REPUBLIC OF BOTSWANA

2012/13 BUDGET STRATEGY PAPER

Ministry of Finance and Development Planning

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A. INTRODUCTION

1. Government adopted a Public Finance Management Reform (PFM) Programme as a response to the current socio-economic challenges that require prudent management of public finances. The objective of the PFM Reform Programme is to ensure optimal utilisation of public resources for long-term sustainable development. It is aimed at strengthening financial management, effective and efficient service delivery and accountability. This Budget Strategy Paper (BSP) is prepared as part of the Public Finance Management Reform Programme. The BSP is one of the consultative methods used to enhance transparency and accountability, get feedback from stakeholders on issues that affect Batswana and to enhance understanding of the broad macro-fiscal issues that guide the budget processes and priorities. In other words, the BSP provides broad-based guiding principles for consideration when preparing the Budget and the Budget Speech. It is aimed at enhancing the management and efficiency of public spending to achieve better services to the public given limited resources.

2. The 2011/12 Budget Strategy Paper and the 2011 Budget Speech defined policy objectives which among others included balancing the budget by 2012/13, reducing the size of Government (particularly the wage bill as a percentage of GDP) over the medium term and making the most out of every Pula of public expenditure. This was aimed at achieving the goals of; rapid economic growth, eradication of abject poverty, employment creation and enhancing economic diversification. Strategies for achieving these among others included, focusing on high return Government initiatives as well as creating space for private sector growth, and continuing to build the necessary infrastructure. While all these policy objectives still remain relevant to date, some of the projects driving them will be completed by the end of the 2011/12 financial year.

3. This is, therefore, as an opportune time to set or refocus priorities and spending for the 2012/13 financial year. It is equally important, as we approach the mid-point of the tenth National Development Plan (NDP 10), to critically take stock of policies, strategies and projects and reprioritise such in line with the Plan objectives and indeed with Vision 2016 goals. For these to occur, all concerned must develop an understanding of the cost-effectiveness of the various components of their spending and that of others so that funds are allocated in the most effective way within the constrained revenues. Further, with fewer resources and tight budgets to satisfy diverse needs in the future, much more emphasis must be placed on the quality of public spending. To achieve this it will require extensive consultation within the public sector, local authorities as well as the political arena. In this regard, the BSP will be made available to the public through forums such as

stakeholder workshops and Government website as a way of sharing information, enhance transparency and accountability of the public sector.

4. This Budget Strategy Paper starts with an overview of the performance of key economic variables and gives a snapshot of projections for 2011 and beyond. This is followed by fiscal strategy and budget priorities, options for restoring the fiscal balance and implications of for the 2012/13 priorities and budget ceilings.

B. ECONOMIC PERFORMANCE

- ***Economic Growth***

5. Following a contraction by 4.9 percent in 2009, the domestic economy seems to be on track to recovery with the overall economy registering a growth rate of 7.2 percent in 2010. This is mainly attributable to significant improvement in the mining sector, with a growth rate of 7 percent in 2010, compared to a decline of 21 percent in 2009. The non-mining sectors also registered robust growth of 7.3 percent in 2010, from a modest growth of 4.3 percent in 2009. All the non-mining sectors registered positive growth rates led by agriculture (15.7%), construction (15.4%), trade, hotel and restaurants (9%), manufacturing (6.6%) and water and electricity (5.5%), while other sectors recorded an output expansion below 5 percent.

6. The good performance in the non-mining sectors is encouraging, especially given that growth in general government slowed down in 2010 in contrast to what was realised in 2009. This may imply that tightening of government spending to restore fiscal sustainability is beginning to bear fruit at least in the short term. Against this backdrop, the role of Government in the economy should be reduced further and restricted to those services that cannot cost-effectively be provided by the rest of economy. Going forward, Government will focus on providing a conducive environment for private sector-led growth and development.

- ***Monetary Policy***

7. Botswana's monetary policy is guided by the medium-term objective for inflation, as derived from an assessment of prospective developments for various determinants of inflation. Monetary policy continues to focus on achieving sustainable, low and predictable level of inflation which helps to maintain international competitiveness of the domestic economy and contribute to the broader national objectives of sustainable economic development, employment creation and diversification. High and volatile inflation is detrimental to economic growth as it discourages financial saving and generates uncertainty for investment decisions; and it also erodes the purchasing power of incomes, hence reducing living standards.

