

# State Hegemony, Macro Effects and private enterprise in Malawi

SIGERE Working Paper number 2002/34/pub Econ.

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Also presented at:

The second 2002

Public Economics "Weekend" Conference

Burwalls, University of Bristol

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## ABSTRACT

This paper investigates the rationale for proliferation of state enterprises and implications for public sector expansion in Malawi. Since government depends on a combination of taxes and aid, and external and domestic borrowings, the paper investigates the fiscal, monetary and balance of payments effects of the public sector and implications for private enterprise development.

The paper finds that high levels of aid and fiscal revenues triggered by buoyant export markets in the 1960s anchored a Stalinist-Marxist style public sector expansion intended to build socialism alongside a state bureaucracy and one party politics. However, collapse of export commodity prices in the late 1970s repositioned the Malawi economy in such a way that costs of state hegemony emphasized its own economic vulnerability.

Large fiscal imbalances emerged as apprehensions over loss of political control heightened by pressures of multiparty politics forced government to maintain the large public sector. Under pressure from oil price inflation, the influx of Mozambican refugees and drought, government resorted to higher levels of deficit monetisation and fiscal reallocations; giving priority to state enterprise subvention. These were manifested in reduced public investment, surging inflation and stagnation in per capita GDP.

Implications of public sector expansion and government's intransigence to reform include restrictive industrial, trade and financial policies that depressed savings, hindered private investments and encouraged capital flight. The policy also encouraged public sector inefficiency and resulted in high public deficits, increased foreign borrowing and recourse to credit from the domestic banking sector. These have had serious implications for crowding out the private sector and debt service and balance of payments problems.

The new economic regime in Malawi advances Smithian ideals of a lesser role of the public sector aided by liberalization to eliminate price distortions, unrealistic interest rates and exchange rates. Privatization also aims to ease off fiscal pressures while industrial liberalization aims to develop a new competitive culture in business. Discriminatory tariffs have been abolished while liberal trade policies continually aim to integrate Malawi to world trade.

Despite these initiatives, serious difficulties arise from downsizing of the public sector. The end of subsidization is manifesting itself into widespread joblessness. Macroeconomics of the market economy remain elusive and government is caught at a vicious intersection of rational economic reforms and fierce opposition from political activism. There is also rising disagreement over deflationary policies of the IMF.

## INTRODUCTION

### Public sector expansion

Since the mid 1960's the government of Malawi followed a policy of seeking comprehensive ownership of the means of production and also centralized management of the economy. This aimed to give the economy a state driven boost anticipated to trickle down to the poor masses, hitherto marginalized during colonial rule.

Extensive government involvement in business via state enterprises spanning a wide range of private sector activities has been a key manifestation of public policy. On one hand, government created a publicly funded development bank, Malawi Development Corporation to establish private companies. On another, the government used the Agriculture Development and Marketing Corporation (ADMARC) to recycle profits from produce trading into state ownership of industry.

Apart from direct investments undertaken by the state treasury in over 40 enterprises, government ministries also established more than a dozen commercial parastatals in the fields of agriculture, manufacturing, industry, mining, commerce and services. In addition, Press Corporation owned by Life President Banda undertook widespread acquisitions in strategic areas of the economy, consolidating itself into the largest single business conglomerate in the country.

This paper investigates trends in growth of the public sector, its intermediate effects on fiscal policy choices available to the government and implications on budget management. The paper also examines intermediate effects of public sector growth on monetary policy choices available to the government, particularly in the setting or determination of interest rates and exchange rates.

In view of government's inevitable dependence on taxes, foreign aid and domestic and foreign debt, the paper also examines financial behaviour of the state in terms of tax policy, the role of aid, as well as accumulation of domestic and external debt.

On the basis of these analyses the paper develops a cause-effect paradigm for public sector expansion and macroeconomic aggregates, and their implications for private enterprise.

The main contribution of this paper to public sector economic policy is its role in the determination the speed and depth of public sector reform required to exonerate the economy from the fiscal burden of a large public sector and also create an atmosphere conducive to sustainable private enterprise development.

### **Observations and Conclusions**

Public sector expansion in Malawi brings out two potentially illuminating courses of study. One course evokes a conception of the public sector as part of a nationalist political hegemony

that subjugates private initiatives of the colonial establishment by introducing state sponsored competition in the private sector. This is to guarantee discontinuation of uncontrollable colonial business influence.

The second conjures up the image of a government driven by the Stalinist-Marxist philosophy that the state should determine, inter alia, "*allocation of resources, distribution of income and consumption, levels of saving and investment, and relative prices of goods and services*. This is intended to build socialism alongside one party politics and a state bureaucracy.

The third course of investigation identifies economic successes engendered by favoured commodity export prices of the 1960's and high levels of aid, as two factors that raised the appetite for government's policy of comprehensive ownership of enterprise and direction of the economy as a result of a weak private sector at the time of independence in 1964.

All three aspects are applicable, but despite the strongest philosophical tenacities, the collapse of export commodity prices in the late seventies repositioned the Malawi economy in such a way that the large public sector emphasized its economic vulnerability. However, the government sustained its intransigence to public sector reform, which was viewed synonymously with relinquishing an important instrument of political power.<sup>2</sup>

Despite its legitimate role as policy action for reform Malawi, state resistance to divestiture proposals were heightened by the fact that they coincided with pressures of multiparty politics in other African countries. Moreover, advocates of public sector reform were foreign agents like the World Bank, IMF and the USAID.

Initially, higher levels of monetisation covered up the widening deficit resulting in a surge in average inflation to 15% per annum (1980-90). Per capita GDP had also stagnated within \$160-\$170, while public investment dropped from 13.6% to 8.2% of GDP as a result of reallocating fiscal resources giving priority to state subvention also resulted in a drop in.

As export commodity price deflation worsened from 3.8% per annum in 1975-84 to only 1.4% during 1985-89, escalating costs of imports under the influence of petroleum price inflation resulted in a widening external gap threatening balance of payments stability. In fact, as export price deflation worsened further to 0.2% per annum during 1990-98, the government increased foreign borrowing to conceal the gap despite conventional wisdom demanding enterprise restructuring.<sup>3</sup>

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<sup>2</sup> Low export prices weakened Agriculture; hence industry and service sectors. As GDP plummeted in the 1980's Malawi saw both unemployment and inflation soaring, driving much of the country's population below the threshold of poverty. Fiscal revenues also suffered while external value of the currency showed signs of fatigue as a result of declining reserves. Public sector imbalances worsened with declining levels of aid as a result of rising demand for foreign assistance to new democracies in Eastern Europe

<sup>3</sup> Import prices rose by 6.4% per annum during 1975-84 and escalated to 8.4% per annum during 1985-89

The civil war in neighbouring Mozambique which forced a million refugees into Malawi, at a time when the country was also experiencing severe drought also exacerbated fiscal pressures on government. Growth for the period 1980-94 had plummeted to only 1.6 percent while the budget deficit escalated to 15 percent in 1994 reflecting unabated fiscal pressures.

Under pressure from state subvention, the government merely shifted the resource hemorrhage to the banking sector. From only 2% in 1973, the share of bank credit consumed by parastatals had risen to 26% in 1978 while private sector credit suffered a corresponding reduction from 76% to only 51% of total credit.

