REPUBLIC OF BOTSWANA

2013/14 BUDGET STRATEGY PAPER

Ministry of Finance and Development Planning

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A. INTRODUCTION

1. At the beginning of each Budget cycle, the Ministry of Finance and Development Planning produces a Budget Strategy Paper (BSP). The Paper provides an overview of developments in the global and domestic economy for the purpose of laying down policy options and framework for the current year's budgeting process. It is also used as a consultative framework in getting views and contributions from the general public including the political leadership on issues that need to be considered during the budget cycle. Hence, it serves as a tool for not only opening discussions on the budget to a wider audience but also to instill transparency in the use and allocation of national resources. The BSP is a key part of the process in preparing a national budget which is responding to the needs and aspirations of the citizens.

2. This year's Paper is prepared at a time when there are still uncertainties regarding prospects of both the global and domestic economy. This makes it difficult to predict the likely path that the international markets will take particularly the demand and sales of diamonds. The situation is further compounded by issues of: drought; recurring incidents of foot and mouth disease; the on-going HIV & Aids pandemic; and relatively high unemployment and income inequality rates.

3. Revenues available to Government are expected to decline in the medium to long-term. Further, since 2008, the trade balance has continued to be negative while the inflation rate in Botswana is still high compared to that of our trading partners. There has, however been an improvement in the level of foreign reserves but, building them up further will take a while since outstanding debt needs to be serviced.

4. Though the economy is now slowly recovering from the impact of the global downturn, real GDP growth rates are still below pre-crisis levels. While this can be attributed partly to the economic uncertainties, declining levels of labour productivity and investment in low return projects are also impediments to a high growth strategy. An economic diversification strategy that puts emphasis on increased capacity for non-mineral exports and private sector led growth is necessary.

5. The current state of affairs puts pressure on Government to be more cautious in determining the correct expenditure portfolio for the year. This calls for acceleration in the implementation of the Public Finance Management Reform Programme by adopting among others: a Medium Term Fiscal Framework, multi-year forecasting tool to support fiscal discipline and strategic allocation of resources that focuses on high return and self–liquidating projects.

6. It is worth pointing out that, the Mid-Term Review (MTR) of NDP 10 started in March 2012 and is expected to be concluded in April 2013. The MTR of NDP 10 will include a review of fiscal rules to better prepare public finances for the post diamond era. As part of the MTR, the eight Thematic Working Groups (TWGs) formed during NDP 10 have been condensed into four broad-based thematic areas of: Economy and Employment; Sustainable Environment; Social Upliftment; and Governance, Safety and Security. These TWGs have been instrumental in developing the national priority areas for the remaining years of NDP 10 and should do the same during the budgeting.

7. This Paper begins with an overview of the domestic and global economies. It then discusses aspects of: the domestic economy outlook and risks; fiscal strategies and budget priorities for 2012/13; and implications for 2012/13 budget ceilings. It ends with a conclusion that gives a summary discussion of the BSP as a whole.

B. ECONOMIC PERFORMANCE OVERVIEW

THE DOMESTIC ECONOMY

Economic Growth

8. The revised national account data from Statistics Botswana indicate that at constant 2006 prices, GDP growth was 8.0 percent in 2011 compared to 8.1 percent in 2010. Despite this good overall performance of economy, the mining sector registered a poor performance (particularly diamond sales) in the second half of 2011. In 2011, the mining sector experienced a contraction of 2.2 percent compared to growth of 22.7 percent in 2010.

9. However, the non-mining sector performed relatively well, with real growth of 10 percent in 2011 compared to 5.6 percent recorded in 2010. The highest growth was in Construction at 18.5 percent in 2011, followed by General Government and Trade, Hostels and Restaurants at 15.2 percent and 13.4 percent, respectively. Transport and Communication, Financial and Business Activities, and Personal and Social Services grew at 8.8 percent, 8.7 percent and 7.3 percent, respectively. Other sectors such Water and Electricity and Agriculture, Forestry and Fishing registered contraction of real domestic value added of 74.5 percent and 22.4 percent, respectively.