8. With the medium term inflation outlook looking positive, it is anticipated that inflation will fall within the objective range in the second half of 2012. It is on this basis that the bank rate was maintained at 9.5 percent since December 2010. This is expected to contribute to savings mobilisation, and fostering productive investment while facilitating international competitiveness of the domestic industry.

- ***Exchange Rate Movements***

9. The exchange rate policy focuses on maintaining competitiveness as measured by the real effective exchange rate (REER). Botswana introduced the crawling band exchange rate mechanism in May 2005, to ensure a stable real effective exchange rate of the Pula against a basket of currencies of major trading partners (comprising the SDR and the South African rand). This is achieved through continuous gradual adjustment of the Pula at the rate based on the differential between the expected domestic inflation and forecast inflation for trading partner countries. As Botswana's inflation remained higher than that of trading partner countries, the nominal Pula exchange rate crawled downwards in 2010. The trade weighted nominal effective exchange rate depreciated by 2.7 percent. The real effective exchange rate of the Pula, on the other hand, appreciated by 1.7 percent, owing to a positive differential between inflation in Botswana and major trading partner countries that exceeded the rate of crawl.

10. In nominal terms, since the beginning of 2011, the Pula appreciated against major hard currencies, while it depreciated against the South African rand. The Pula depreciated by 2.3 percent and 2.8 percent against the rand and the Euro, respectively, while it appreciated by 5.9 percent and 5.3 percent against the US dollar and the Japanese Yen, respectively.

11. According to the latest data from Bank of Botswana, in real terms, comparing April 2010 and the same month of 2011, the Pula depreciated by 0.2 percent against the South African rand, while it appreciated against the SDR and the US dollar by 4.3 percent and 11.3 percent, respectively. Consequently the REER appreciated by 1.6 percent over the same period, indicating that the differential between domestic inflation and the average inflation of trading partner countries is reducing and thus ensuring stability of the REER.

- ***Inflation***

12. The average annual inflation for 2010 was 6.9 percent. The average annual national inflation rate however increased and remained above the Bank of Botswana (BoB) objective range of 3 – 6 percent, reaching 8.5 percent in February 2011 before declining to 7.8 percent in July 2011 but increased again to reach 8.6 in September 2011. This increase was mainly a reflection of an upward pressure from increases transport fares on the

domestic market economy and on the international oil and food prices which has been experienced since the beginning of the year. On the domestic front the upward adjustment in administrative prices particularly electricity tariffs and some levies also contributed to increases in consumer prices.

- ***Balance of Payments***

13. In 2010 total exports increased by 26.9 percent, from P24.6 billion in 2009 to P31.2 billion. Total imports also increased from P28.6 billion in 2009 to P32.4 billion in 2010, an increase of 13.2 percent. Total exports of goods and services were valued at P8.8 billion in the first three months of 2011, compared to the P7.6 billion recorded in the same months in 2010. Imports on the other hand were valued at P12.2 billion over the same months indicating a significant growth when compared to P9.5 billion recorded in the same months in 2010. The current account show a slightly higher deficit of P5.1 billion in 2010 compared to a deficit of P3.9 billion in 2009. In contrast, the capital account show a surplus of P129 million in 2010 while a deficit of P2.2 billion was recorded in the financial account.

14. The overall balance of payments for 2010 was a deficit of P6.5 billion compared to a deficit of P4.6 billion in 2009. As at June 2011, Botswana's foreign exchange reserves stood at P60.0 billion compared to P55.4 billion in June 2010, which is an increase of 1.0 percent. The Government Investment Account, which represents that part of foreign reserves that belongs to Government, was P18.9 billion in June 2011 compared to P17.2 billion in the previous year, representing an increase of 9.9 percent.

- ***Government Budget***

15. The overall balance for 2011/12 is a budget deficit of P6.16 billion from P6.6 billion in 2010/11. Revenue and grants amounted to P31.8 billion in 2010/11, and is forecast to be P35.1 billion in 2011/12. The deficits experienced in recent years are an indication of declining government revenues. Both recurrent and development expenditure remained at the same high levels, as Government opted not to retrench staff but rather to scale down recurrent costs and to maintained development expenditure at same levels so as to stimulate economic growth. Further, due to a decline in revenue, Government has had to drawdown on foreign reserves as well as contract debt to finance the budget.