Against all the tenacity to maintain state enterprises, the reality had emerged that the sector had increasingly become a major liability to Malawi. From the highs of 9.5% of GDP in 1980 state enterprise contribution to national output was to only 3.9% in 1986. Contrary to government's justification of the role of parastatals in industrial development, the share of public enterprises in non-agricultural activity was only 6% of GDP in 1991 compared to 11.7% in 1980.

Despite consuming a large share of bank credit equivalent to 38% of GDP in 1986, the share of gross domestic investment attributed to state enterprises had declined to only 10.2% from 49.6% in 1980. In relation to national output, the share of public enterprises in gross investment also declined from 12.3% of GDP to a mere 2.2%.

Initially, these trends elevate growth policy choices between consumption (private and public) that is growth neutral and capital formation (private and public) that drives economic growth, as the primary problem in Malawi. However, given that credit haemorrhage covered operational losses and payroll demands of bloated employee registers, directed credit facilitated the transfer of resources from capital formation to consumption. This underscores problems of allocation inefficiency that links external debt growth to weak growth via extensive consumption spending.

Government intransigence to demands for reform has resulted in privatisation yielding only 35 transactions being completed between 1980 and 1993. This does not compare well with the fact that the new economic regime concluded 9 privatisations in 1996 alone. In a period of five years (1996-2001), the new economic regime had concluded 44 privatisations, raising a total of \$1.2 billion.

### **Theoretical Implications**

These observations resurrect stipulations of the Public Choice theory that "...governments can do nothing right because politicians, bureaucrats, businessmen and citizens act solely from a self-interested perspective using power and lobby to procure the authority of government for their own selfish ends".

State resistance to reform also typifies the contention of "Nelson's Third Law," that 'the worse a government regulation [or practice] is, the harder it is to get rid of it' because there are other persons and entities deriving benefit and therefore willing to defend it

In a retrospective revisionist interpretation, these observations suggest that the belief in trickle-down public economics in Malawi is, in fact, in serious error in relation to the impact of economic theory on economic strategy exemplified by public sector expansion. In place of 'the power of (economic) theory' the findings in this paper suggest a 'theory of economic power' as the rationale for proliferation of state enterprises.

Two further extensions emerge within the context of the theory of economic power; the first is that government use of public resources and direction of bank lending to preferred enterprises resurrects stipulations of the Financial Oligarchy Theory (FOT). Although FOT is fashioned along the lines of financial patrimony of developed states over poor countries, its basic reasoning [that domination of capital is key to gaining economic control] evokes great similarity with state domination of financial capital as exemplified in Malawi's domestic setting.

The second extension is that the presence of 'Administrative oligarchy' can also be discerned in the Malawi setting. This is in relation to the propensity for the state to capitalise on bureaucratic controls within its legitimate regulatory powers, but to safeguard business interests of the state against pure competition from the private sector.

Available evidence also suggests ideological origins of public sector expansion intended to build socialism contingently synergized by hysterical one party politics and state bureaucracy for purposes of consolidating political power. Protectionism and over-regulation are designed to guarantee state enterprise success alongside an imperial business community of political cadres who enjoy waivers in pursuit of 'capitalism of the few', sparingly extended to political allies in a phenomenon commonly recognized as 'crony capitalism'.

This arises from the fact that authoritarianism had been the defining characteristic of the neo-colonial state in Malawi; the President's role in business introduces a capitalist cum political and constitutional phenomenon for which Okoth-Ogendo has coined the term "Imperial Presidency".<sup>4</sup> In authoritarian Malawi power was personified by Life President Banda who had authority and prestige over the legislature and courts of law; the representative organs of the people.

The conditions observed in this research are consistent with 'state hegemony' a subtle form of economic tyranny that enables the state to present its own interests as universal while marginalizing those sectors of society that offer competition. The State hegemony in Malawi was legitimized by subsidies, artificially low product prices, low interest rates, and over-valued exchange rates, but at the cost of large budget deficits, high level of seignorage, high inflation,

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<sup>4</sup> Okoth-Ogendo, 1991

rapid accumulation of domestic and external debt, weak factor markets, crowding out of credit and macro instabilities that undermine private enterprise.

The arguments outlined above also evoke the power of Gramsci's theory of hegemony born from the basic idea that the state cannot enforce control unless by stealth or other, more intellectual or capricious methods the cost of which is born by society itself. These costs are manifested in Malawi as a debt overhang and high debt services payments, as a result of borrowing contracted to meet demands of a large public sector. The costs are also manifested in the form of a very low capital transfer value on privatisation and underdeveloped domestic capital markets that make privatisation synonymous with foreignization.

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DISCUSSION

## Chapter 1:

### PUBLIC SECTOR EXPANSION

#### Political Dimensions

The birth of Malawi as a nation state is documented in the context of apprehensions from the protracted struggle against imperialism that became more pronounced after attainment of self-government in 1963 (Goldsmiths, 2000). The post-independence destabilization of Angola, Zimbabwe and Mozambique, bears testimony to the risk that tribal minorities can be indoctrinated into civil insurrection in pursuit of self-serving power sharing; at the instigation of disgruntled remnants of the colonial establishment.

The postcolonial 'state' embraces 'unity' as the means to prevaricate colonial tactics of divide and rule or any other threat of postcolonial polarization. Design of the 'state' mirrors imperatives of national integration, given the dangerous ethnic and social cleavages that pervaded the political and social landscapes in the three regions of the country,

At a political level, the 'state' advocates the single party designed to subdue and keep dynamics of a free society under surveillance and also force its various competitive tendencies to occur within a single defined political arena.

At the administrative level, the 'state' also advocates superiority of bureaucracy as structured machinery for awarding approvals of private activity while the state exercises regulatory control of all activity through central government, regional/provincial and district/local government.

The political and administrative configuration of the state has implications for the state economic agenda, poised to diminish colonial economic influence or its transmission to indigenous economic influence (Schacter, 2000).

In economic terms, the government postures itself as a benevolent amalgamation of newfound political values and economic authority seeking to provide for the needs of 'masses' hitherto marginalized by colonial rule. This practically relegates private enterprise to peripheral significance while public sector is defined along the principles of Stalinist-Marxist philosophy that the state should determine, inter alia, *"allocation of resources, distribution of income and consumption, levels of saving and investment, and relative prices of goods and services.*

In this context, private enterprise exists as the preserve of an elite utilising political power to accomplish objectives of political accumulation in a fashion that evokes the term 'capitalism of the few'. The phenomenon is reminiscent of the state driven cornering of the agricultural sector via massive land transfers from the poor, a phenomenon biologist Garrett Hardin (1968) had coined the expression, 'tragedy of the commons'.

Few exceptions occur in the extension of regulatory immunity to allies of the political establishment in a characteristic form of 'crony capitalism'. Pure private enterprise therefore subsists as a residual opportunity outside unmitigated public sector expansion and merely escaping the tentacles of restrictive government policy.

### **Economic Dimensions**

Unlike the acquisitive approach adopted in emerging communist states of the 1940's, public sector expansion in Malawi, as in other African states has been a resource driven phenomenon reflecting the combined leverage of domestic fiscal improvements and robust external aid.

