PROGRAM INFORMATION DOCUMENT (PID)
APPRAISAL STAGE

May 16, 2018
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Operation Name	Second Agricultural Support and Fiscal Management DPO
Region	Africa
Country	Malawi
Sector	Central government administration (70%) General public administration sector (30%)
Operation ID	P164122
Lending Instrument	Development Policy Lending
Borrower(s)	Republic of Malawi
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Implementing Agency	Ministry of Finance, Economic Planning and Development
Date PID Prepared	May 16, 2018
Estimated Date of Appraisal	May 22, 2018
Estimated Date of Board Approval	June 26, 2018
Corporate Review Decision	Following the corporate review, the decision was taken to proceed with the preparation of the operation.

I. Key development issues and rationale for Bank involvement

Exogenous climate induced shocks are a major source of vulnerability in Malawi, exacerbating macroeconomic instability, and making it harder for the country to break the cycle of dependency. Extensive reliance on basic farming methods and reliance on rain-fed agriculture, together with a growing population, has made food security a recurrent challenge as well as adding to pressures on land use, soil fertility and forest resources. In recent years Malawi has suffered from weather shocks at an increasing frequency, including simultaneous floods and droughts in early 2015, followed by another major drought in 2016.

The majority of the poor remain locked in low productivity subsistence farming, and this poor agricultural productivity is exacerbated by thin and distorted maize markets. Access to infrastructure, services, land, working capital, and market opportunities are all limited, but Malawi's current strategy for increasing agricultural productivity centers disproportionately on fertilizer and seed subsidies, particularly for maize through the Farm Input Subsidy Program (FISP). FISP, however, is not poverty targeted and is inefficiently managed. It consumes more than half of total public spending in agriculture, crowding out expenditure in other important areas. While FISP reform is necessary, public spending must also be rebalanced and other productivity-enhancing measures that might reduce vulnerability, including irrigation, deserve greater attention. So too does diversification into off-farm activities and scaled-up social safety net programs: these help temper the price and weather shocks that can otherwise drive households into poverty, or prevent them from escaping it. Similarly, maize market interventions designed to promote price stability (through the Strategic Grain Reserve (SGR) and Agricultural Development and Marketing Corporation

(ADMARC)) in fact undermine incentives for agricultural commercialization, leaving the country overly dependent on a smallholder agricultural sector that is vulnerable to climatic shocks.

Weak public financial management transmits recurring shocks into fiscal indiscipline, in turn exacerbating macroeconomic instability. Besides a short period after 2005, when fiscal space opened up following debt relief, fiscal indiscipline has frequently been a source of instability and volatility in Malawi. There have been recurring instances of fiscal slippages, where realized deficits significantly exceeded those planned at the beginning of the year, and the central bank financed most of the gap. These slippages often result from both a shortfall in resources and unplanned expenditures undertaken during the year. Volatility in foreign aid receipts has also played a role in erratic fiscal management, with the 2013 "cashgate" public financial management scandal resulting in the most recent downturn in Official Development Assistance (ODA) provided on budget.

Malawi is thus confronted with twin pressures arising from vulnerability to climate shocks and weak fiscal management, both of which contribute to macroeconomic instability. The vulnerability to climate shocks is being manifested in the declining growth rate and deteriorating poverty outcomes. And adverse weather shocks, coupled with weak public financial management, exacerbate existing fiscal pressures and constrain the country's capacity to respond to shocks.

The recent food security crisis has added urgency to the need to undertake difficult and politically challenging reforms. The proposed program outlines a series of policy and institutional reforms that the Government of Malawi is undertaking to reduce distortions in, and improve the performance of, the agricultural sector; and to restore basic public financial management and accountability systems. It is a first, but critical, step towards breaking the cycle of vulnerability. The proposed operation, which is the second in a series of two, is high risk and intended to combine stabilizing measures with support to an emerging, forward looking reform agenda.