16. According to our latest projections, the total revenues and grants for 2012/13 are forecast to be P39.881 billion, a growth rate of 13.6 percent. Consequently, total expenditure must decline by about 3.3 percent, compared to a growth rate of 7.4 percent for 2011/12 to be equal to revenues in order to balance the budget. Total expenditure as a percentage of GDP, therefore, is forecast to reduce from 34.2 percent realised in 2011/12 to 29.1 percent in 2012/13. Hence the budget ceiling for 2012/13 is

set at P39.881 billion to cover all public expenditure, including transfers to local authorities and public enterprises, as well as loan repayments.

- ***Public Debt***

17. As continued budget deficits are not advisable, Government is committed to balancing the budget in 2012/13, as well as implementing stringent debt management strategies.

18. Hence despite the unprecedented increase in external borrowing to finance Government budget, both internal and external debt levels at the end of 2009/10 financial year were kept within the statutory limits of 20 percent of GDP each. With the drawdown of external loans during 2010, the external debt ratio stood at 19.1 percent while the internal debt ratio was 8.2 percent of GDP at the end of the 2010/11 financial year.

C. ECONOMIC OUTLOOK AND RISKS

- ***Global Economy***

19. The world economy is continuing to recover albeit at a slower pace than was anticipated in 2010. The April 2011 World Economic Outlook (WEO) of the International Monetary Fund forecasts world real GDP to expand by 4.5 percent in 2011 compared to 5 percent in 2010. Growth in emerging and developing economies is forecast to be about 6.5 percent, while that in advanced economy is expected to be 2.5 percent. The major trading partners to Botswana, United States of America and the Euro area is expected to continue to grow in 2011. This will benefit our export sectors, particularly the mining sector, as these major economies provide the markets for our exports.

20. On the downside, the recent difficulties of earth quakes, tsunamis and floods in Japan might negatively affect the world diamond prices thus bringing more challenges to the mining sector and domestic economy. In addition, the conflicts in the Middle East pose significant risks for the oil industry which could lead to even higher prices of crude oil during the course of the year.

- ***Domestic Economy***

21. The Botswana economy is expected to grow by 5.7 percent in 2011, mainly driven by improvements in the mining sector, particularly diamonds. Despite this positive outlook, there are uncertainties and risks in the medium term particularly regarding the future profitability of diamond production and SACU revenue as these constitute a substantial share of Government revenue. Further, the country still faces a number of challenges going forward. Poverty, HIV/AIDS, and unemployment rates, for example, still remain relatively high. The periodic occurrence of the Foot and Mouth Disease poses a challenge particularly to the Agricultural sector. Equally

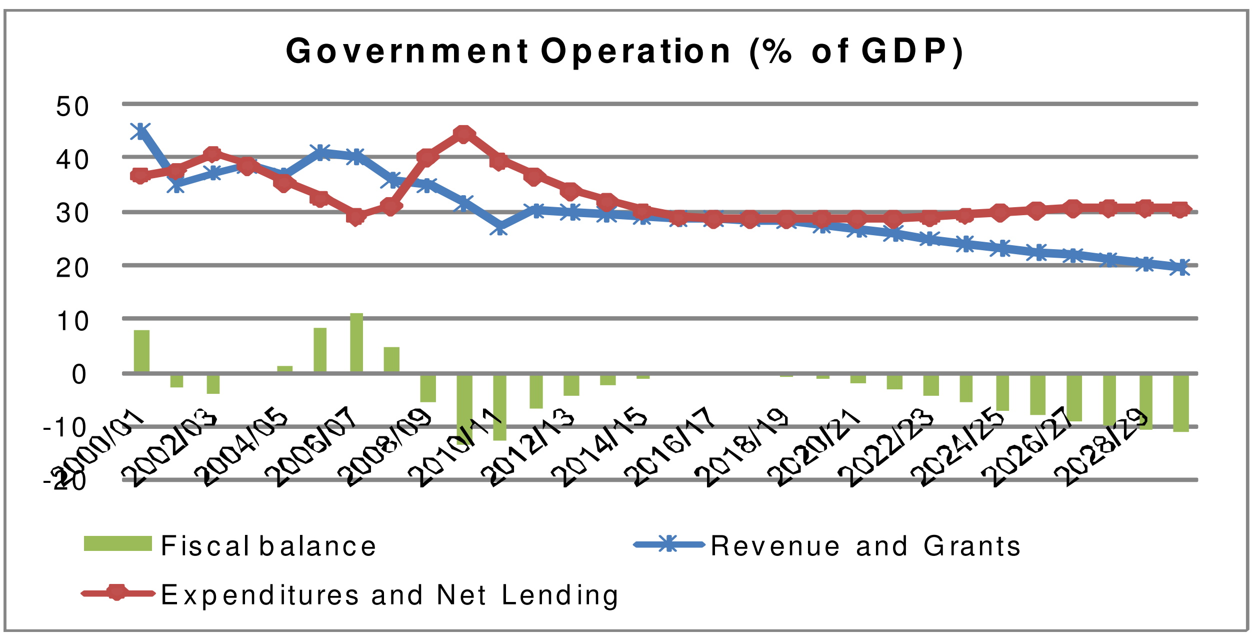
important is the need to enhance overall competitiveness and accelerate economic diversification as a means for ensuring continued economic growth and social transformation.

