

Chapter 3 - Institutional Analysis

Ministry of Finance and Economic Planning

A. PUBLIC EXPENDITURE MANAGEMENT: THE BUDGET PROCESS

1. The central tool for the management of public expenditure is the budget process. The design of this process, and in particular, the institutional framework that supports it, is crucial for good public expenditure management. Before examining the benefits, problems and possible solutions to the existing process, this chapter will clarify the definitions of key terms and establish the links between the institutional framework of the budget process and the country's overall aim of poverty reduction.

2. At the outset it is essential to clearly distinguish between three terms that are commonly confused: the **budget process**, the **Budget** and the **Medium Term Expenditure Framework (MTEF)**. The **budget process** refers to the whole public expenditure management cycle, including Budget preparation, presentation, implementation, monitoring of actual expenditure and a review of the process feeding back into Budget preparation (see Figure 3.1). As such, the **Budget** is only a small part of the **budget process**. The **MTEF** is a specific way of conducting the budget process, which involves a rolling three-year programming process based on costed strategic priorities, and an output focussed approach with the objective of developing an integrated realistic budgetary framework. As such, the MTEF and the budget process should not be seen as separate and parallel but rather “the distinction...should disappear” (OPM 1999).

3. Good management of public expenditure impacts on the overall aim of poverty reduction through three main channels. Firstly, by contributing to aggregate fiscal discipline good management improves macroeconomic stability and performance; and reduces inflation and boosts growth, which are both essential for sustainable poverty reduction. Secondly, improved strategic prioritisation boosts the quality of public expenditure by ensuring that scarce financial resources are targeted at activities within social sectors that are most effective at reducing poverty. Thirdly, improved operational performance boosts efficiency, ensuring that government maximises the benefits from those scarce financial resources.

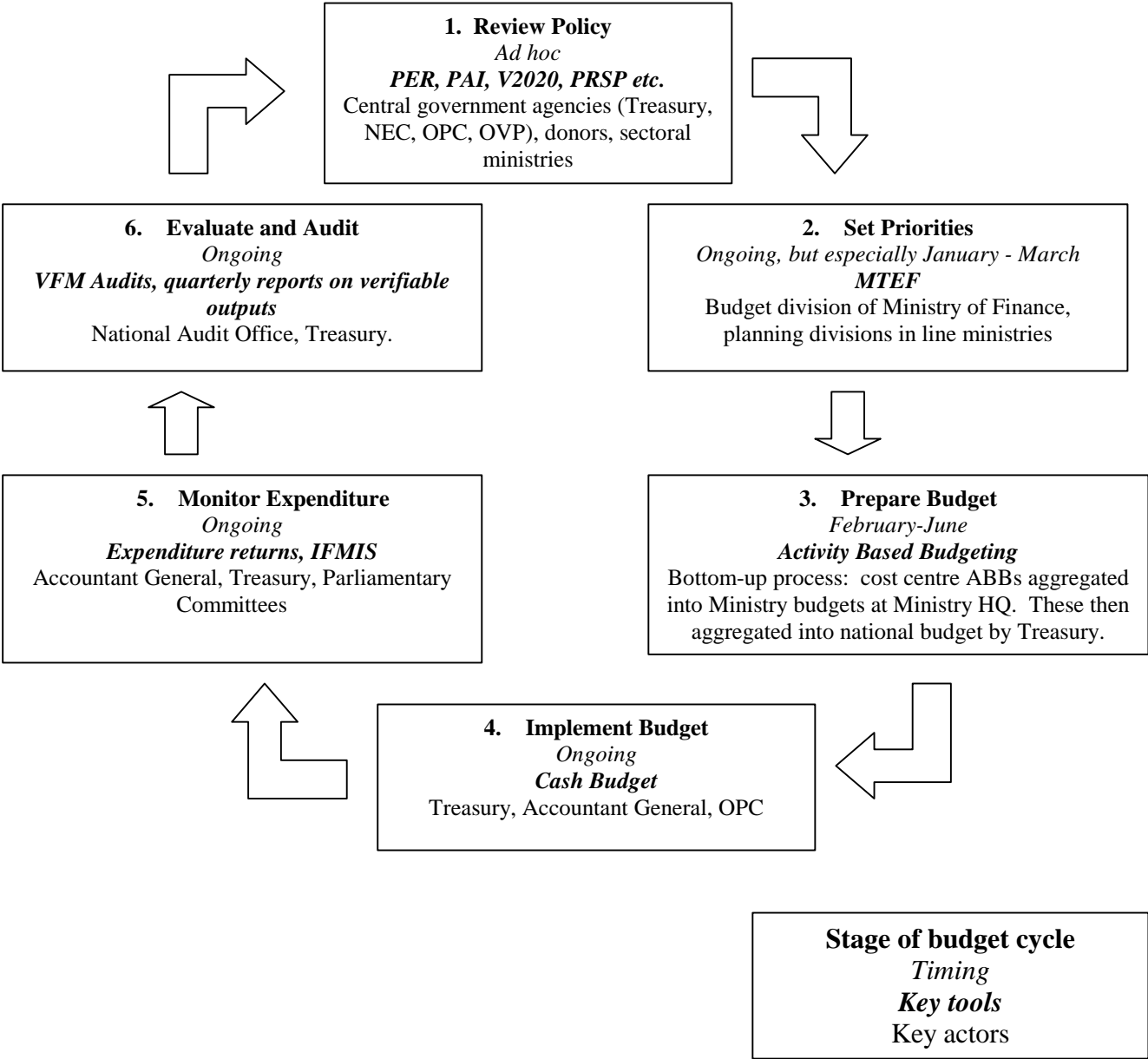
4. Despite the achievements of recent innovations in public expenditure management, the Malawian budget process is still flawed. The most fundamental symptom of the failings of the budget process is the lack of credibility of the budget, as reflected in persistent of large discrepancies between budgeted and actual expenditures as discussed in Chapter 2. This is a reflection of both poorly prepared and unrealistic budgets and insufficient monitoring mechanisms. Budget preparation (stages 1-3) and Budget implementation and monitoring (stages 4-6) are interdependent. No budget, no matter how well prepared will be properly implemented unless there are adequate incentives embodied in a monitoring mechanism. Similarly, no implementation and monitoring system will be able to force the implementation of a badly prepared and unrealistic budget.

5. A central failing of the budget process is therefore a lack of integration of the various components. To a large extent the six stages of the budget process outlined in Figure 3.1 below are subject to different institutional arrangements rather than being part of a co-ordinated whole. In particular, the MTEF has not been fully integrated into the budget process. **To a large extent the budget process is still dominated by the preparation of the Budget, which remains an incremental inventory of inputs prepared by budget sections**

in line ministries. The MTEF is seen as a separate system of unimplemented prioritisation exercises prepared for the Ministry of Finance by the planning sections of line ministries.

