PROGRAM INFORMATION DOCUMENT (PID)
APPRAISAL STAGE

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Operation Name	Malawi Agricultural Support and Fiscal Management DPO
Region	Africa
Country	Malawi
Sector	Central government administration (70%); General public administration sector (30%)
Operation ID	P153753
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	February 15, 2017
Estimated Date of Appraisal	February 17, 2017
Estimated Date of Board Approval	April 4, 2017
Corporate Review Decision	Following the corporate review, the decision was taken to proceed with the preparation of the operation.

I. Country and Sector Background

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 current 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 is high risk and intended to combine stabilizing measures (in response to the food crisis) 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 is also providing 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 proposed DPO will catalyze these investments by addressing some of the key binding policy constraints that have amplified Malawi's vulnerability.

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 Second Malawi Growth and Development Strategy (MGDS II), as well as the broader World Bank Group goals of ending extreme poverty and boosting shared prosperity.

III. Rationale for Bank Involvement

Malawi's medium term development program is anchored on the Second Malawi Growth and Development Strategy (MGDS II), being implemented over the 2011-2016 period. The objective of the MGDS II is to create wealth through sustainable economic growth and infrastructure development as a means of achieving poverty reduction. The implementation of MGDS II has now just reached its completion point, with most of the strategy's laudable objectives remaining unmet. Macroeconomic instability, together with the breakdown of Malawi's public financial management system, and the resultant loss of on-budget development assistance, plus exogenous weather shocks have all played a role. This has triggered significant reflection ahead of the preparation of Malawi's next medium term development strategy beyond 2016. Key lessons learned include the need for a more realistic set of assumptions, including on the availability of financial resources, a more prioritized set of focus issues, and a greater focus on the "how to" of development rather than the "what to". The Bank is supporting this process, including through the preparation of a new Country Economic Memorandum which will inform the preparation of the new strategy.

A second successive year of weather related shocks has 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, 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 is a key step 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 with guidance provided by the GFEM. A number of other MDAs are also closely involved in the reform program, including the MoAIWD. 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 supported by the proposed DPO 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 persistence of entrenched political interests may impede the passage or implementation of the Government's bolder 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 reforms that necessarily cut against those with influence. This risk 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 Government performance after "cashgate".

Maintaining macroeconomic stability is also a major source of risk, and is exacerbated by external shocks and climate-induced natural disasters. Although encouraging steps have been taken towards restoring macroeconomic balance, the path ahead will continue to be difficult, especially given continued food security challenges and a weakening external environment. The Government's ability to contain public spending and increase domestic revenues is unproven, and a restoration of full donor budget support 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 floods and drought of 2015. The demonstrated volatility of aid flows in a heavily aid-dependent country also features heavily in this equation. With further external shocks and a continued lack of budget support, it will be hard for the Government to manage the fiscal gap and maintain macroeconomic stability; service delivery will also deteriorate further, and counterpart Government support for important new projects will be very hard to mobilize. These risks are partially mitigated by continued close policy dialogue on macroeconomic and fiscal management issues, including through the Malawi Economic Monitor (MEM) series, as well as continued investment in disaster risk management and resilience. The WBG's longer-impact efforts to improve physical and social resilience form a prominent part of the current CPS, and additional risk mitigation measures will need to be explored jointly by donors and Government, including against the volatility of aid flows.

Institutional capacity is a long-term agenda in Malawi. The Bank is heavily engaged in these 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, and by setting prior actions/triggers at a downstream level.

Weak fiduciary control systems have undermined public policy effectiveness and slow progress in addressing gaps is a further source of risk, both to the DPO and the WBG's broader program in Malawi. The 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 some internal pressure for reform.

VII. Poverty and Social Impacts and Environment Aspects

The overall net poverty and social impact of policy and institutional reforms supported under this DPO is expected to be positive (with some negative distributional effects arising from the reforms to the FISP). Reforms supported under the DPO 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 grain reserve management and ADMARC operations, by reducing price volatility, could have a positive poverty and social impact, especially on those households which are currently food insecure. Similarly, the public financial management reforms will help strengthen expenditure management and budget execution, public accountability and transparency.

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. A recent Poverty and Social Impact Analysis (PSIA) provides insights into the distributional implications of proposed FISP reforms.

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

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