22. These realities pose a major challenge as Government has to reduce total spending while at the same time balancing the demands to adequately satisfy social and economic spending requirements. The reduction in total spending in the coming financial year and beyond means that the major line items such as personnel emoluments, transfers to local authorities and public enterprises will have to decline. This in turn requires all arms and levels of Government to focus spending on high priority and high return activities and scale down spending on low return activities or programmes.

- ***Beyond NDP 10***

23. According to the NDP 10 baseline projections, diamond profitability is projected to decline significantly starting in NDP 11. This will put pressure on the revenues with likely depletion of fiscal savings and increases in net debt. Figure 1 depicts the likely scenario for government operations, based on the baseline assumptions.

Figure 1: Actuals and Projections of Government Operations:



Source: Ministry of Finance and Development Planning

24. The scenario depicted in Figure 1 is likely to continue leading to unsustainable debt level and posing a threat to overall macroeconomic stability. This, therefore, points to an unsustainable fiscal position in the long run, if there is no policy correction. Further, the fiscal strategy for 2012/13

must take into account what is likely to be obtained in the medium to long term.

D. FISCAL STRATEGY AND BUDGET PRIORITIES

- ***Fiscal strategy***

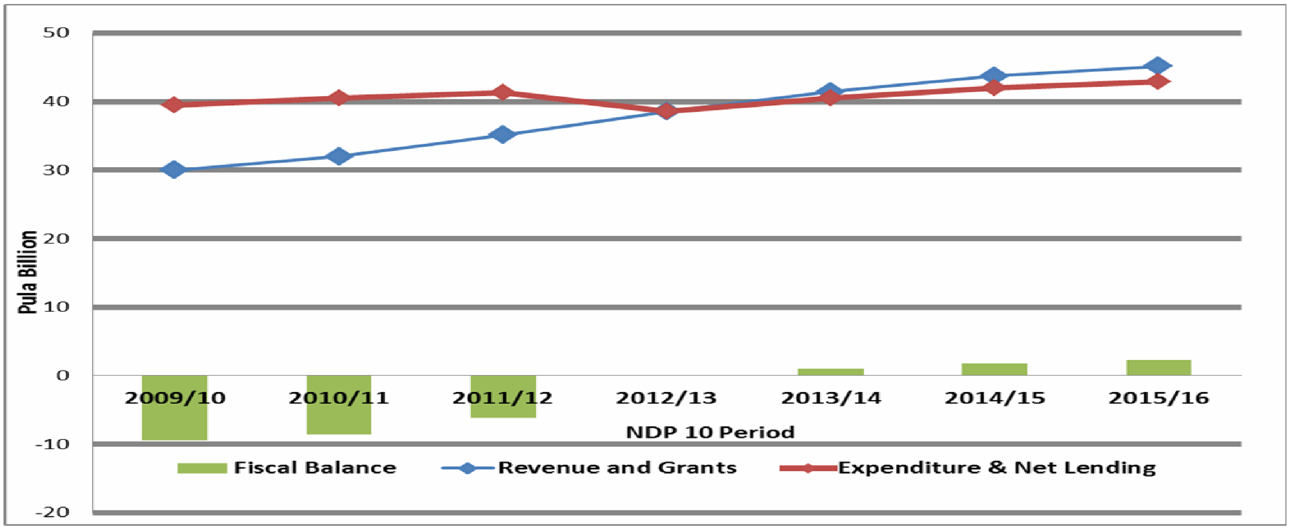
25. With accounts given above, the strategic thrust of accelerating diversification of the economy as outlined in the previous BSP cannot be underestimated. Emphasis was also placed on creating a conducive environment for the private sector so that it plays a major role in driving economic development, continuing investment in appropriate skills for the domestic job market, continue investing in high-return projects and leveraging additional support for service exports. Such realities are by nature medium to long-term and as such remain as applicable today as they were during the previous financial year.