6. This chapter aims to evaluate the current institutional arrangements and the impact of recent reforms. Where problems remain, possible solutions are suggested. The first sections examine overall co-ordination and capacity issues that are central to the successful management of public expenditure. The following sections examine the institutional framework for each of the six stages of the budget process. After this, there is a brief summary of the MTEF Review. The Implementation Plan that is the central output of the MTEF Review should form the way forward on many of the issues discussed in this chapter. The last sections of this chapter focus on other institutional reforms that will have a significant impact on public expenditure management, in particular, decentralisation, civil service reform and Sector Wide Approaches (SWAs).

Figure 3.1 – The budget process¹



¹ Taken from the Public Expenditure Management Handbook 1998

B. CO-ORDINATION ISSUES

7. **A central reason behind many of the problems of the budget process is a lack of co-ordination at all levels.** Firstly, the lack of a clear relationship between the Ministry of Finance and the National Economic Council creates a lack of co-ordination between planning and implementation at the macro level. The recent creation of the Ministry of Finance and Economic Planning has gone some way to resolving these problems, as the planning and macroeconomic roles of the National Economic Council are to shift to the Ministry of Finance and Economic Planning. However, the exact role of the National Economic Council and the timing of the transition remain unclear.

8. A second set of co-ordination problems exists within the Ministry of Finance, in particular, in defining the relative roles of the Economic Affairs, Budget, and Debt and Aid Management Divisions. Currently there is some duplication of effort and more importantly, several functions that are not performed. For example, economic and sectoral analysis of aid flows is often not done as it is unclear whether the DAD or Economic Affairs Division is responsible. In order to resolve these problems, it is crucial that the roles of the different sections are clearly defined and managed effectively. In addition, it is urged that all three sections be fully involved in the budget process. For example, Debt and Aid Management should actively participate in budget preparation and implementation so that projection of foreign inflows is accurate and where they are changed they should advise the budget section immediately. Similarly, Economic Affairs should work closely with all sections so that fiscal targets are achieved.

9. The third level of co-ordination problems occurs between the Ministry of Finance and the line ministries. A frequent complaint from those in the line ministries is that the Budget Division of the Ministry of Finance does not give adequate and timely guidance or incentives. For example, in recent years the Ministry of Finance has been persistently late in providing sectoral ceilings for the Budget. In addition, the lack of communication between the Ministry of Finance and the line ministries has encouraged the perception that the MTEF and other institutional reforms are “owned” by the Ministry of Finance. **In order to fully implement an MTEF based budget, effective leadership from the centre of Government is needed. In this sense, effective does not necessarily mean strong. Equally important is the participation (and therefore ownership) of the line ministries.**

10. Co-ordination between the Ministry of Finance and the line ministries depends to a large extent on the desk officers who form the day-to-day link between the ministries. There have been recent attempts to build the capacity of the desk officers, for example through training in costing analysis. However, the shortage of officers remains a fundamental problem. **Further recruitment and training of desk officers should be a priority for the Budget Division.**

11. Co-ordination problems also exist between planning and finance staff within the line ministries. This is reflected in the continuing separation of the recurrent and development budgets. In order to move from planned prioritisation to implementation of prioritisation, the planning and finance sections in each sectoral ministry must work together. To this end, Budget Co-ordination Committees have been formed. Members of these committees encompass personnel in Planning, Finance and Administration. The Controlling Officer in each sector ministry is the chairperson. In the past, Budget preparation and formulation was the responsibility of planning sections. With the Budget Co-ordination Committees, all the sections in the ministries are actively involved. Hence, the Budget should be seen as the Ministry’s Budget not the Planning section’s budget. However, it is clear that the potential of

these committees has not been fully realised and that what is needed now is to strengthen them.

12. Finally, there has been a problem of co-ordination between Government and donors. Donors often press for their own projects and policies without taking into account the overall sector policy or budget. In addition, different donors often demand separate sectoral reviews that take up the time of those in the ministry concerned. Strong Government leadership is essential for the donor co-ordination issue. Such leadership requires that Government demonstrates its ability and willingness to implement realistic policy and activities. Key tools in achieving this objective are the Sector Investment Programmes (SIPs) and Sector Wide Approaches (SWAs). These are discussed in section I below.

13. A related problem is the proliferation of policy reviews and reform initiatives within Government, including Vision 2020, the Policy Analysis Initiative (PAI), the Policy Framework Paper (PFP) and now the Poverty Reduction Strategy Paper (PRSP), this Public Expenditure Review (PER), the MTEF Review, the Functional and Strategic Reviews, the Policy Investment Framework (PIF), the Sector Investment Programmes (SIPs), and the Sector Wide Approaches (SWAs). The reviews often overlap, implying duplication of effort and thereby misusing already scarce capacity. Also, the conclusions of the reviews often conflict, which creates problems for implementation. As a result of this and the fact that the reviews are often seen to be owned by donors, few are ever implemented.

14. This proliferation of reviews and reform initiatives in Government should be addressed by a co-ordinating body in a central ministry. This role has already been proposed for the restructured National Economic Council. All policy reviews and reform initiatives in government should have to be reported to this co-ordinating body, together with progress reports. The co-ordinating body should ensure that the terms of reference of the review in question do not overlap with others, and that policy recommendations do not contradict each other. Secondly, the co-ordinating body should assist with the dissemination of the report in order to ensure understanding of its implications by all stakeholders, and thus improving the prospects for the implementation of its recommendations.

C. CAPACITY ISSUES

15. Shortage of capacity (especially human) in the civil service remains a fundamental problem, not just for public expenditure management but more generally². Indeed, the need to increase capacity is a recurring theme throughout both this chapter and the whole PER. It is important to recognise that solutions to capacity problems are not as simple as they may appear. Recruitment is made difficult by financial constraints and a shortage of qualified applicants. Training, especially long term, faces problems of exacerbating the numerical shortage of personnel (both during the training period and after through the “brain drain” effect). Purchases of computer equipment are often undermined by a lack of adequate training, unequal distribution of equipment between ministries and cost centres, and rapid obsolescence. In addition, both recruitment and training initiatives are undermined by the high attrition rate of civil servants, largely caused by the HIV/AIDS pandemic.

16. The high attrition rate makes it essential that **where possible, capacity building measures are focussed on institutional capacity rather than individual capacity**. For

² For example, see the Chapters on the Health and Education sectors, where human capacity shortages are particularly acute.

example, rather than just training a small number of individuals, technical assistance should provide training manuals and other such support to the institution as a whole.