Improvements in Malawi's fiscal viability derive from unbroken growth during 1964-78 when export commodity price inflation averaged 7.1% per annum. Using vast quantities of available land and credit, the estate sector had responded to favourable prices with massive expansion in agricultural output. This translated into high rates of agricultural sector growth averaging 4.1% per annum during 1965-80.<sup>5</sup>

Malawi's export revenues doubled from \$67million in 1967 to \$148 million in 1975, translating into robust expansion in aggregate demand. Most notable in these developments was phenomenal growth of incomes of tobacco farmers arising from 18.3% annual growth in output. Apart from accounting for improvement in the country's foreign reserves these outcomes also accounted for a major boost in fiscal revenues

These developments are reflected in overall GDP growth averaging 5.5% per annum, underpinning buoyancy in secondary and tertiary sectors.<sup>6</sup>

Total Debt to GDP ratios averaged 53.6 % (1967-73) reflecting the strength of inflows of concessional loans accounting for an average of 31% of total fiscal resources. Grants from donors also accounted for 9.8% of total fiscal resources (TFR).<sup>7</sup>

Domestic revenues accounted for 48.7% thus minimizing the need for domestic borrowing, which accounted for only 4.9% of Total Fiscal Resources. At 12.8% in relation to GDP (1967-73), domestic revenues far outpaced levels achieved in later periods when revenues averaged 8.1%.

### **Public Sector Expansion**

During much of the 1960's public investment had accounted for two-thirds of total investment, thus underpinning major improvements in social welfare as total expenditure on Health and Education exceeded 5% of GDP (Msosa, 1998). Capital expenditure also shot to the highs of 12% of GDP in 1970 and remained above 7% throughout the period to 1975.

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<sup>5</sup> Annual tobacco production rose from 20,600 tonnes in 1967-71 to 54,580 tonnes in 1980

<sup>6</sup> Industry and services growth averaged 6.4% and 6.7%, respectively

<sup>7</sup> Total Fiscal Resources include domestic revenue, domestic and foreign loans and grants

Despite continued improvements in fiscal resources during the mid 1970s, public resources became increasingly deployed towards a program of creating and supporting loss making state enterprises in industry, trade, finance, and farming and property development.

The government's created the Malawi Development Corporation as a publicly funded development bank specialized in establishment of new industries. MDC was mandated to provide long-term financing for investment in projects undertaken through acquisition of shares from foreign enterprises or completely new investments in industry. The rationale for the MDC was defined along the needs for robust financial and project development effort at the country's early stages of development.

Hence, MDC's key industries included the labour intensive Portland Cement Company of Malawi, which supplied cement to the local building and construction industry; packaging Industries, catering largely for cement and industrial carton box packaging as well as investment in Commercial Bank of Malawi, one of the country's only two banks after independence.

MDC also owned Cold Storage Company, the only approved abattoir and front for development of beef farming in the country; Agrimal, a company involved in production of hoes and farm equipment and Plastic products Ltd, also involved in industrial packaging.

The government also compelled the agricultural marketing board, ADMARC to establish ADMARC Investments Company with the sole purpose of recycling profits from produce trading into state ownership of industry. Much of its revenue base arose from the difference between the produce price of the maize staple and the price paid to ADMARC by urban consumers.

ADMARC also bought and sold [sometimes for export] a range of smallholder cash crops including cotton, groundnuts, sorghum, millet, etc. ADMARC also used trading profits to produce highly lucrative tobacco varieties for direct export to foreign markets.

Using resources from both trading profits and subventions from government, ADMARC built a portfolio of investments in various sectors of the Malawi economy. Apart from being the sole investor in Finance Corporation of Malawi, a trade bank exclusively providing import export finance, ADMARC joined Barclays and Standard Bank in the localization of National Bank of Malawi.<sup>8</sup>

ADMARC also owned Malawi Insurance Brokers Ltd acquiring a large share of insurance business from trade finance. ADMARC also established Grain & Milling Co Limited providing milled maize flour, the only alternative to maize grain sold directly through over 1000 depots established throughout the country. Grain and Milling also became the sole producer of bread flour for all bakeries in the country as well as poultry feed and animal feed.

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<sup>8</sup> The only other commercial bank apart from one owned largely by government and Malawi Development Corporation

In addition to the state owned ADMARC and MDC, the government itself invested in various enterprises that would elicit pure private sector participation. Through the Treasury, government acquired shares in the New Building Society, as a co-investor with Lonrho. New Building Society became the only mortgage company in the country.

Government also acquired a minority shareholding in Commercial Bank of Malawi, which supplemented MDC's investment in the same bank, resulting in majority state control. Government also owned Leopard Match Company, Malawi Catering Services, Malawi Dairy Industries, Malawi Property investment Company and the Malawi Rural Finance Company.

Press Corporation owned by Life President Banda undertook a number of acquisitions in the strategic areas of the economy. Press Corporation joined ADMARC as co-investor in National Bank of Malawi also raising the stake from the state sector. Press Corporation also joined MDC as investors in National Insurance Company similarly raising the shareholding of the state. Press also undertook joint investments with Carlsberg Denmark in Carlsberg Malawi, ensuring that it maintained a majority.

The state's presence in the agricultural sector was also manifested through Press Corporation, which owned a large number of tobacco estates under Press Agriculture Limited, General Farming Co Limited. This was in addition to Khasu, Mudi, Kasonjola and other private estates owned personally by Dr Banda.

Meanwhile, a personal company of Life President Banda, Blantyre print also acquired shares in Limbe Leaf tobacco, jointly with a global leaf buyer, Universal Leaf Company. Limbe Leaf tobacco, in turn, took up shares in Auction Holdings Ltd, the company owning all auction floors for tobacco trading in the country. Its co-shareholder was state owned ADMARC, practically keeping tobacco trading under state control.

### **State Domination**

Apart from enhancing state domination, the above ownership structures reflect strong infusions of politically appointed management. By virtue of state control of New Building Society and Commercial bank of Malawi, John Tembo<sup>9</sup> was state nominated Chairman in both companies, thus relinquishing 100% of mortgage finance industry to the same person as 40% of the commercial banking sector.

As chairman of Blantyre Print, owned by Life President Banda, John Tembo was also automatically appointed Chairman of Limbe leaf Co and Auction Holdings Ltd, which run the Auction floors. As a lead local shareholder in National Bank of Malawi, Press Corporation also had their managing director as Chairman and he came right under the Chairman of Press Corporation, who was also John Tembo, thus rendering 100% of the finance sector to leadership of one individual.

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<sup>9</sup> John Tembo was Uncle to Government Hostess Cecilia Kadzamira who was also private companion of Life President Banda

In the 1970's, Life President Banda issued a directive removing all Asian traders from the rural areas to urban and peri-urban centers. This paved the way for expansion of Peoples' Trading Centre retail shops owned by his own Press Corporation. Lonrho, a company owned in London by Tiny Rowland, a personal friend of the Life President also established Chipiku stores dominating the entire rural wholesale network.

Peat Marwick & Co, a public accounting firm owned by a personal financial advisor to Life President Banda became the only firm to audit farms and estates that obtained loans from Commercial Bank of Malawi (CBM). Conversely, the appointment of Peat Marwick & Co as public accountants and auditors became a gateway to financing from Commercial Bank of Malawi.

In 1984, the Malawi government specifically issued bonds purely for debt recovery replaced Bad debts of Press Corporation to Commercial Bank of Malawi amounting to \$39 million. Both companies had one chairman: John Tembo. In the 1990's, Six million shares held by Press Corporation in loss making Dwangwa Sugar Corporation, were simply transferred to government in exchange for the state treasury issuing a cheque for the nominal value of the shares at time of acquisition. Lynod Chakakala Chaziya was both Chairman of Press Corporation and Minister of Finance.