26. In order to drive the country forward, diversification efforts should be continued by investing more on those sectors that have the potential to create more local industries and employment opportunities for citizens and in turn reduce poverty. It is also imperative to review legislative and administrative structures that are still an impediment to private sector participation in the economy.

27. For the 2012/13 budget, priorities will include maintaining the existing infrastructure, completing on-going projects such as those on energy, dams and roads as well as investing on high rate of return and self-liquidating projects. Government strategy must therefore now focus on efficiency of public spending, productivity of the public service as well as reflecting priorities in budget allocations both within and across Ministries while reducing spending gradually. To ensure that the budget conveys a true picture of our fiscal stance and priorities, all Government revenues and expenditures, regardless of funding source, must be identified and managed from one central point. This will assist in defining what constitutes national priorities as opposed to sectoral and/or Ministerial priorities.

28. Further, as reflected in NDP 10 and last year's Budget Speech, balancing the budget in 2012/13 and returning to modest surpluses thereafter is a central commitment of the Government's fiscal principle (Figure 2).

Figure 2: Actuals and Projections of Government Operations



Source: Ministry of Finance and Development Planning

29. A number of key initiatives announced in the 2011/12 Budget, such as freezing of new posts, rationalization of parastatals and outsourcing some Government services, would certainly reduce the size of the public sector wage bill. These expenditure reducing initiatives must be expeditiously implemented in the nest financial year.

30. Containing borrowing and managing the debt burden will be one of fiscal stances that we should categorically face head on in the 2012/13 Budget. Total debt stood at about P27.6 billion which among others included ADB, WB, IBRD, OFID and Chinese loans. With GDP at P100. 9 billion, total debt (internal and external) therefore stood at 27.37 percent of GDP. Suffice to indicate that borrowing and going into debt is not necessarily bad provided that such commitments are used for high return self-liquidating projects and there is a clear strategy of how this debt is going to be settled.

31. The current presumption, therefore, appears to be that available resources should be allocated to "deserving" sectors/programmes and projects on the basis of their backward and forward linkages with the rest of the economy particularly those that result in ripple positive effects on economic growth. Priority should be given to completion of on-going projects, making completed facilities operational and harmonising cross cutting issues. To facilitate for this, Ministries should also review scope of work even for on-going programmes.

32. There is need therefore to extensively use the Thematic Working Groups (TWGs) constituted during the preparation of NDP 10, in identifying such deserving sectors/ministries and setting expenditure priority areas and indicative ceilings within and between such Sectors/Ministries. Such priorities should be guided by broad-based medium-term national priority areas as outlined in NDP 10 unless where prevailing circumstances dictate that there

be an adjustment in such priorities areas. Ministries should therefore review their scope of work even for ongoing projects for example education financing.

33. Besides the use of TWGs, the implementation of the Public Finance Management Reform Programme aimed in part at moving towards a Medium-Term Expenditure Framework (MTEF) that consists of a top-down resource envelope, and a bottom-up estimation of the current and medium-term costs of existing policy should assist in optimising intra-sectoral allocations. This is because, by design, the MTEF processes strives to match costs with available resources and indicate fiscal targets, revenues and expenditure estimates necessary for achieving specific development initiatives.

34. Hence the 2012/13 budget cycle provides an opportune time to achieve our fiscal objectives and set precedence for project/programme prioritisation as most carry-over projects have now been completed and new ones are likely to be introduced. To achieve this, the setting of priorities needs to coincide with the preliminary setting of the budget allocation parameters at the beginning of the budget cycle, so that the priorities guide allocation within the constraints of the budget parameters.

- ***The Policy Options***

35. Central to the budget setting process is the overall commitment by Government to balance the budget by 2012/13 and to ensure medium to long run fiscal sustainability. To achieve this, there is need to improve the quality and value of the public goods and services associated with Government public expenditures, broaden the revenues base as well as enhance tax collection. To this end, the recent revisions to the Finance and Audit Act as well as Tax amendments came at the right time. Simplification of the tax system will enhance compliance and will also broaden the tax base and possible. However, there is need to ascertain that such tax reforms, have not over-provided for tax incentives/relief to the extent that this could be counterproductive to increasing the tax base and overall government revenue.