17. The shortage of computers in the line ministries can be improved by maximising the use of existing computers. For example, the establishment of computer rooms instead of having computers in individuals' offices would increase their use. Some co-ordination from the central ministries would also be beneficial, for example, through supplying standard software to all ministries.

18. However, it is clear that with the problems faced, capacity will remain a serious problem. Even if there is an effective recruitment drive (following reform the civil service salary structure), an intensive training programme and the purchase of thousands of computers, there will still be capacity shortages. To reduce the shortages further, the capacity supply enhancing measures must be complemented by capacity demand reducing measures. In particular, there is need for enhanced donor co-ordination over missions and administrative arrangements (discussed in section B above and in the section on SIPs and SWAs below) in order to reduce donor demands on scarce capacity, particularly in the sectors where donors are highly active (education, health, agriculture, macroeconomic management).

19. Another important capacity demand reducing measure would be to ensure that in each sector and in the overall management of public expenditure, there is consistency in the approach taken – in the words of one delegate at the CG Meetings, there should be a “moratorium on new concepts”. This relates to the need to co-ordinate policy reviews and reform initiatives as discussed in section B. However, behind this there is a more fundamental need to stop using up scarce capacity in absorbing new (usually donor driven) concepts and instead to concentrate on implementing the basic reforms that have been agreed upon, particularly in expenditure management and donor co-ordination.

D. PRIORITY SETTING – THE MEDIUM TERM EXPENDITURE FRAMEWORK

(i) Development of the MTEF in Malawi

20. The Medium Term Expenditure Framework (MTEF) was introduced to Malawi in order to correct some of the problems of the existing budget process. These problems were highlighted in the 1990 Public Expenditure Review and the 1995 Budget Management Review conducted by the World Bank (World Bank 1990, 1995). The first central problem was the failure to link policy making and planning to the recurrent budget. Although the development budget was generally well prepared by planners and based on overall Government policy and planning, the recurrent budget was not planned and was generally prepared on an incremental basis. The second central problem was that the budget system was focused on the short term rather than the medium to long term. Not only were budgets prepared for one year, but in addition, the recurrent and development budgets were subject to separate analysis. This led to a strong upward bias in development expenditure (reinforced by donor pressure) and a shortfall in recurrent expenditure needed to maintain the development projects.

21. To address these problems, the MTEF was intended to introduce strategic, medium term budgeting, bringing together policy-making, planning and budgeting roles of Government into a rolling three-year horizon. The focus in Malawi was on the reallocation of expenditure on priority activities. As such, the role of the Budget under the MTEF was to change from a centralised inventory of inputs adjusted on an incremental basis to an output focused approach

based on costings of priority activities and projections of available resources. In order to ensure consistency and comprehensiveness, the MTEF reforms were also intended to lead to the integration of the recurrent and development budgets. Under the MTEF, overall budget preparation should consist of six stages which correspond to boxes 2 and 3 in Figure 3.1 (Africa Consulting 1999):

- A. Projection of 3 year overall resource availability through a macroeconomic framework;
- B. Determination of preliminary 3 year sectional ceilings on the basis of government intersectional priorities;
- C. Projection of 3 year sectional expenditures based on intra-sectoral prioritisation through Logical Frameworks and costing of priority activities;
- D. Reassessment of 3 year sectoral ceilings based on additional information from stage C;
- E. Developing detailed annual estimates for first year; and
- F. Review and finalise estimates to form the basis of the Budget.

22. The MTEF was introduced in Malawi on a phased basis, starting with five key ministries (Agriculture and Irrigation; Education, Sports and Culture; Health and Population; Works and Supplies; and Police – together accounting for 40 percent of the recurrent budget) in 1995/6, expanding to twelve ministries in 1996/7 and covering all ministries and departments by 1997/8. The initial phases of the MTEF emphasised prioritisation through the production of logical frameworks. Although the emphasis was on the budgetary processes of the line ministries, the MTEF was from the start managed by the Ministry of Finance.

23. The MTEF has improved the definition of goals and objectives across government. Furthermore, the use of logical frameworks has facilitated the translation of these goals and objectives into strategies and actions. In addition, a macro-economic framework has been developed to project resources for three years, facilitating forward budgeting. As a result, the prioritisation of expenditure has been improved though there are still some problems to be resolved.

24. Inter-sectoral allocation has improved more than intra-sectoral allocation since the introduction of the MTEF (see Chapter 2). However, it seems likely that much of this improvement is due to policy change separate from the MTEF, in particular the decision to introduce free primary education in 1994. The implementation of intra-sectoral prioritisation exercises has been largely limited to the non-wages and salaries recurrent budget.

25. Despite the achievements of the MTEF, it is widely accepted that there are some major flaws in its operation and that it has not lived up to expectations. In particular, implementation of intra-sectoral prioritisation has been limited, largely as a result of the failure to integrate the MTEF fully into the budget system. In addition, there has been insufficient progress in developing a system of forward budgeting, very limited moves towards the integration of the recurrent and development budgets, and a lack of adequate costing exercises. In summary, it seems that the central failing of the existing MTEF process is that it has come to be seen as a process separate from the budget process belonging to the Ministry of Finance and donors.

(i) Remaining problems with the MTEF

26. Two important technical problems associated with the implementation of the MTEF have been the lack of adequate capacity in Government to produce either realistic costings of priority exercises or projections of resource flows. These are at the core of any MTEF-based analysis and are essential in moving from abstract policy priorities to concrete budget proposals – to bridge the gap between policy-making and implementation. The inaccuracy of resource availability (both in terms of annual levels and timing) and the costs of planned activities is a central reason for the major disparities between budgeted and actual expenditure.

27. The first phase of MTEF failed to address the problem of costing of activities. Despite the success of recent attempts to introduce costing exercises in some line ministries (for example, in the Ministry of Education, Sport and Culture's Policy Investment Framework), costing has not been integrated into the budget process. This lack of costing has meant that unfeasible policies have persisted and hence too many activities have been attempted relative to the resources available, undermining the implementation of the budget and leaving many priority activities under-funded. Despite the various costing initiatives, there is still insufficient understanding of what exactly the costing of activities involves and how to go about it.

28. Costing of priority activities should strike a balance between a realistic assessment of current costs for similar activities and an idea of model unit costs (costs in an ideal situation). The sectoral chapters of this PER make a first attempt at developing such a methodology. A training programme was run in February 2000 for budgeting staff from key ministries in order to alleviate capacity constraints before the preparation of the 2000/2001 budget.