10. Special attention is needed to attract investment in the non-mining sectors and increase the export diversification of domestic products as well as enhance their competitiveness in international markets. This will require full implementation of the Economic Diversification Drive strategy in a more business friendly environment.

Inflation and Monetary Policy

11. Containing inflation remains a great challenge to Botswana, as overall inflation rose in 2011 to average 8.5 percent from 6.9 percent in 2010. The high international oil and food prices contributed partly towards this high domestic inflation in 2011. According to the World Bank's commodity price data report produced in 2011, the world crude oil price increased by 40 percent from an average US$79.64 per barrel in 2010 to average US$111 per barrel in 2011. The same report shows that most of the food items experienced price escalation in 2011, with international prices of sorghum, maize and wheat rising by 80 percent, 60 percent and 35 percent, respectively. These occurrences filter into the domestic economy as part of imported inflation, making the country vulnerable to external price shocks.

12. Going forward, the year on year inflation rate have been declining in the first four months of 2012, registering 8.8 percent in January but decreased to 7.5 percent in April and recording 7.1 percent each in September and October 2012. The decreasing trend is expected to continue into the last quarter of 2012 mainly due to constrained domestic and global economic activities.

Trade Balance

13. Exports volume declined by 6.5 percent in quarter one of 2012 compared to quarter one of 2011. This downward trend in exports is attributed to global economic uncertainties particularly the euro area and constrained demand for luxury commodities in advanced countries especially in the United States of America and Japan which are major buyers of Botswana's diamonds . Imports on the other hand, increased by 5.7 percent during the same period. Hence trade balance has worsened recording a deficit of P2.93 billion in quarter one of 2012 compared to a deficit of P2.88 billion in quarter one of quarter of 2011.

Exchange Rate Movements

14. Government of Botswana continues to implement a crawling peg mechanism to maintain a stable and competitive exchange rate against a basket of currencies of major trading partner countries, namely South African rand and the Special Drawing Rights currencies. A stable Real

Effective Exchange Rate is achieved by adjusting the Nominal Effective Exchange Rate daily to direct the peg along a pre-determined path in line with its major trading partners' expected inflation differentials. The exchange rate movements shows that the crawling exchange rate for Botswana has been effective in maintaining the position of domestic producers but it does not adjust immediately in response to a major international shock such as the drop of diamond sales in 2008 and 2009. The exchange rate should therefore be supplemented by fiscal and monetary policies for it to remain effective.

15. According to the Bank of Botswana Annual Report of 2011, the Pula depreciated in nominal terms by 2.5 percent while it appreciated by 1.5 percent when adjusting for differences in inflation rates of trading partners countries. On a bilateral basis, the Botswana Pula strengthened against the South African rand but depreciated against other major currencies of trading partners.