The operation is part of a multi-pronged World Bank Group response to help Malawi "break the cycle" of vulnerability. In the context of El Niño-induced drought conditions and a severe food security crisis, the Bank provided financing to address short-term needs via a Drought Recovery and Resilience Emergency Response Project and additional financing to the Strengthening Social Safety Nets Project. A new Agricultural Commercialization Project, as well as the Shire Valley Transformation Project aim to support medium-term investments in diversified and more drought-resistant agriculture. The DPO series will catalyze these investments by addressing some of the key binding policy constraints that have amplified Malawi's vulnerability to shocks.

II. Operation Objectives

The objective of the proposed DPO series is to improve incentives for private sector participation in agricultural markets and to strengthen fiscal management through more effective expenditure controls and greater transparency. Creating an improved agricultural policy environment, scaling up social protection, as well as strengthening financial reporting, oversight and public expenditure management are essential parts of efforts to improve Malawi's ability to absorb shocks, as well as laying the foundations for future agricultural growth and productivity improvement.

This objective will be achieved through two pillars of policy and institutional reforms aimed at: (a) making agricultural markets work better; and, (b) strengthening accountability and restoring confidence in public finances. These reforms support the Government's priorities as outlined in the Third Malawi Growth and Development Strategy (MGDS III), as well as the broader World Bank Group goals of ending extreme poverty and boosting shared prosperity.

The proposed operation is the second in a series of two programmatic development policy financing operations, and builds on a number of reforms already undertaken across the two pillars and supported under the first operation.

III. Rationale for Bank Involvement

Malawi's medium-term development program is anchored around the third Malawi Growth and Development Strategy (MGDS III), being implemented over the 2017-2022 period. The objective of the MGDS III is to build a productive, competitive and resilient nation. The strategy was prepared via a highly consultative process, including a reflection on the lessons learned from implementation of the preceding MGDS II. These included the need for a more realistic set of assumptions, including on the availability of financial resources, a more prioritized set of issues to focus on, and greater attention paid to the "how to" of development rather than just the "what to".

Two successive years of weather related shocks have highlighted the need to build resilience and "break the cycle" of vulnerability in Malawi. Floods, followed by two years of drought conditions, have stimulated demand for reforms to increase buffers and rebalance public expenditure towards areas that will improve climate resilience, particularly in the agricultural sector. Reforming agricultural incentives is also a necessary step towards removal of distortions and the creation of positive incentives for commercialization and diversification.

The repeated impact of climatic shocks has also prompted a critical review of Malawi's current agricultural policies, opening up space for policy dialogue in politically challenging areas. These include sensitive areas such as the FISP, land management, the regulation of commodity trade, as well as the way that ADMARC and the SGR intervene and shape prices and incentives in Malawi's maize markets.

The proposed operation also supports some of the critical reforms drawn from Malawi's public financial management and public service reform programs. Rebuilding integrity and oversight in Malawi's PFM systems and strengthening public procurement are key steps towards restoring macroeconomic stability, which in turn is the foundation upon which sustainable growth and poverty reduction can be achieved.

IV. Tentative financing

Source:		($m.)
International Development Association (IDA)		80.0
	Total	80.0

V. Institutional and Implementation Arrangements

Implementation of this operation is being coordinated by the MoFEPD. A number of other MDAs are also closely involved in the reform program. Day to day responsibility for monitoring and evaluation falls under the responsibility of the Debt and Aid Management Division of the MoFEPD.

Monitoring and evaluation of the reform program will be undertaken jointly by the Bank and Government teams. These two teams will meet regularly to monitor progress in implementing the agreed policy and institutional reforms supported by the operation, and to assess progress made towards achieving the expected results. Result indicators have been specifically selected to reflect available data sources in Malawi, and build on lessons learned from earlier policy based lending operations that recommend the use of simple and manageable results frameworks using available secondary sources of data.