29. Resource projections should be based on a reliable revenue projection model. This revenue projection model itself depends on accurate inputs of macroeconomic parameters that are exogenous from the model (For example, national accounts and monetary data). At present, there are no behavioural macroeconomic models that, among other things, could be used for revenue forecasting. The Reserve Bank of Malawi has developed a Financial Programming Model but it is yet to be fully developed in order to assist in revenue forecasting. The major barrier to developing robust projections of revenue has been the unavailability of reliable data as well as the instability and fragility of the Malawian economy. Under current macroeconomic conditions, accurate forecasting is extremely difficult. Adding to these problems, the timing of foreign inflows is very difficult to predict, largely due to conditionalities. Sometimes, even after conditions have been met, there are delays in transferring the funds. These delays greatly affect the budget implementation, as the whole process of MTEF is rendered useless, as Treasury cannot fund ministries according to their priority areas.

30. A further problem with the sectoral ceilings has been their timing. A frequent complaint from the line ministries has been that the sectoral ceilings have been delivered three weeks before discussion of estimates. This leaves insufficient time for ministries to prepare their budgets. It is important that sector ceilings are defined early, say, three months before budget discussion. Again, this problem is largely caused by capacity constraints in the Ministry of Finance, although it is also to some extent a donor co-ordination problem since Government negotiations with the World Bank and IMF have tended to delay the input of basic parameters into the revenue-forecasting model.

31. In order to improve the realism and timing of resource projections, there is need to improve the quality and timely availability of data at the National Statistical Office. With quality data, the Financial Programming Model initiated by the Reserve Bank should be improved to be used as a tool for macroeconomic modelling. The timing of resource projections can be further improved by increased donor co-ordination – in particular, an enhanced sensitivity by the World Bank and IMF to the timing of the budget cycle such that macroeconomic missions are timed in order to facilitate rather than delay the development of resource flow projections.

32. The failure of the MTEF is also to a large extent the result of ownership and attitudinal problems. The lack of consultation with stakeholders and participants during the initial implementation of the MTEF combined with a lack of information and therefore understanding of the MTEF process have together created a perception of narrow ownership of the MTEF. It is perceived by many that the MTEF is a process owned by the World Bank and the Budget Division of the Ministry of Finance. This perception reinforces the separation of the budget process and the MTEF.

33. The lack of understanding of the MTEF is largely a result of the lack of clear explanation of the relationships between MTEF and other reform initiatives such as SIPs, SWAPs, PIFs, the PAI, the PER and Vision 2020. Instead of these initiatives forming a united reform effort, they are often seen as conflicting exercises forced upon the Government by rival donors. As a result, there is little enthusiasm for them across Government.

34. This lack of ownership and understanding is particularly important at the level of senior management. If senior managers of the line ministries see the MTEF as a Ministry of Finance and donor owned exercise or do not understand the importance of the MTEF, they will not internalise the MTEF process within the ministry. As a result, these managers will continue to ask for information based on the old budget system. Thus, their subordinates will be forced to continue with the old system in parallel to the MTEF. Consequently, the MTEF will continue to be a marginal activity de-linked from the budget process. Building understanding and ownership of the MTEF at a senior level is one of the key aims of the MTEF Review process described in section J below

E. BUDGET PREPARATION

35. For the recurrent budget, the Budget preparation cycle formally begins when the Ministry of Finance issues a Treasury Circular advising ministries to start preparing their budgets. Overall themes and priorities for the Budget are communicated in this and subsequent Treasury Circulars. In each ministry, each cost centre is instructed to prepare its own budget³, and these cost centre budgets are aggregated into a Ministry budget. This Ministry budget is then presented to the Ministry of Finance and is discussed at a series of Budget hearings. Since the Ministry budgets are almost always over the allocation, the Ministry is instructed to cut the budget. Once the revised budgets are received, they are then aggregated and merged into one document, and final adjustments are made before presentation to Parliament. Each of these stages is discussed below.

³ The instruction to cost centres to start preparing budgets often comes chronologically before the instructions from the MOF to the line ministries.

(i) **Budget preparation within individual ministries**

36. The preparation of individual ministry budgets is supposed to be done through Activity Based Budgeting (ABB). ABB was introduced as part of the MTEF reforms in order to facilitate the implementation of prioritisation by the MTEF process and to enable improved monitoring of expenditure. ABB is intended to reflect the new output focus of public expenditure management, replacing the input focus of the traditional line item budget. In addition, ABB allows for a bottom-up approach to budgeting since individual activity based budgets are prepared by cost centre managers. In practice, this has been the main beneficial impact of ABB. In some ministries, these individual Activity Based Budgets (ABBs) have been successfully consolidated into an overall ABB for the Ministry. However, in others, such as the Ministry of Education, Sports and Culture (OPM 1999), individual ABBs have not been consolidated at the Ministry level, since there is a perception that it is line item budgets that matter in the determination of the final national Budget.

37. This conflict between ABBs and line item budgets is a central factor in the continued separation of the MTEF from practical Budget preparation. The conflict is largely caused by the failure to include the accounting staff both in sectoral ministries and at a central level (the Accountant General's Office) in the introduction of the MTEF. For accounting purposes, the line item, input based Budget is still necessary. The ideal situation would involve Budget preparation based on ABBs, so that where cuts are made they are made to specific lower priority activities, and so that the final budget is output based. However, in order to meet accounting requirements, the budget would also be consolidated on the basis of line items.

38. For this ideal situation to become reality, the individual activity based budgets need to be in a common format (both in terms of types of activity and computer software). This would require the ministry headquarters distributing a customised template spreadsheet for individual ABBs to cost centres in advance of budget preparation, together with training on how to use the software involved⁴. In many if not most cases this would also involve providing access to suitable computer hardware. In reality, however, most of these conditions are not in place (although advances are being made, for example in the Ministry of Education, Sports and Culture). As a result, **there is a tendency to abandon the ABB concept at the cost centre level and consolidate budgets only on a line item basis**. This tendency is reinforced by the accounting staff in the line ministries (reporting to the Accountant General), who are under pressure to produce a line item budget to a tight deadline. This incentive is further increased by the historical failure by the Ministry of Finance to impose sanctions on ministries that do not produce consolidated ABBs based on realistic costings. **For ABB to become a reality, the Ministry of Finance must put in place adequate incentives, for example, by reducing the budget allocations to ministries that do not provide an output based budget with a three year horizon.**

39. The example of the 1999/2000 Ministry of Education, Sports and Culture budget process⁵ is indicative of the problems of budget preparation across government. The prioritisation document upon which budgets were supposed to be based was not distributed until after cost centres had prepared their draft budgets. Another problem was the late provision of sectoral ceilings by the Ministry of Finance. As a result of these problems, when the Ministry of

⁴ It is important to note that this software does not have to be purpose made or complex – a relatively simple Excel spreadsheet with linked sheets would be sufficient.