Balance of Payments & Foreign Reserves

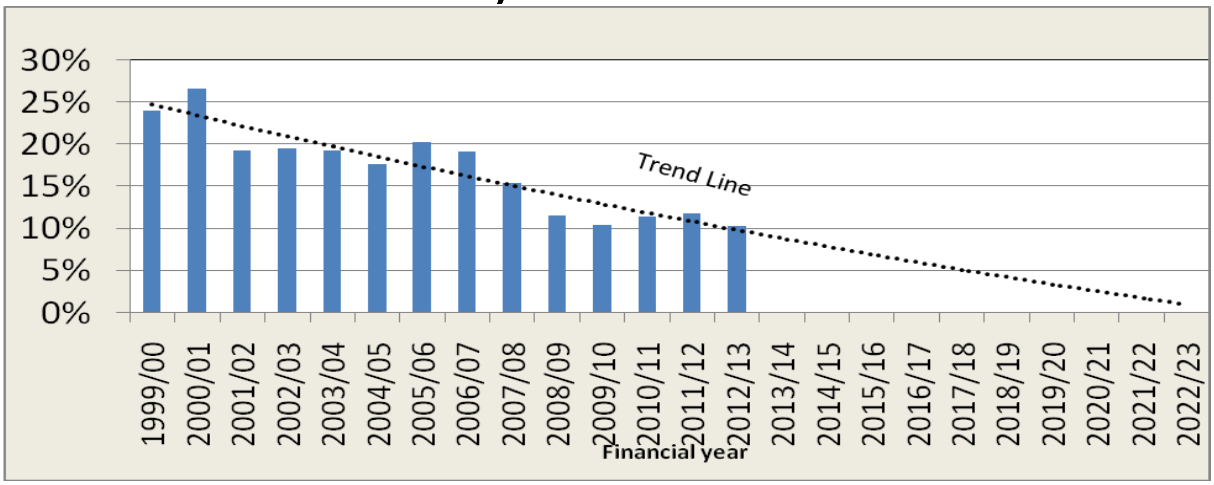
16. Provisional figures of balance of payments in 2011 show a surplus of P3.4 billion compared to a deficit of P6.5 billion in 2010.The current account balance indicated a surplus of P2.7 billion compared to P1 billion over the same period.

17. Foreign exchange reserves which were P57.97 billion in August 2011 stood at P60.8 billion in August 2012, a 4.9 percent increase. However, the same foreign exchange reserves have decreased by 10.9 percent from US$8.68 billion to US$ 7.83 billion over same period. However, at this level, foreign reserves are still below maximum highest level of P72.8 billion recorded in October 2008 during the pre-crisis period. The current level of foreign reserves is enough to cover only 17 months of imports of goods and services. Hence there is need to keep on building and replenishing them for use in future especially as the world economy is still clouded with uncertainties.

Government Revenue and Expenditure

18. Following a steady increase in 2010/11, total revenues and grants received in 2011/12 increased by 19 percent to P38.03 billion. They increased further to P42.9 billion in the 2012/13 Budget estimates and are expected to continue increasing in 2013/14 (annex 1). It is also worth noting that the mineral revenues which have been Government's main source of revenue are expected to decline in the medium to long-term (Chart 1). Further, most Debswana mines are likely to go into underground mining in the coming decades and this will increase production costs and thus reduce profit margins and consequently payments to Government.

Chart 1: Mineral Revenue/GDP



Source: MFDP

19. On the other hand, total expenditure and net lending which stood at P40.4 billion in 2011/12 increased by 3.5 percent to P41.81 billion in 2012/13 Budget. For the 2013/14, Government will continue to tighten its fiscal policy stance and hence a modest increase of 4.4 percent in government expenditure has been projected. Over time, recurrent expenditure has been allowed to increase while development expenditure reduced (see Annex 1). Should the proposed budget be allowed as it is, there will be an increase in the budget surplus from P1.15 billion in 2012/13 to P2.096 billion in 2013/14, mainly due to increase unexpected revenues from SACU.

Debt Situation and Management

20. The total outstanding debt decreased from 22.7 percent of GDP in at end of 2011/12 to 21.5 percent projected for the end of 2012/13 which is within the debt statutory limit of 40 percent of GDP for domestic and external sources combined. External debt is expected to stand at 16.2 percent of GDP at end of 2012/13 compared to 16.9 percent of GDP in 2011/12. Similarly, domestic debt stood at 5.8 percent of GDP at end of 2011/12 compared to 5.3 percent in 2012/13. There is however, need to develop domestic capacity to facilitate Government funding. Bond issuance could be a pivotal instrument in developing domestic capital markets. However, it is important that the country should develop a Debt Management Strategy and strengthen the capacity of the current debt office to execute its mandate prudently.