36. In addition, there should be restraint on certain expenditure categories particularly growth of the total wage bill which has over the years grown quite substantially relative to those of comparable middle income countries. This is one area which has of late received considerable attention both at national and international level. Reducing the wage bill will certainly reduce the size of government expenditure in the medium to long run. The ongoing Government initiatives of out-sourcing some activities (such as cleaning, land servicing and security services), as well as privatisation and rationalisation of parastals is a step in the right direction for right-sizing the public service and should perhaps be fast-tracked. As there are implications

for this exercise to create redundancies and retrenchments leading to increased unemployment, we will have to develop a Safety Net Strategy for those affected. Further, given the sensitive nature of this issue it will require a wide and higher level of consultation to create a common understanding of the implications of such an exercise.

37. There is also need to limit the size of fiscal deficits in order to return to a sustainable economic growth path. This could be facilitated in the short term by; continuing to do more with less with the private sector taking the lead in growing the economy; widening the revenue resource base outside mining and SACU and; lowering both recurrent and development expenditure levels to fall within the available resource envelope that does not include substantial borrowing. Ministries also need to review the expenditure categories under the recurrent budget to cut down on waste for example, workshops and conferences, special expenditure, general expenses and supplies etc.

38. In summary, the only policy options are revenue enhancement and expenditure management. Hence, the policy priorities are greater revenue collection through administration of tax policy; expenditure efficiency, public investment management, re-orientation of expenditure composition; better planning and budgeting; as well as debt management. Another critical question to address is when we should implement corrective action. The answer can only be now, to avoid painful adjustments in the coming years.

E. IMPLICATIONS FOR THE 2012/13 INDICATIVE BUDGET CEILING

39. Given that the country is still recovering from the global recession, the development budget, should as a priority, be allocated to on-going projects. For successful completion of on-going projects, the principle of cost containment such as a freeze on acquisition of new vehicles should be continued. In this regard, any project that requires additional funding should be subjected to a rigorous cost and benefit analysis. Further, Ministries should identify projects to be delayed to accommodate any cost increases.

40. In an effort to enhance project optimisation all sectors should identify inter-relationships between projects in order to make them fully operational as well as leverage opportunities presented by such projects.

41. For the 2012/13 financial year and beyond, any increases in revenue should be used to build up depleted reserves and reduce deficits rather than taking up new commitments.

F. CONCLUSION

42. As the projections and analysis show, future economic growth will have to depend on delivering higher quality services with fewer inputs. It will also depend on how policies pursued to date are adapted and effectively used to meet changing circumstances. Of critical importance is the need to limit the size of fiscal deficits within the constraints set by available revenue and statutory requirements. To do otherwise would lead to a debt trap where further public spending would have to be slashed substantially in order to service the debt.

43. Further, the fiscal objective of balancing the budget during 2012/13 and accumulating modest surpluses thereafter should not be done at the expense of economic growth. Neither should reprioritisation of projects and scaling back of public spending be a constraint to private sector development and economic growth. Key to achieving these will be extensive consultation to reach a common understanding by all on what limits exist to individual budget ceilings and to the extent that there is an absolute need to institute measures that will cut government expenditure to acceptable levels. It is also important to emphasise the need to use any additional revenue for debt servicing and building on our reserves other than on making new commitments unless if these are self-liquidating and high return projects and programmes.

44. It is very clear that while Botswana has grown rapidly over the years, the growth has not been balanced across the sectors. This makes economic diversification the only way to develop dynamic non-mining sectors that can maintain higher living standards and fiscal sustainability. It is also critical to ***'look beyond today'*** when we make decisions on priorities and spending.

Appendix Table 1: GDP and Budget from 2007/08 to 2014/15, P millions (actual and projections – Base case scenario)

FY	GDP, current prices, FY	growth rate	Revenues & Grants	Recurrent Expenditure	Development Expenditure	Net lending	Total Exp & Net Lending	Balance
2007/08	80 344	17.8%	28 629	18 579	6 548	-305	24 822	3 808
2008/09	87 313	8.7%	30 455	23 889	11 458	-197	35 151	-4 696
2009/10	86 551	-0.9%	30 023	25 732	13 006	752	39 489	-9 466
2010/11*	106 374	22.9%	31 791	27 090	13 312	-27	38 418	-6 627
2011/12 F	120 600	13.4%	35 098	30 581	10 774	-94	41 261	-6 163
2012/13 F	137 035	**13.6%**	**39 881**	31 905	7 947	0	39 881	0
2013/14 F	150 494	9.8%	43 798	34 309	7 510	0	41 840	1, 959
2014/15 F	161 702	7.4%	47 060	36 439	6 918	0	43 398	3, 662

Source: MFDP, 2011
*GDP figures include forecast of calendar quarter one of 2011
F represent forecast