For all intents and purposes, the government's intrusive hand in the private sector, coupled with personal business interests of the President practically drove Malawian entrepreneurship to the informal sector. Foreign investment materialized only if undertaken in partnership with government, its agencies or the President's companies.

Although state ownership of agricultural marketing boards had economic justification, the concept of extracting surpluses from poor farmers to finance state owned investments in industry and commerce remains a reincarnation of colonial exploitation. The government's own election manifesto had gone to great length with indictment of state paternalism under colonial rule as the main cause of widespread poverty and deprivation.

The pace and ferocity of state presence in the private sector in Malawi is such that it rivaled any program of nationalization undertaken in the eastern block. Sound business remained a preserve of the top political hierarchy while the average Malawian businessmen was relegated to the fringes of entrepreneurship. Despite availability of ventures of interest to foreign investors, the fact that they could not find a pure indigenous partnership resulted in many such ventures being abandoned. This was the case with investors seeking non-involvement in politics. This may partly explain the country's persistent state of technological backwardness, limited diversification and integration to international markets.

## Chapter 2

### INDUSTRY POLICY IMPLICATIONS

#### Protectionism

A major concern over public policy in Malawi is that organs of government have been awkwardly positioned as competitors as well as regulators of private enterprise as a result of extensive state involvement in the private sector. By virtue of its ownership of business, the government ceases from being a fair regulator of a level playing field for business to an institution privileged with regulatory powers to use against its own competitors.

The government's requirement for an industrial license before commencement of any industry may have been introduced as a regulatory measure but its outcome exemplifies the motivation to mount barriers against competition. The provision for license was promulgated in the Industrial Development Act of 1966, but the precondition for investors to prove source of funds for the business, conclude company registration and also ensure that land and foreign exchange had been procured meant that any potential investor had to face an array of state institutions with mutually exclusive decisions to make.

For example, land approval was the responsibility of the Ministry of Lands, while Ministry of Justice administered registration of companies. ADMARC, MDC, PRESS CORPORATION or the treasury, all of which were institutions within the state apparatus, either controlled sources of finance or were the funding sources themselves. The Exchange Control Act, administered by the Reserve Bank of Malawi, another state institution, also regulated the provision of foreign exchange.

Although preconditions for license, source of funds, company registration and land and foreign exchange underline interdependence of state institutions, there was no particular logical order in the decision making process. Business proposals that enjoyed widespread support may easily have suffered the 'free rider' problem as each willing institution thought it could only move after the other institution had moved first. In the process no institution moved and this was the subject of many investors who relocated to neighboring countries.

Since each application had to be made separately to each organ of government, there was obvious asymmetry and its accompanying costs as each agency required its own set of information. Typical of a bureaucracy, there was no sharing of information except the decision outcome of an application. Lack of transparency also entailed high uncertainties given that a negative decision in one ministry could have been reversed a positive decision in another.

Some business proposals suffered a 'critical herd instinct' especially if they were attractive. The natural instinct of a public official was that, given the preponderance of state enterprises or the President's empire, any sound proposal undertaken privately would have circumvented their

imperial interests. The tendency to 'wait and see' or wait instructions had the effect of protracting the period of consideration thus killing off entrepreneurial enthusiasm.

Through its control over the two commercial banks, the state funded development bank and the mortgage company, the government also controlled the flow of funds to enterprises. The authority to approve foreign exchange also remained in the hands of the Reserve Bank of Malawi. These arrangements did not change after the government established the Malawi Investment Promotion Agency (MIPA), which became relegated to a protocol office for investors.

The only innovation under MIPA was that it comprised officers seconded from organs of government not necessarily representing those organs. By replacing the investor in the communications, MIPA developed a certain flow in the application processes sometimes engaging senior members of the board to lobby with senior government officials.

Certain processes would still remain unchanged; company registration took a minimum of six months as applicants' details were vetted by the intelligence agencies, while formalization of a land lease would take up to two years. Loan applications would take longer, sometimes requiring invoices to be revised thus resetting the exchange control application process.

Despite these difficulties, final issuance of a license still depended upon existing industries agreeing to competition. A common excuse involved trivializing the size of the market to justify the fact that existing operators had adequate capacity to meet domestic demand. Some licenses were granted, but on condition that the new operator did not sell locally.

In most cases disputes protracted over a period of two to five years, during which prices of capital equipment changed affecting project viability. The sensitivity of such disputes was that they involved communications with chairmen who had been politically appointed to such positions and were more likely to influence a financing decision after the license had been issued.

### **Inward Looking Industry**

Much of the industrial development undertaken by state enterprises in Malawi since independence was in tandem with government's policy of import substitution that aimed to generate savings in foreign exchange incurred on finished goods imports by producing them locally. Initially, the policy seemed to work as a result of the impetus from agricultural expansion and its implications on growth of domestic aggregate demand.

In the early years after independence, Malawi achieved high rates of industrial growth averaging 6.4% per annum (1965-80). This was attributed to expansion in industries processing agricultural products (especially tobacco, tea and sugar) and growth of import substitution industries producing consumer goods for a captive market (see trade controls, below).

Industrial growth was reflected in doubling of the index of manufacturing employment from 91.0 in 1969 to 184.0 in 1978 (1970=100, UN Statistical Yearbook, 1979/80, page 89). The index of industrial production also rose sharply from 56 in 1970 to 122.0 in 1978 (1975=100). As at 1969, Malawi had only 1,200 workers registered unemployed.

However, the implications of import substitution policy have been largely adverse for Malawi. The limited size of the local market meant that capacity utilization in most industries depended on high rates of growth in domestic aggregate demand for consumption. In the absence of established industries manufacturing for the export market, a drop in export prices during the late 1970's marked a major turning point in industrial expansion in Malawi.

The resulting contraction in the flow of foreign exchange, hence negative growth rates for net national income translated into serious constraints in the growth in domestic aggregate demand. Consequently, industrial expansion receded to only 2.2% per annum 1975-84, some of which was absorbed in a build up of inventory.

The rate of growth of industrial raw material imports declined in tandem to the drop in domestic aggregate demand. Subsequently, industries also suspended long term investment decisions and reduced capital imports, followed by major reduction capacity utilization, and finally the labour force.

The resulting downturn in the economy was broad based as reflected in declining wages in every sector of the economy as shown in Table 3.1. The highest drop occurred in the manufacturing sector with wages dropping from \$75 in 1980 to only \$13.00 in 1995, losing 83% of the value.

**Table 3.1: WAGES IN ECONOMIC SECTORS OF MALAWI (CURRENT \$ PER MONTH)**

	1980	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
Agriculture sector	20.00	14.00	13.00	12.00	13.00	15.00	16.00				
Industrial Sector	75.00	54.00	57.00	53.00	53.00	65.00	55.00	47.00	40.00	21.00	13.00
Mining & Quarry	36.00	29.00	20.00	17.00	17.00	20.00	30.00	23.00	59.00	30.00	18.00
Construction	60.00	31.00	29.00	29.00	29.00	30.00	31.00	34.00	33.00	22.00	17.00
Trans, storage & Comm.	99.00	50.00	47.00	49.00	62.00	63.00	70.00	66.00	63.00	37.00	25.00
Community, Social & personal							59.00	50.00	43.00	24.00	12.00

Source: African Development Indicators 1998/99

These indicators suggest that deterioration of Malawi industrial output and the consequent rise in unemployment are characteristic signals of the pitfalls of a policy of import substitution industrialization where market viability is exogenously determined. Even if it is argued that the rationale for industrial protection was not to protect government interests in business but to avoid industrial saturation given the limited size of the domestic market, the policy failure subsists not in protection but in industrial orientation.