⁵ As reviewed in “Implementing MTEF in the Malawi Education Sector” by Oxford Policy Management for DANIDA May 1999.

Finance ceilings were released, the first draft of the Ministry of Education, Sports and Culture budget proved to be well in excess of the funds available. Since there was no activity based overall budget, the budget could not be altered according to defined priorities.

40. Budget Co-ordination Committees (BCCs) were introduced in many ministries in order to improve co-ordination of the budget process within ministries, in particular to bring together planning and finance staff along with representatives of senior management. However, it is clear that in most cases, the potential of these committees has not been fully exploited.

(ii) Budget preparation by the Ministry of Finance

41. Once each ministry has completed its draft budget, it is presented to the Ministry of Finance. This is followed by a Budget Hearing, during which the ministry concerned formally presents and defends its draft budget to the Ministry of Finance. During these hearings, the Ministry of Finance as guided by Cabinet will readjust the ministerial allocations and ask the ministries to adjust their budgets accordingly (almost always involving substantial cuts). In theory, these cuts should be made on an activity basis, cutting back or eliminating lower priority activities. However, in practice this is often not possible since the ministries budget is not aggregated on an activity basis.

42. Once all the individual ministerial budgets have been submitted, discussed and adjusted in line with national policy, the Ministry of Finance aggregates them into the overall Budget. Since the ministries' budgets are submitted in different formats, this involves manually re-entering all the data. Not only is this time consuming but it also increases the number of errors (in terms of omissions and arithmetic mistakes) in the final Budget document. In addition, where ministries did not cut their budgets sufficiently during the budget hearings, the Ministry of Finance will make further cuts where necessary.

43. The shortage of time towards the end of the budget preparation process also reduces the scope for detailed macroeconomic analysis of the final budget. In particular, analysis of the monetary impact of the budget is largely limited to the outline of the macroeconomic framework at the beginning of the budget preparation process. To the extent that the final budget does not match the original framework laid out and that the macroeconomic situation changes between the initial outline of the macroeconomic framework and the finalisation of the budget, there is insufficient time for necessary changes to be made at the end of the process.

F. BUDGET IMPLEMENTATION

44. Budget implementation is overseen by the Budget Implementation Committee composed of Treasury and the Accountant General. Despite this however, the management of budget implementation has to some extent been complicated by the unclear relationship between Treasury, the Accountant General, Office of the President and Cabinet (OPC) and the National Audit Office (NAO).

45. The persistence of considerable off-budget expenditure is the key symptom of failure of budget implementation. This is partly due to the lack of realism of budgeted expenditures, as discussed above, but is also the result of a failure to properly enforce the Budget.

(i) Cash Budget

46. In 1996 Government introduced the cash budget system as a temporary measure to reduce fiscal indiscipline. The system remains in place as the central tool for budget implementation. The central principle of the cash budget system is that government spends only what it collects and that individual ministries spend only those funds released by Treasury into the ministries' accounts in commercial banks. Suppliers have been repeatedly informed that they should not give provide goods or services to government on credit.

47. In order to manage the cash budget system, Treasury has developed a cash flow system so that all expenditures are based on expected inflows. The cash flow indicates what government expects to have as inflows and it is from this that funding to ministries is based. In order to come up with a government cash flow Ministries are required to submit their own cash flow for the whole year. Treasury consolidates this and matches it with government inflows. In order to refine the system, it is being planned that from the 2000/1 financial year, Treasury will be advising ministries in advance if their cash flow will not be honoured. However, this can be hampered by unforeseen delays in disbursements of loans and grants from donors.

48. The cash budget system has had some success, as demonstrated by the reduction in accumulation of arrears. However, implementation of the cash budget has faced many problems as demonstrated by the fact that ministries continue to accumulate arrears regardless of various circulars that purchases should be made on a cash basis only. Firstly, technical problems associated with the unpredictability of donor inflows and departmental receipts. Secondly, the cash budget has so far failed to change the prevailing attitudes in government towards budgeting and expenditure.

49. Although the basic rationale of the cash budget system – to ensure that government spends only what it collects – is consistent with the MTEF, the cash budget system can cause problems. In particular, **the cash budget system comes into conflict with the MTEF process insofar as ministries' planned activities may be delayed or cancelled because of unpredictable cash flow**. Although such problems may indicate a lack of realism in planned expenditure, they may also be a result of seasonalities in revenue collection and expenditure needs or of delays in donor assistance. In such circumstances, the strategic prioritisation of expenditure over a three-year time horizon comes into conflict with the short-term demands of the cash budget system. For example, the cash budget system does not prevent funds being diverted to unapproved uses, leaving approved and often priority activities under-funded.

50. The cash budget system has failed to create a shift in attitudes towards an understanding of the need to maintain hard budget constraints, as demonstrated by the persistence of arrears. In many line ministries, the impression that extra funds can always be obtained from the Ministry of Finance persists. Thus, **budget constraints are seen as soft and budget allocations are not "locked in"**. This is perpetuated by the significant proportion of funds that is allocated to the Ministry of Finance in the budget, the willingness of the Ministry of Finance to fund extra-budgetary expenditure in the past and loopholes in the Finance and Audit Act.

51. The introduction in May 2000 of the Credit Ceiling Allocation Mechanism (CCAS) was designed to improve the cash budget system. Under the CCAS, all ministries are to be informed of their updated monthly spending ceilings on a quarterly basis so as to improve cash flow projections. These updated ceilings rather than allocations in the Budget will form

the budget constraint. In addition, rather than paying this allocation into the individual ministries' accounts in the commercial banks, the commercial banks will be informed of the credit ceiling for the month and will be instructed not to clear any cheques issued in excess of this ceiling. Cheques within the ceiling will be cleared on a daily basis through the Reserve Bank of Malawi. This will end the anomaly whereby Government was borrowing its own money, with the commercial banks purchasing Treasury Bills using the large deposits put into individual ministries' accounts at the beginning of every month.

52. Under the CCAS, commitment reports detailing commitments made for future expenditure are to be presented together with the existing expenditure returns on a monthly basis. The credit ceiling allocation for the relevant Ministry will then become the funding level net of commitments, which will be paid for separately at the appropriate time. It is hoped that this will eliminate the build up in arrears that has undermined expenditure control efforts in the recent past, by ensuring that all expenditure commitments are honoured and accounted for.