VI. Risks and Risk Mitigation

The overall risk of the proposed operation is "high", as are the expected returns to successful implementation. The program is subject to four main risk areas: (i) political and governance; (ii) macroeconomic; (iii) institutional capacity; and (iv) fiduciary risks.

Political and governance risks are central to the success of the program, as well as Malawi's broader development strategy. The pervasiveness of corruption and the persistence of entrenched political interests surrounding the choice of specific policies and the operation of specific institutions may impede the passage or implementation of the Government's bolder agricultural market, governance and PFM/PSR reforms, as has happened many times in Malawi's history. The WBG is heavily invested in macro-fiscal and governance reform, and is attentive to the political realities of reform—but it would be unwise to underestimate the resilience of vested interests and the risks inherent in actions that necessarily cut against those with influence. These risks will inevitably be amplified as Malawi approaches elections in 2019. These risks can, to some extent, be mitigated by building broad public support for policy reforms—as public pressure to restore the credibility of Government institutions is high, and there is much greater public scrutiny of public sector performance after "cashgate".

Maintaining macroeconomic stability is also a major source of risk, and is exacerbated by external shocks and climate-induced natural disasters. The Government's ability to contain public spending and increase domestic revenues is mixed, and a restoration of largescale on-budget financing by donors is dependent on visible gains in improving the control environment. Similarly, with its reliance on a few primary exports and a relatively undiversified economy, Malawi remains vulnerable to external demand and price shocks as well as to weather-related disasters, as demonstrated by the droughts in 2015 and 2016. The volatility of aid flows in a heavily aid-dependent country also features heavily in this equation. With further external shocks, it may be hard for the Government to manage the fiscal gap and maintain macroeconomic stability; service delivery could also deteriorate further, and counterpart support for important new projects would be hard to mobilize. These risks are partially mitigated by continued close policy dialogue on macroeconomic and fiscal management issues by both the Bank (through the DPO series) and the Fund (through its program), and deepened investment in disaster risk management and resilience.

Institutional capacity is a long-term agenda and lays at the heart of Malawi's challenge. The World Bank is heavily engaged in this arena through an array of instruments, as are a large number of other development partners. The risks are somewhat mitigated by selecting only the highest priority policy and institutional reforms for inclusion in the proposed DPO program, by focusing only on the most critical areas of policy dialogue, by having realistic expectations, and by setting prior actions at a downstream level. In addition, the objectives of the DPO are shared by Malawi's major development partners and form part of a collective policy dialogue.

Weak fiduciary control systems that undermined public policy effectiveness and slow progress in addressing gaps are a further source of risk, both to the DPO and the WBG's broader program in Malawi. The World Bank's assessments point to a climate of high fiduciary risk, even if the specific loopholes associated with "cashgate" have been closed. Continued close collaboration with Government and development partners on the PFM agenda will strengthen collective efforts, while the Government's own commitment and need for a resumption of budget support should help maintain internal pressure for reform. Further mitigation is provided, to an extent, by the strengthened role of Malawi's external accountability organizations. Increased scrutiny by the NAO and by the PAC, together with improved disclosure standards and greater public debate, have served to highlight to the public the extent of past fiduciary slippages.

Finally, the risks of not engaging in a constructive way are equally large. While not strictly a fragile state, Malawi displays many of the symptoms of fragility. Much of the reform agenda supported by the DPO series emerged during a time of crisis and significant political and economic stress. Failure to engage positively in support of an important, but still uncertain, change process runs the risk of leaving emerging reforms (and reformers) isolated and vulnerable to reversals.

VII. Poverty and Social Impacts and Environment Aspects

The overall net poverty and social impact of policy and institutional reforms supported under this DPO series is expected to be positive. Reforms supported under the DPO series will both directly and indirectly contribute towards improving living standards of the poor. Improved and lower cost access to formal land titles will benefit poor and vulnerable land owners, particularly women, who have disproportionately had weaker access to legal ownership of land. Transparency around ADMARC operations, by reducing price volatility, could have a positive poverty and social impact, especially on those households which are currently food insecure. Allowing the use of warehouse receipts as a source of finance would similarly help to address access to finance constraints in rural areas. Similarly, public financial management reforms that aim to help strengthen expenditure management and budget execution, public accountability, procurement and transparency, are expected to contribute towards improved service delivery.