Given the sensitivities of the export market, especially after the 1973 round of oil price increases, Malawi greatly needed to prevaricate dangers of export price deflation that by strengthening her export base. A possible avenue existed in the promotion of non-traditional exports, but the government's emphasis on an inward looking industrial strategy and the accompanying restrictions had destroyed incentives for development of any industry.

## Chapter 3

### TRADE POLICY IMPLICATIONS

#### **Tariff Restrictions**

The commitment of government to protect Import Substitution Industry is also manifested by protectionist trade rules placing heavy restrictions on imports. This included license requirements for certain imports and physical controls in the form of quota restrictions. In some cases, the government sanctioned a complete embargo against specified imports or imports from certain countries.

Although rationalized on grounds of revenue generation, the system of import tariffs appeared to have served the functions of largely holding back imports. The fact that tariffs were not uniform for all products and that the methods of cascading additional rates of surtaxes, excise duties and levies differed among various imports suggests a discriminatory element was present. The entire tariff regime was consistent with a policy of discouraging domestic consumption of certain imports and, by implication, protection of certain local industries.

The tariffs effectively combined with other required authorisations making importation cumbersome as well as raising transactions costs. Where an import licence was required it was critical that the importer obtained authorisation from the Ministry of Trade, before an application for foreign exchange would be lodged with the Reserve Bank of Malawi.

If the arguments for import restraint are accepted, the policy of high tariffs does not seem to have recognized the differential effects on final products in relation to raw materials entering the production process. The negative impact of tariffs has been significant on industries using imported raw materials thereby raising the cost of production and tying up large amounts of capital in the form of work in progress.

The inequities of government involvement in business are also manifested by the frequency of tariffs waivers awarded against state enterprises thus placing the pure private sector at an undue disadvantage (Tanzi, 2000). State enterprises also enjoyed guaranteed markets in the public sector as well as access to bank finance to meet raw material obligations.

#### **Export licensing**

Government also mounted trade restrictions against exports considered essential raw material for domestic industry. For a long time exports of groundnuts and cotton were liberal until shortages at local factories forced government to prohibit export. Groundnuts and cotton were significant inputs to edible oil production and textiles, respectively. Shortages had arisen from the fact export prices were almost double those offered locally.

Conventional economic logic would dictate that domestic users of groundnuts and cotton paid export parity prices or the government itself provided subsidies to the industrial

manufacturers of oil and textiles. However, the restricted nature of factor markets in Malawi was such ADMARC owned both ginneries and therefore held a complete monopsony for raw cotton.

Government therefore permitted the exploitation of maize producers to extend to producers of both groundnuts and cotton with obvious negative implications for rural incomes. In effect it was ADMARC that held the export license in anticipation that excessive production required offloading on the export market, but without change to the underlying producer price. ADMARC turned out to be the main shareholder in the textile factory and the ensuing oversupply resulted in ADMARC also acquiring National Oil Industries using cotton seeds as inputs while extra lint was exported.

The effect of these restrictions has been to create opportunities for economic rent. For imports, license holders exploited the market both in terms of over pricing in the face of limited supplies, as well as demands for prepayment made before imports reached the country. It was also common practice for traders to hoard goods and induce artificial shortages from which they could profit.

### **Over-regulation and Corruption**

High tariff rates raised the incentives for smuggling or under-declaration of goods imports given the magnitude of savings from duty evasion (Tanzi, 1998, Van Rijckeghem & Weder, 1997). Where traders complied in full, high tariff rates almost always resulted in the extra cost being passed on to the consumer.

There is no record of cotton and groundnuts smuggled from Malawi [as expected] although there are indications that more than 50% of the crop was involved. From 171,000 tonnes in 1980 groundnuts output sold to ADMARC was down to 141,000 tonnes in 1988. Output sales declined throughout the 1990's reaching 31,000 tonnes in 1994. However, liberalization of producer prices since the advent of democracy in Malawi has resulted in ground nut output sales bouncing back to 70,000 in 1997. Cotton has registered the same trend.

Overall, licensing has not benefited Malawi. Tariffs on imports have tied capital into raw materials before value is added thus undermining capacity utilization with the negative consequences for job creation. In the absence of government policy on re-exports, industries also faced higher import costs of production and the inevitable export price disadvantage.

In fact, protection has not protected Malawi industry. Essentially, the economy should have been protected from adversities of export commodity price deflation, not from domestic competition. Performance of state enterprises was generally dismal, due to poor management, political interference, and organizational inefficiencies of state bureaucracy that protection offered no real advantage. Despite unlimited access to public resources, public sector investments were already poorly conceived, and the design and quality of their products/ services was so poor and pricing so sub-optimal that protection could not alleviate.



## Chapter 4:

### FINANCIAL POLICY IMPLICATIONS

#### **Directed Credit**

State control over banks exercised concurrently with ownership of commercial state enterprises presents a case of conflict of interest whose implications are difficult to resolve in the context of the distinction between fiscal and monetary policy. Beyond direct state subvention of parastatals, government role in directed credit schemes was tantamount to channeling the peoples' private savings into funding of state enterprises. The fact that interest rates had been artificially low also supports the charge that resources of ordinary citizens have been used to subsidize politically inspired state entrepreneurship.

Given that bank provision of credit to non-performing enterprises relied on the generosity of the state to refinance them when such funding turned into bad loans, fiscal policy remained inextricably fused with monetary policy. Technically, the state also exercised fiscal policy via the monetary institutions.

It is also arguable that the governments caused major failures in allocative efficiency of the financial system by awarding credit on the basis of institutional alliance than on the basis of the marginal efficiency of an investment or ability to repay. As a result of state inspired modalities for credit allocation, a large section of the independent private industrial sector, which undertook competitive business activity with potential for creating jobs, simply remained excluded from the credit system.

As a result the private sector share of credit was only 24% in 1987, a drop from 76% in 1973. During the same period, the share of bank credit to the public sector rose from 44% to 69%. Despite such privileges, state enterprises failed to live up to their mandate of supporting industrialization; their share of non-agricultural GDP was only 6.1% in 1985, down from 11.1% in 1980.

Like the policy of subvention of state enterprises, sustainability of interest rate repression and the system of directed credit also depended on continued favourable performance of the export commodity sector from which much of the savings were derived. Success of the policy also depended upon exchange control limiting the range of alternatives available against the domestic financial assets.

These policies also suggest that government had opted for short term budget supported venture capital development at the expense the important task of creating functioning capital markets to support a self-sustaining market for investment financing. Continued government ownership also undermined the task of laying institutional foundations of bond and equity markets that would have been facilitated by private ownership. To underline the fragility of measures put in place by government, public funding and the policy of compelling banks to

lend to specific sectors experienced a major setback at the onset of the drop in export commodity prices in 1978.<sup>10</sup>

### Interest Rate Repression

For much of the 1970's and 1980's, government held interest rates below market-clearing levels thereby engineering a massive transfer of wealth from savers (mostly households) to parastatal borrowers.