(iii) Creating hard budget constraints

53. In order to ensure that line ministries see budget allocations as hard budget constraints, it is necessary to fully explain the Ministry of Finance's own budget, breaking it down and demonstrating that there is no contingency fund or "treasure chest" that is available to be plundered. In addition, it is important that hard budget constraints are a reality – the Ministry of Finance should avoid giving out extra funds except where it is unavoidable. Where a Ministry accumulates arrears, Treasury should ensure that these are paid by charging the Ministry's vote.

54. Central to the creation of hard budget constraints is the clarification of responsibilities for expenditure and the enforcement of sanctions against those responsible for deviations from the budget. There is currently some confusion as to whether Ministers or Principal Secretaries are ultimately responsible and answerable to Parliament for their ministries' spending. This issue needs to be resolved. More importantly, **there is need for punitive measures to be introduced in the Finance Act for the controlling officers who continue to receive goods and services on credit leading to the accumulation of arrears.** This will enforce the cash budget regulation and lead to a reduction of arrears. As of now there are no punitive measures for controlling officers not following the regulations. Improving sanctions will also involve increasing Parliamentary scrutiny of expenditures through the Public Accounts Committee and the Budget and Finance Committee.

55. In March 2000, the Minister of Finance and Economic Planning launched the "Ten Point Plan" that focussed on budget reform, and in particular on tackling the issues raised in the previous paragraphs. As such, the "Ten Point Plan" contains several innovations designed to impose hard budget constraints and eliminate the accumulation of arrears. Firstly, all borrowing by Ministries will be subject to a new review process. All details of proposed loans will be reviewed by the Ministry of Finance and Economic Planning before being assessed by the Loans Review Board to be chaired by the Reserve Bank of Malawi. Only once this body has approved the loan will appropriate parliamentary approval be sought.

56. The second expenditure control mechanism is the immediate vetoing of all extra-budgetary expenditure except for unanticipated emergencies. It was recognised that in order to provide some flexibility there is need to develop a framework for virement such that it can be subject to parliamentary approval, possibly involving supplementary budgets. A third

expenditure control measure is the discontinuation of all direct payments by Treasury. All Ministries have been informed by means of a Treasury Circular that Treasury will no longer pay directly for any service provided to another Ministry. This will prevent the situation where contractors for other ministries came to Treasury demanding payment with scant evidence of delivery.

G. MONITORING EXPENDITURE

57. To a large extent, creating hard budget constraints depends on effective monitoring of expenditure. Without mechanisms able to detect deviations from the budget in a timely manner, the sanctions proposed above will be ineffective.

58. The current monitoring system is based on each ministry submitting monthly expenditure returns to Treasury. It is a requirement that once Ministries are funded, expenditure returns are submitted by the 10th of each month. Non-submission of expenditure returns leads to withholding of any further funding. These expenditure returns are then consolidated in order to be presented to Cabinet on a monthly basis.

59. However, existing reporting arrangements are inaccurate, time consuming and focussed on inputs rather than outputs. **Monthly expenditure returns submitted by some ministries and subvented organisations are late and/or unreliable.** The expenditure data submitted to the Ministry of Finance is often late and unreliable, as demonstrated by the often large discrepancy between expenditures reported by the ministries and expenditures as measured by levels of funding to ministries. These problems are to a large extent the result of a lack of enforcement of the sanctions against late and inaccurate reporting i.e. withholding of funding.

60. As a result of the late and inaccurate nature of many expenditure reports, there has been inadequate verification of the consistency of actual expenditures with the Budget. **For the Budget to be enforced and respected, the expenditure returns must be checked for consistency with the budget, and where there are serious deviations, the necessary sanctions must be applied.**

(i) IFMIS

61. A crucial reform in this area is the introduction of an Integrated Financial Management Information System (IFMIS). This system is being introduced under the Accountant General with the assistance of the World Bank. IFMIS will be fully computerised, enabling expenditure data to be analysed and shared instantly over a network. The system will be introduced on pilot basis starting with Ministries of Education, Sports and Culture; Agriculture and Irrigation; and Health and Population by December 2000 and for all ministries by July 2001. This project is important for the Malawi Government and in particular for the Ministry of Finance as **IFMIS is intended to solve most problems faced in monitoring Government expenditure. However, experience of installing similar systems in other countries has demonstrated the need to proceed with caution and to have adequate transitional arrangements in place.**

62. Capacity building within ministries is necessary to complement the introduction of IFMIS. Thus there is need to continue to train ministry staff in expenditure report preparation and reduce the unreliability of the data.

(iv) Fiscal transparency

63. On fiscal transparency, the Ministry of Finance has already drafted the report that will be published in the local press and Internet. This report is to be published quarterly starting from December 1999. One problem is that Government cannot be sure of the information the public would like to have. Therefore, in the second report, comments from the public will be taken into account.

64. In addition, under the “10 Point Plan”, the minutes of monthly meetings between the Minister of Finance and Economic Planning and the Governor of the Reserve Bank to discuss monetary and fiscal performance and policy will be published six weeks after each meeting

H. EVALUATION AND AUDIT

65. Performance is supposed to be monitored through the submission of quarterly reports on verifiable outputs (as identified in the MTEF logical frameworks). In addition, the National Audit Office is supposed to carry out a full audit of every ministry and department annually. However, because of capacity problems and the continued input focus of the Budget, these basic monitoring mechanisms have not been properly used in recent years.

66. The proposed audit reform is expected to promote good governance and transparency in Government ministries as increasingly demanded by both the Malawian public and the donor community. The Auditor General reforms will improve the manner in which audits are scheduled and conducted. These reforms will also assist government in improving the quality and economy of expenditures through the employment of mandatory value for money (VFM) audits. The coverage of audits is expected to rise to 75 percent from 45 percent in the first 3 years. The reforms should also reduce the number of complaints and irregularities. In particular, the separation of the Finance and Audit Act as part of the reforms will make the Auditor General's office an independent body separate from the civil service, thereby giving it more power to carry out its functions.

I. POLICY REVIEW

67. Policy reviews are currently carried out on an ad hoc basis, with little co-ordination between reviews and frequently little follow-up of recommendations. As discussed above (in Section B on co-ordination issues), in order to rectify this situation, a strong central co-ordinating body within the National Economic Council is needed. In addition, Government **should introduce an annual Public Expenditure Review, based on the present PER.** The annual PER would not have to be as comprehensive as the present PER, and could instead act as an update on expenditures in the past year and cost implications of new policies.