However, reforms to FISP supported under the program are expected to have distributional effects. The current FISP is justified on the basis that most smallholders in Malawi lack the cash resources or access to credit that would enable them to purchase inorganic fertilizer at commercial market prices and soil nutrients, particularly nitrogen, are essential for maize production. These nutrients are in short supply, and inorganic fertilizer is the most effective short-term method for farmers to add nutrients to the soil. The FISP has multiple stated objectives, including: (i) increasing smallholder maize yields and overall levels of production; (ii) achieving reductions in poverty levels; (iii) promoting food security; and, (iv) enhancing rural incomes. However, households who should be targeted to increase maize productivity are likely not the same households who should be targeted to reduce rural poverty. Therefore, though the FISP was never intended to serve as a social safety net, it has in effect acted as a form of cash transfer for land and labor constrained households who have cashed out their coupons, so the reforms that reduce the subsidy will have distributional consequences.

Because of these distributional consequences, the DPO supports an expansion of the Social Cash Transfer program as a means towards putting in place an effective safety net for the extreme poor. The SCT therefore offers an important alternative and set of advantages to reach the extreme poor compared to the FISP. First, the SCT is a targeted intervention, with repeated rounds of payments devised to smooth consumption. Notwithstanding challenges in targeting logistics, the SCT offers a predictable stipend to beneficiaries compared to the lottery protocol that has existed under FISP. In this context, the DPO supports the progressive strengthening of the SCT program as a means of providing a responsive safety net that meets the needs of the extreme poor.

The prior actions supported by the DPO series are expected to contribute positively towards improved climate resilience in Malawi. Reforms to the FISP, which has long crowded out public expenditure in the agriculture sector, will free up fiscal space to enable a more balanced set of agricultural investment activities including in climate-smart agriculture as set out in the new National Agricultural Policy. Similarly, improved functioning of agricultural markets should lead to the reversal of incentives that have tended to encourage maize mono-cropping, growing on marginal and drought-prone land resulting in soil erosion and a general lack of agricultural diversification. Improved security of land tenure could lead to higher levels of investment in land stewardship, and thus reduce land degradation. That said, complementary improvements to the broader conservation and natural resources management policy framework will also be necessary to ensure positive environmental outcomes from a better functioning set of agricultural markets in Malawi.

Actions supported by the DPO series also provide a basis to sustainably improve Malawi's land tenure, thereby supporting agricultural productivity growth and gender equity. Clarifying estate boundaries and managing the process of lease renewal/cancellation in a fully electronic system will generate public revenue, allow unused land to revert to customary tenure, and create a basis for investment on land that was formally recognized. Demarcating TLMAs and communal lands within them will allow to assign authority and responsibility for receiving benefits from sustainable management of land and natural resources. Careful piloting of systematic customary estate registration will allow to develop low-cost participatory processes that reduce tenure insecurity and increase productivity by fostering investment and transparent operation of land markets. These benefits will not be automatic: canceling estate leases in a non-transparent fashion may lead to land grabbing by powerful interests. Land registration that fails to safeguard communal and environmentally sensitive areas or properly documents women's rights may lead to irreversible natural asset loss or permanently disempower women. Complementary IDA-financed investment projects will provide technical support and impact monitoring to prevent such negative effects and any relevant regulatory actions will be included in future DPOs as needed.

Other prior actions are not expected to result in significant effects on the environment. The implementation of measures to strengthen the management of public finances and improve accountability in the public sector are expected to have a neutral effect on the environment. However, there are linkages between environment degradation and weak macroeconomic management and governance. Hence, it is expected that there will be some positive indirect effects on the environment associated with policy and institutional reforms supported under the program.

VIII. Contact point

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