Moreover, because strict foreign exchange controls prevented households from converting their savings into foreign assets, households were forced to accept negative real interest rates. Real deposit rates have not been positive in Malawi until 1990.

Agenor and Montiel (1996) define financial repression as a phenomenon associated with negative interest rates caused by government interventions. McKinnon (1988) identifies financial repression in the context of reductions in the flow of loanable funds associated with discretionary bank lending.

Agenor and Montiel also identify financial repression as a source of retardation in investment, which occurs by punishing liquid assets and encouraging inflation hedges. They also argue that financial repression also undermines monetary stability required to support robust open markets in stocks and bonds.

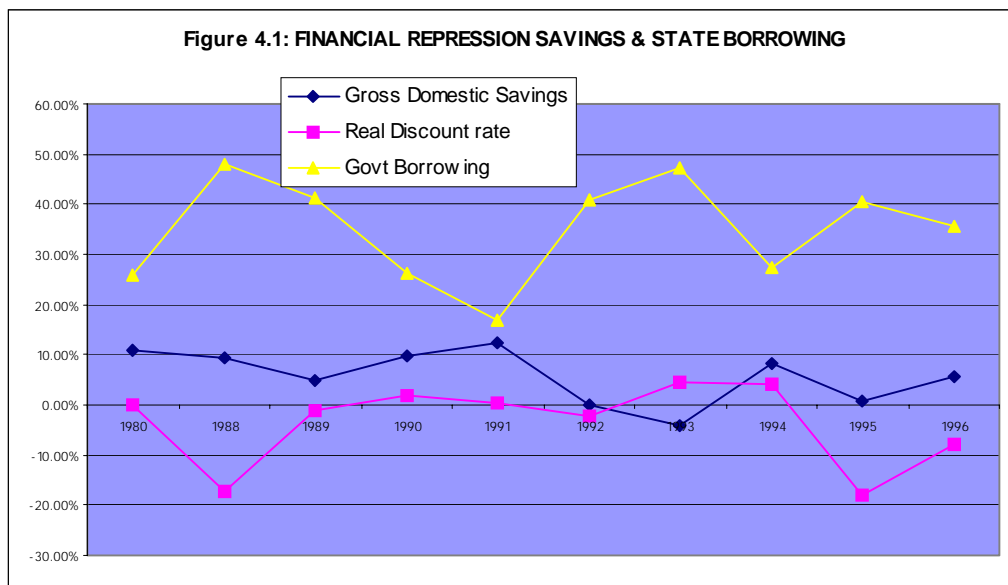


Figure 4.1 above shows that the Malawi economy seems to save more when the government is borrowing less and vice versa. This would suggest that financial repression is also consistent with government desire to secure resources to finance the budget or resource transfers to selected industries in the parastatal sector at a very low cost.

<sup>10</sup> Commercial bank once provided lending to tobacco farmers buying off estates from ADMARC only

There is nothing seriously wrong about public financing or directed credit, but in assessing whether selective interventions were good for growth, the desirable approach would have been to set prerequisites for success. In that way government would be using criteria for evaluation and distinction of good from bad projects.

The experience of Malawi is that Policymakers concentrated on propping up industries without engaging in evaluation or restructuring to avert failure. The governments also neglected to develop institutional mechanisms to establish clear performance criteria for selective interventions and also to monitor performance. The role of government seems to have been predicated on the provision of cash to avert stoppage.

### **Exchange Rate Policies**

Through the Reserve Bank of Malawi, the government also persisted with a system of rationing foreign exchange without transparent and objective criteria. In some cases, local availability of products being imported was enough ground for rejection irrespective of pricing considerations, term of payment or product specifications.

The combination of exchange controls, tariffs and the authorisations was cumbersome enough to raise transactions costs and dissuade potential importation. Where an import licence was required it was critical that the importer obtained authorisation from the Ministry of Trade, before an application would be considered for foreign exchange by the Reserve Bank.

Bank rules also restricted consideration of import approval only for importer who would have deposited the equivalent amount of the value of imports with their bank. Due to lack of adequate information, the Reserve Bank ended up approving finished products while declining importation of raw material to make the same product. In the event that exchange control approval was obtained, importation also had to take place within 90 days. Any change either in price of the suppliers or the cost of insurance and freight required a fresh submission of a revised set of certified invoices.

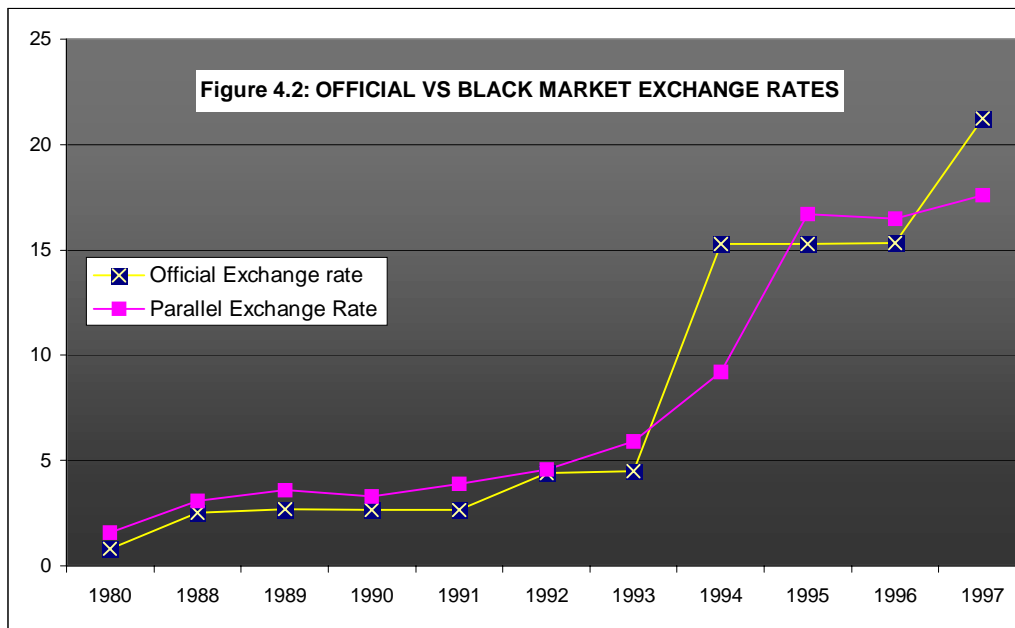
These arrangements clearly stifled Malawi's ability to participate effectively as a trading partner in the international economy. Most significant was the negative impact of these arrangements on industries using imported raw materials recurrent work stoppages. However, state enterprises experienced limited hurdles thus placing the pure private sector at a multiple disadvantage.

The system clearly distorted incentives for competition, as importers were required to have proceeds from exports reach their account within 90 days from the date of export, thus making it impossible to offer competitive payment terms.

## Black markets

Figure 4.2 below suggests that rationing of foreign exchange promoted the rise of a black market. Throughout the 1980's, the black market price of foreign exchange remains above the official rate, except 1994 when the Kwacha experienced a major devaluation.