J. THE WAY FORWARD

68. As suggested above, a central requirement is the integration of the whole budget process, preferably centred on the MTEF. Many of the formal institutional structures needed are already in place (e.g. Activity Based Budgeting, Budget Co-ordination Committees) or being introduced (e.g. IFMIS, Audit Reform). What remains is the need for attitudinal shifts and improvements in co-ordination so that these formal institutional structures are properly used in a co-ordinated fashion

69. Following the recommendations of the first draft of the present chapter, Government has been conducting a review of the budget process through the MTEF Review⁶. **The central goal of the MTEF Review is to produce a detailed and implementable improvement plan for the MTEF.** In addition, it is intended that through the consultative processes included in the Review process, the understanding of the purpose and nature of the MTEF will be improved. In particular, it is anticipated that the involvement of politicians and senior officials will strengthen the process by ensuring that the right questions are asked and thus that the right incentives are handed down to those involved in implementation.

70. The review team determined at an early stage that this improvement plan could not be limited to narrow technical considerations, but should instead be concerned with all aspects of the management of public expenditure (including all stages of the budget cycle in figure 1). The starting point of the MTEF review was the conclusion reached in the first draft of the present chapter – that the MTEF has not had the impact hoped for, in particular that the MTEF is largely seen as an “add-on activity” owned by the Ministry of Finance and donors rather than an essential tool for public expenditure management across government.

71. However, despite these apparent failings of the MTEF, strong support remains for the concept of the MTEF. There has also been a growing recognition of the excessively high expectations placed on the MTEF. The introduction of similar reforms in New Zealand and Australia took ten years. With the limited resources available to introduce and guide the Malawian MTEF, the lack of substantial progress is to be expected. What is needed is to consolidate the successes of the MTEF, learn from the failures and to move to a new phase of implementation. This is what the MTEF Review and Improvement Plan are intended to do.

(i) **MTEF review methodology**

72. The first stage of the review process was to diagnose the progress and constraints in the implementation of the MTEF. This consisted of bringing together the previous reviews of the MTEF experience and assessing the root causes of the problems observed. The second stage involved identifying the essential characteristics of a well-functioning MTEF based on past experience and international examples. The next stage was to identify ways of moving closer to the achievement of these characteristics. The proposed measures were defined as specifically as possible and work is ongoing to combine these into a draft plan of action.

(v) **Findings so far**

73. The team agreed on seven essential characteristics of a well-functioning MTEF that form the basis of the review and improvement plan. For each of these characteristics, the draft Plan of Action includes a description of why it is an essential characteristic, why it does not apply to the Malawian case and what activities should be undertaken to ensure that the characteristic does apply to the Malawian case. These activities are then broken down into individual tasks. A brief summary of this is provided here.

74. The first essential characteristic is **political involvement and commitment**. For the MTEF to be successful, the Cabinet must be seen to be part of the process, using the MTEF process to translate their political programme into reality. It is also essential that other politicians, particularly parliamentarians, understand the MTEF process so that they can

⁶ The first draft of the present chapter was used as an input into the MTEF Review, and the two documents are designed to be complementary

properly play their role as “watchdogs” to protect the budget. In order to move closer to this situation, the main activities agreed upon were to develop a user friendly budget information package and to strengthen the Parliamentary Committees dealing with public finance and expenditure.

75. The second essential characteristic recognises the need for **effective management and co-ordination of budget reforms**. It has to be admitted that there has until now been insufficient co-ordination and monitoring of the MTEF across government. To overcome these problems, the improvement plan includes the publication of an updated operational handbook for the MTEF, a management development programme for middle and senior managers across government and a strengthened structure for authoritative management of the budget in the Ministry of Finance and line ministries, including the establishment of dedicated MTEF teams in all line ministries.

76. An essential characteristic highlighted by those in line ministries is the need for **predictability in the funding of services**. Unpredictability of resource flows undermines attempts at planning. Unpredictability occurs at various levels, including erratic flow of funds from donors to treasury, from treasury to the line ministries and from line ministry headquarters to service delivery points. Improving predictability involves improving forecasting of domestic resources, developing risk management systems, improving co-ordination with donors and improving accountability so as to ensure that resources are only spent on planned activities.

77. A well-functioning MTEF requires that **policies are clear, consistent and affordable** so that they can be translated into implementable and budgeted activities. In reality, however, policies are often confusing, frequently changed and unaffordable. In addition, policy formulation and review is weak and poorly linked to the budget process largely due to poor quality policy analysis as a result of capacity constraints. In the proposed improvement plan, policy formulation is to be strengthened through the creation or strengthening of Policy Analysis Units within line ministries. These Policy Analysis Units would then report to a central National Policy Unit in the Office of President and Cabinet that would act as a policy “clearing house”. The National Policy Unit would also help improve policy-making by reporting directly to Cabinet.

78. For the MTEF to work effectively, there needs to be **transparency in the preparation and presentation of the budget**. The main activities proposed to ensure this are to promote programme-based budget preparation with clear output indicators (requiring a review of Activity Based Budgeting) and to implement a user friendly, output based budget presentation.

79. Significant amounts of off-budget expenditure undermine the prioritisation process that lies at the heart of the MTEF. There is therefore need to ensure **comprehensiveness of budget coverage**. Currently, much public expenditure is incurred in an unexplained way outside the budget process, the recurrent and development budgets are planned separately and there are many donor projects that are deliberately kept outside the budget process. In order to rectify these problems, the team proposed that there is increased co-ordination between the planning of the recurrent and development budgets, that current moves towards Sector Investment Programmes (SIPs) and Sector Wide Approaches (SWAs) are encouraged, and that attempts are made to improve budget discipline across government.

80. The need for increased **accountability** in order to improve budget discipline emerged as the most important of the seven essential characteristics. At present, financial discipline is weak and good performance is not encouraged. The Review Team identified four root causes, namely a lack of transparency about expenditures made and outputs achieved, inadequate monitoring of service delivery, a lack of enforcement of rules and procedures and low morale in the public service.

81. In order to rectify these problems, the Review Team agreed on a large number of outputs reflecting the complexity and importance of the problem. The solutions are centred around the four root causes. The first set of activities deals with creating an effective and transparent review process. The second set is intended to improve monitoring. The third set involves reviewing, revising and enforcing appropriate rules and effective controls on expenditure and revenue collection, including a rigorous system of disciplinary action and effective audit follow-up. The final set involves introducing a modern performance management system and encouraging a professional ethos in the civil service

(vi) Way Forward

82. When the draft Plan of Action is completed there will be a series of formal consultations with politicians, civil servants, civil society and donors. On the basis of these consultations, a detailed work-plan and budget for the improvement plan are to be developed. Implementation of the Action Plan will start formally after this process has been completed. However, several of the proposed actions have already been implemented through the Ten Point Plan and other recent initiatives. It is important that these actions are built upon and that the momentum gained in consolidating and revitalising the MTEF process is not lost.

