitudes to maintain hard budget constraints. This is of course not surprising.

A new government got into power in May 2004 and it has made an impressive start. The new President appears committed to fiscal discipline and tackling corruption, and there have been some concrete actions. Moreover, there is a great deal of anecdotal evidence of an actual change in public finance management, as well as a positive IMF-evaluation of the budget data available in September 2004. However, it remains to be seen whether this is sustainable or not; Malawi has a long track record of behaving well in order to attract foreign aid and then reverting back into old behaviour of fiscal indiscipline (see IMF, 2001a).

## Appendix: List of people interviewed\*

Name	Post	Organization
Mr R.A. Kampanje	Accountant General	Ministry of Finance
Mr P.C. Matanda	Deputy Accountant General	Ministry of Finance
Ms D. Banda	Director	Ministry of Finance
Mr S. Simwaka	Deputy Director	Ministry of Finance
Mr Z. Soko	Director	Ministry of Finance
Ms F. M'Bawa	Director	Ministry of Economic Planning and Development
Mr B. Botolo	Director	Ministry of Economic Planning and Development
Mr B. Mtonya	Director	Ministry of Economic Planning and Development
Mr P. Lungo	Change Management Advisor	Office of the President and Cabinet
Mr H.Kalongonda	Auditor General	National Audit Office
Mr S. Gomani	Deputy Auditor General	National Audit Office
Mr I. Wadi	Director	Public Prosecutions
Mr G. Kaliwo	Director	Anti Corruption Bureau
Mr Mzoma	Deputy Director	Public Procurement
Hon. T. Kalebe, MP	Chair:	Budget and Finance Committee
Hon. A. Banda, MP	Deputy Chair	Public Accounts Committee
Mr A. Whitworth	Economic Adviser	DFID
Ms L. Mangham	Economist	DFID
Mr J. Pons	Head, Economics and Public Affairs	European Union
Mr A. Scek	Technical Adviser	GTZ
Ms T. Hoven	1:st Secretary, Economist	NORAD
Ms C. Roehler	Economist, Fiscal Affairs Department	IMF
Mr D. Mphande	Senior Financial Management Specialist	World Bank

\* The list includes people met with during the CABS Review, 4-8 October, and interviews conducted 1-10 November 2004.



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