Theoretically, this implies that shortage of producer goods caused by inadequate availability of foreign exchange may have placed a price premium on certain goods resulting in profit being earned outside the confines of productivity. The high profit margin hurt the consumer as raising the price of foreign exchange in parallel markets, which became an acceptable norm within the limits of rational business.



On the supply side, government exchange controls implied that exporters who earned dollars face the trade off between queuing up to regain access to their own foreign exchange or dispose it at a price that covered the costs of queuing up for more foreign exchange.

It can be argued that these were not the right conditions for Malawi to develop a viable industrial sector. Free private enterprise with ready access to foreign exchange and lower tariffs would have been the ideal conditions of successful industrialization policy. Despite their privileged position, parastatals experienced episodes of foreign exchange shortage, which became generalized throughout the private sector. This had implications on the use of industrial capacity and job creation.

## Chapter 5:

### COSTS OF THE PUBLIC SECTOR

#### Economic Downturn

The end of Malawi's fortunes did not come abruptly. The first wake up call came from a 39% drop in export prices in 1978, as a result of the worldwide recession triggered by the second round of the oil crisis. Although export prices remained favorable, growing at 3.8% per annum during 1975-84, agriculture expansion declined to an annual average of 2.2% reflecting receding prospects that influenced precautionary uptake in farm credit. This translated into lower rates of GDP growth averaging 3.2%, also reflected in growth of industry and service sectors, at 2.7% and 3.7% per annum, respectively (see: Table 5.1).

The period from 1970-76 saw inflation rising to 9.8% from only 2.3% in 1960-70. During 1980-90 annual inflation surged further to an average 15%. Over a period of fourteen years (1975-1989) per capita GDP remained stagnant at \$164, and the Kwacha showed signs of fatigue, losing 1% of its value every year (1975-84) and losing a further 2.2% per annum during 1985-89.

**Table 5.1: ECONOMIC AGGREGATES (annual average growth)**

	1965-80	1975-84	1985-89
GDP (annual growth)	5.50	3.20	1.90
Agriculture	4.10	2.20	1.20
Industry	6.40	2.70	3.70
Services	6.70	3.70	3.70

*Source: UN Statistical Yearbooks, 1978, 1985 and 1992*

From a high of 25.3% of GDP (1975-84) gross investment dropped to 17.3% (1985-89), the biggest drop being registered in public investment from 13.6% to 8.2% of GDP during the same period. The build up of uncertainty, stagnation in confidence and rising interest rates also resulted in a drop in private investment from 7% to 6% of GDP.

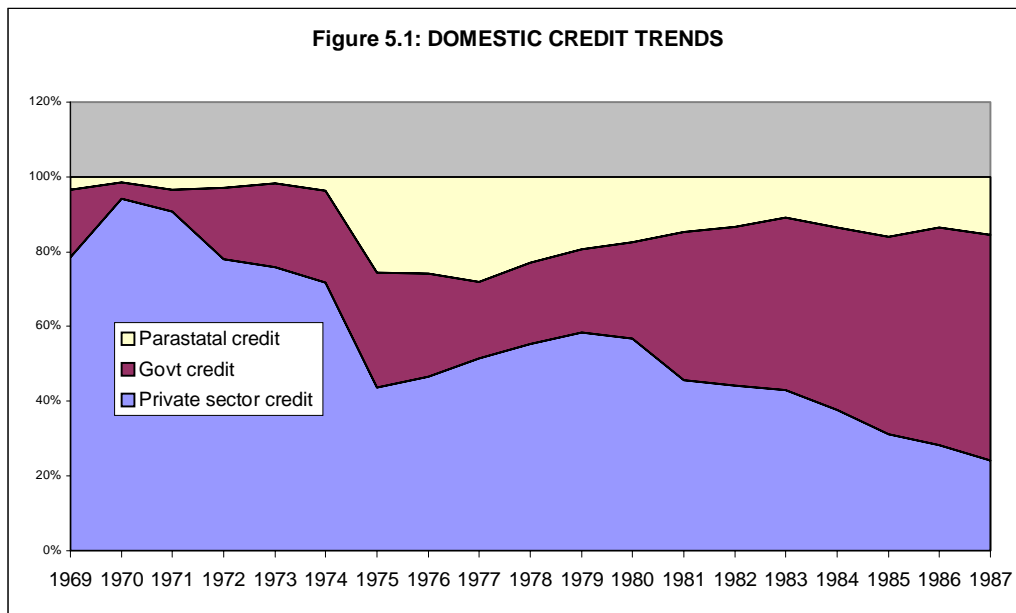
These adverse developments arose from retarded annual growth in export prices from 3.8% in 1975-84 to only 1.4% during 1985-89, which worsened to 0.2% during 1990-98. At the same time costs of imports continued to rise under the influence of high costs of petroleum products.<sup>11</sup>

The subsequent period of 1980-94 saw the economy and the public sector enter a period of serious imbalance. There were severe shocks, including increases in oil prices and transport costs related to external trade, as routes through Mozambique were disrupted by civil war. The war in the neighboring country forced up to 750,000 refugees into Malawi, at a time when it was experiencing severe drought.

Investments dropped sharply and foreign reserves dwindled. Growth for the period 1980-94 was only 1.6 percent. The budget deficit, rising to 15 percent in 1980 alone, averaged above 10 percent during 1981-87, and escalating back to 15 percent in 1994.

Pressures arising from deteriorating economy and rapid expansion of the parastatal sector obviously weighted heavily upon the fiscal budget. Persistent losses by parastatals had resulted in government providing the resources to keep them running, at least until 1974.

Government persisted in avoiding the question of reforming the sector to make it more independent, market orientated, efficient and competitive. Instead, priority was given to reduction of parastatal drainage of public resources, a strategy that saw a mere redirection of the financial hemorrhage from the fiscal budget to the banking sector.



From only 2% in 1973, the share of bank credit consumed by parastatals rose to 26% in 1978. The crowding out effects resulted in private sector access to credit declining from 76% to only 51%, during the same period.

### Crowding Out Effects

Figure 5.1 above shows that despite fiscal relief from redirection of parastatal financing, government continued to exploit exclusive privileges of obtaining credit from the Central bank to sustain its appetite for spending. As parastatal share of credit was soaring, government share of credit remained between 22% and 23% through out the period but the combined total

<sup>11</sup> Import prices rose by 6.4% per annum during 1975-84 and escalated to 8.4% per annum during

government and parastatal borrowing soared to account for 76% of domestic credit (1983-87). Private sector borrowing which was reduced to only 24% reflects much the working capital deficiencies that characterized the private sector.<sup>12</sup>

Reforms aimed at making state enterprises more independent, market orientated, efficient and competitive were perceived as a means of wresting their political control over the economy. Reluctantly, though, some African states agreed to address the drainage of public resources by ending state enterprise dependence on the fiscal budget. However, in the absence of progress on liberalization of the financial sector, this strategy saw a mere redirection of the financial hemorrhage from the fiscal budget to the banking sector. In most African states, this is reflected in the rising share of bank credit consumed by state enterprises.

The end of communism in Eastern Europe had the effect of heightening African of how the continent had positioned itself in such a way that emphasized its own vulnerability to economic meltdown. Large public sectors and intrusive government showed that the African experience of state making had been about moving states from colonial conflict and chaos to nationalist exploitation. Large public sector had achieved consolidation of political space more than the presumed economic benevolence. The single party system and the stifling bureaucracy had emerged as instruments for perpetuation in power ambitions of a particular clique.