83. The Plan of Action is to be finalised in June 2000 following formal consultations with politicians, civil servants, civil society and donors. This Plan will include a detailed work-plan and budget for the improvement plan. The intention is then that the implementation of the improvement plan will begin in July 2000.

84. The review team has identified a number of Critical Success Factors that are needed to ensure the success of the MTEF improvement plan.

- Active Sponsorship from the President and Cabinet
- Early Gains in Accountability
- Organisational Effectiveness of the Ministry of Finance
- Close co-ordination across the central agencies
- Bringing donors into the budget/MTEF process

K. OTHER INSTITUTIONAL REFORMS

(i) Decentralisation

85. Further reforms that have a significant impact on the management of public expenditure include decentralisation, procurement reform, and civil service reform. Decentralisation will fundamentally change the way in which Government spends its revenues. Devolving powers of expenditure control to District Assemblies, will necessitate a substantial reassessment of the role of Central Government. In fact, decentralisation may provide an opportunity to adopt new and more effective methods of public expenditure management. Careful attention must be paid to designing an institutional framework that supports an MTEF-style budget process.

It is important that the old institutional framework that has become embedded in Central Government is not allowed to become embedded in the new Local Governments.

(vii) Civil service reform

86. Civil service reform is crucial for improving incentives within the civil service and thereby building capacity. The salaries for civil service at the higher level have fallen by 40 percent to 50 percent in real terms from 1993 to 1999 whilst equivalent private sector salaries have increased by a factor of six. This has reduced morale for professionals in the civil service and is the main reason for the substantial “brain drain” from the public to the private sector. It is in this regard that under the World Bank supported Second Fiscal Restructuring and Deregulation Project (FRDP II) Successor Credit, the civil service wage structure will be decompressed in order to increase incentives.

87. Procurement reform is intended to bring the procurement roles currently shared between several organisations together as the responsibility of a central Procurement Authority. This new organisation is to act more as an oversight body for the District Assemblies and Central Government ministries, reviewing procurement decisions and providing training in order to improve capacity. In performing this role, it is expected that the new Procurement Authority will prevent the accumulation of arrears and improve the efficiency of procurement, thereby supporting MTEF goals.

(viii) SIPs/SWApS

88. The concept of Sector Investment Programmes (SIPs) refers to a comprehensive review process of sector strategies in consultation with stakeholders and donors. It is a programming mechanism to ensure that projects and programmes in the sector conform to government priorities and the sectoral investments are consistent with expenditure targets and other macroeconomic indicators. Current examples include the Policy Investment Framework (PIF) in the education sector, the National Health Plan (NHP), and the Malawi Agricultural Sector Investment Programme (MASIP).

89. The concept of the Sector Wide Approach (SWAp), on the other hand, refers to an integrated management mechanism that relates to sector policies and strategies with the objective of arriving at a common framework of setting priorities and implementation arrangements. As such, the development of a SIP is an essential precondition for the development of a SWAp. The central objective of a SWAp is to move away from a piecemeal project approach to sector interventions and towards establishing a partnership led by government and including donor agencies and other sector stakeholders covering all interventions in the sector. However, it is important to recognise that the introduction of SWApS is a long-term process involving the gradual phasing out of the project approach rather than an overnight development.

90. SWApS can be seen to operate on two levels: firstly, a policy level whereby Government identifies its priorities (through a SIP) and donors agree to limit their support to these priorities. Secondly, an administrative level whereby there is common accounting and reporting procedures and commingling of funds.

91. At the Consultative Group (CG) Meetings held in May 2000, there was widespread donor support for recent Government initiatives related to SIPs and SWApS. Recent sub-sectoral attempts at developing SWAp type arrangements were also recognised, as was the need to

learn from these experiences. Many delegates urged all involved to press ahead with the development of SWAps whether or not certain elements, for example commingling of funds, are in place.

92. In order for SWAps to be developed, a number of preconditions must be met by government and donors separately as well as jointly. The most important Government condition is the development and implementation of a realistic costed strategic implementation plan based on well-identified priorities and national resource constraints. This would be based on a SIP. A second Government condition is sound macroeconomic management and sectoral level financial management. There must also be transparent procurement and accounting to ensure accountability and to reduce corruption. Finally, there should be strong management and local delivery capacity within the sectors.

93. On the part of donors, there must be a firm commitment to limit sector support to Government's priority activities. Secondly, there must be efforts to develop common financial and progress reporting mechanisms. In addition, a full SWAp requires the untying of aid and the lifting of restrictions on commingling of funds (basket funding). Mutual conditions include the need to build mutual trust and the involvement of civil society to ensure ownership.

94. There has been substantial progress in developing SWAps in the education, health and agriculture sectors. In the education sector, the Policy Investment Framework (PIF) is agreed to meet the requirement for a costed strategic plan. However, several donors have expressed concern that Government has not yet approved the PIF. Despite general willingness by the donors to move the SWAps process forward, this lack of approval is delaying any progress. In the Health sector, several donors have expressed concern that the National Health Plan does not meet the requirement for a *realistic* plan based on national resource and sectoral capacity constraints. Donors have indicated their commitment to the development of a SWAp in the health sector, as long as Government meets its conditions. As in education, some donors might not be able to meet the conditions on untying of aid and commingling of funds in the near future. In the agriculture sector, there is general support for the concept of SWAps, although there has so far been less progress in mobilising donors than in the other two sectors.

95. During the May 2000 CG Meetings, delegates agreed the way forward for the development of SWAps. It was agreed that there is need to draw up a memorandum of understanding between Government and donors, recognising the differences between donors. In addition, it was seen as crucial that SWAps are integrated into the PRSP and budget process. Finally, donors prepared to move the SWAps process forward should do so

L. CONCLUSIONS AND RECOMMENDATIONS

96. The operation of an integrated budget process is crucial for improving the quality and efficiency of public expenditure and thus reducing poverty. A weak link at any stage of the budget cycle can undermine any improvements made to other stages. The Government of Malawi has embarked on a series of reforms to the budget process based around the principles of the Medium Term Expenditure Framework (i.e. strategic prioritisation, output focus, integration of recurrent and development budgets). For these reforms to have the desired impact, a number of problems must be overcome. Whilst some of these problems are technical and their solutions relatively obvious, others are more deep-seated attitudinal problems that are more difficult to solve.