### **Economic Impact of Public Sector**

The reality remains that the parastatals sector had increasingly become a major liability prompting the World Bank to urge Malawi authorities to introduce a combination of measures to improve the management of parastatal finances, while fostering development of private industry, in a transition towards making capitalism more significant.

Declining significance of the public sector is evident from reductions in its contribution to national output. Within a short span from 1980 to 1986, the sector's contribution to GDP dropped from 9.5% of GDP to only 3.9%. Contrary to government's justification of the role of State enterprises in industrial development, the share of public enterprises in non-agricultural activity had declined to only 6% of GDP in 1991 from 11.7% in 1980.

Their share of gross domestic investment also declined to only 10.2% from 49.6% in 1980. In relation to national output, the share of public enterprises in gross investment also declined from 12.3% of GDP to only 2.2%.

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1985-89

<sup>12</sup> In the early 1990s donors withdrew their balance of payments support to Malawi to demonstrate their increasing concern with both the poor fiscal discipline of the government and its human rights violations. The donor community also hoped that aid retrenchment would force the government to hold multiparty elections and pave the way for reform of the economy

Invariably, Gross domestic credit to public enterprises accounted for 38% of GDP in 1986. Apart from covering operational losses, most such credit went to payroll demand of bloated employee registers, which consistently accounted for 12% of formal sector employment in the country. The deleterious effects of parastatal borrowing is manifested by the fact that the share of public enterprises in domestic credit 'outstanding' was as high as 20.4% of GDP in 1991. This was despite state subventions averaging 1% of GDP from 1985-89.<sup>13</sup>

It is inconceivable therefore that despite their prolific role in consuming credit from the banking system, state enterprises contributed a declining share of national output. Furthermore, their share of investment declined, suggesting that most of such borrowed nourished bloated employee registers as well as financing the perks of politically appointed managers. The loss to the economy can be determined in terms of the use such resources would have generated if they had been deployed in the pure private sector. The opportunity costs are very high.

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<sup>13</sup> Quantification of the precise degree of resource haemorrhage by parastatals is a trick exercise is a complex task because it would include Indirect transfers including the absorption of losses, exemptions or non-payment of duties and taxes which remain a major drain on public budgets

## DISCUSSION

The evidence generated in the foregoing suggests that the view that State Enterprises were founded out of the best of intentions stood in contrast to glaring fiscal losses that had resulted in reduced social spending and worsening social indicators. Any attempt to legitimize the role of state enterprises charts a collision course to the fact that these firms had hemorrhaged credit from the banking system that legitimate private investors was driven to the fringes of entrepreneurship.

Government's acceptance of privatisation under the Industrial Trade Policy Adjustment Credit (ITPAC) in 1987 reflects a mere acquiescence to program proposals for which there existed no other alternative. The main obstacles to privatisation in Malawi had been distrust of private enterprise. The fact that privatisation was synonymous with depriving government the means of economic control aroused a tenacious bureaucratic resistance.

Government's intransigence owes to the fact that mistrust was part of the sentiments embodied in the Department of Statutory Bodies, which had failed to oversee improvements in parastatal financial management. Undertaking privatisation within the same institutional framework was tantamount to accepting change without serious commitment.

As a result, 13 years later privatisation resulted in only 35 transactions being completed between 1980 and 1993. This does not compare with the fact that the new government concluded 9 privatisations in 1996 alone. In a period of five years (1996-2001), the new government had concluded 44 privatisations, raising a total of \$1.2 billion.

These results suggest that change of political guard in Malawi in 1994 brought fresh attention to a public sector reform program. The new government embraced an economic agenda based on the premise that privatization required an end to distrustful politics. By advancing political freedoms of expressions, an end to human rights abuses and also free enterprises the atmosphere for distrust dissipated while the philosophy of government shifted from obstructive regulation to demonstration of authority and political will to incentivize free enterprise.

The new government advanced the view of Adam Smith that the state is "*a spectator that steps in to correct the actions of the private sector when it commits errors of commission or omission*". These new beliefs about reduced size and role of the public sector epitomize the contrast between the Malawian old and the Malawian new.

The changed role of the public sector in Malawi is aided by the fact that the government is moving towards market liberalization to eliminate price distortions caused by subsidization and price controls. Unrealistically low interest rates that provided cheap credit to the public sector have been replaced by market-determined rates that aim to allocate capital in accordance with the marginal efficiency of capital. Prudential rules are also in place to limit concentrated borrowing by enterprises endowed with enormous collateral.

Government withdrawal from the banking system has ended the system of directed credit thereby making more financial resources accessible to the private sector. In response to the advent of free and fair competition in the banking sectors, there is increased and diversified development of financial institutions. Potential long term gains point towards more financial deepening and competitive lending.

Exchange rate liberalization has also eliminated implicit subsidies on imports that encouraged inward looking industry. A range of incentives for export industries and realigned currencies are encouraging development of domestic resource based industries targeting the export market. Having raised the domestic opportunity cost of importation, currency values determined by the market is contributing to slower net growth in external debt. The problem of capital flight has been arrested.

The government has also undertaken the task of dismantling discriminatory tariffs that amounted to piggy backing of inefficient enterprise. Trade liberalization is ending the captivity of domestic markets, thus presenting the consumer with choice and the benefit of price competition. Industrial liberalization has also archived requirement for industrial licensing for new entrants.

The new regime also has public expenditure choices defined with a growth-orientation, focusing on its contribution to national savings, expenditure on infrastructure, incentives to invest and cleaning up of the remaining public debt between enterprises and banks. Generally, public expenditure choices are becoming more market-orientated, undertaken like private investment with cost-benefit analyses done prior to investment. An increasing share of expenditure is also being devoted to health and education.

However, despite all the energies directed at economic reform, the new government is facing serious difficulties associated with downsizing of government. The end of subsidization of enterprises means that disguised unemployment is manifesting itself into widespread joblessness. Reversing these measures, at the instigation of political activists and interest groups fiercely oppose many of these measures, means that budget deficits re-emerge and government remains trapped in the vicious circle of stabilizing the economy in the face of declining foreign aid resources.

The tax system has also failed as the economy embarked on the transition to market-orientation. The revenue collapse owes to incompatibility of the old taxation system with a new market-based economy. Privatization means that the state is faced now with millions of individuals and privately owned enterprises while liberalization of prices and wages to market-determined levels means that the state is no longer be firmly in control of the tax base.

High inflation that accompanies liberalization also undermines profits of enterprises, hence less taxable income. Since the onset of market reforms the private sector has become larger and difficult to tax. Financial reforms also mean that the state had to sell off corporate control of

the banking sector to private interests. It is therefore becoming cumbersome to levy withholding taxes without requisite information.

There is also rising disagreement over the policies of the IMF requiring government to reduce expenditures sufficiently so that budgetary surpluses should allow the state to mobilize savings in the private sector, provide resources for privatization and allow the banking sector to foster private investment. However, demands of the development program in Malawi are so imperative that deficit monetisation is inevitable under conditions of inadequate donor funding. Stabilizing the economy demands high interest rates that are hurting private sector institutions.

The reality remains that utopian expectations of the public sector driven political economy have systematically disintegrated. The lesson for the new economic regime in Malawi is to promote more rational management of economic forces and also allow the classical liberal tradition of individualism, free markets and limited government to prevail.

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