THE GLOBAL ECONOMY

21. There is no doubt that the global economy is still facing some challenges. According to the latest World Economic Outlook of October 2012 produced by the International Monetary Fund, prospects for the world economic growth remain weak for 2012. World output for 2012 is expected to grow by only 3.3 percent in 2012, a lower growth rate when compared to 3.8 percent realised in 2011. In advanced economies a slower growth of 1.3 percent is expected in 2012 compared to growth of 1.6 percent in 2011. The United States of America is expected to register a modest growth of 2.2 percent as compared to 1.8 percent over the same period. Similarly, Japan is expected to reach 2.2 percent compared to a contraction of 0.8 percent, whereas the Euro area is expected to contract by 0.4 percent compared to a modest growth of 1.4 percent.

22. The highest growth is expected from Asia sub-group with China and India growing by 7.8 percent and 4.9 percent for 2012 compared to 9.2 percent and 6.8 percent in 2011 respectively. The Sub-Saharan sub-group will grow by 5.0 percent compared to 5.1 percent in that period.

23. Despite this revised upward outlook, the global economy still remains vulnerable, especially from looming shocks in the Euro area. Should this come true, these could have serious implications for the Botswana economy which exports more than half of total exports to the developed markets. Going forward, finding alternative markets like China and India will have to be explored to bridge the gap.

C. DOMESTIC ECONOMIC OUTLOOK AND RISKS

Domestic Economic Outlook for 2012

24. Following a relatively poor performance in 2011, the international diamond markets still not showing any signs of recovery and is likely to decrease slightly during 2012. The anticipated output from Morupule B power station is expected to contribute positively to growth of the water and electricity sector and the overall economy. Most non-mining sectors are expected to continue growing positively due to an improved business environment that support objectives of the Economic Diversification Drive aimed at enhancing an overall competitiveness of our products in international markets.

25. It is against this background that the Botswana economy is projected to grow by 3.5 percent in real terms during 2012. However, this performance could be undermined by current uncertainties in the global market, which may reduce the global output and lessen mineral and beef exports and earnings. In addition, Botswana faces a possible decline in SACU revenues in the medium-term due to continued period of low growth in the region leading to lower levels of imports and possibly negative effects through revisions in the SACU revenue-sharing formula which is currently being negotiated as well as continued moves to lower tariff rates.

26. Furthermore, the country still faces a number of socio-economic challenges going forward that among others include: Poverty; HIV/AIDS; youth unemployment; and a constrained export diversification and promotion of domestic investment. The recurring outbreaks of the Foot and Mouth Disease and drought conditions for 2012 continue to pose serious challenges in the economy, particularly to beef production in the agricultural sector.

D. FISCAL STRATEGIES AND BUDGET PRIORITIES FOR 2013/14

Running a modest surplus

27. The medium to long-run objective of each budget cycle in Botswana is to have a balanced budget. Based on this objective and taking stock of the budget in the four years since 2009, the result is pointing to a cumulative budget deficit of P18.6 billion, indicating that the next year's budget should result in a modest surplus. To run a modest surplus, Government needs to spend less than it receives as total revenue. Whilst striving to fulfill this objective, there is need to ensure that the quality of the services provided is not compromised.

28. Obtaining a budget surplus requires close monitoring and evaluation of NDP 10, programmes and projects. Currently, programme and project management remains a great challenge to Government with notable delays in completion dates, change in scope and resultant cost over-runs. There is therefore an urgent need to improve on: programme and projects design, projects implementation and execution; containing costs by avoiding cost overruns; avoid delays in starting and finishing projects; and refraining from introducing extravagant project specifications either before or after construction has commenced.

High growth strategy

29. Going forward, there is need to return to a high growth strategy via increased productivity and competiveness. The main thrust will be that of adjusting expenditure downwards to match declining revenues so as to avoid further deterioration in the fiscal policy stance. This goal requires a strategic allocation of national resources to deliver the required services to the general public in an equitable and sustainable way. This implies that new commitments should be constrained by the resource set by both endogenous and exogenous factors such as the likely downturn in the global economy and reduced remittances from SACU revenue pool.

Beyond diamonds - Reducing government expenditure

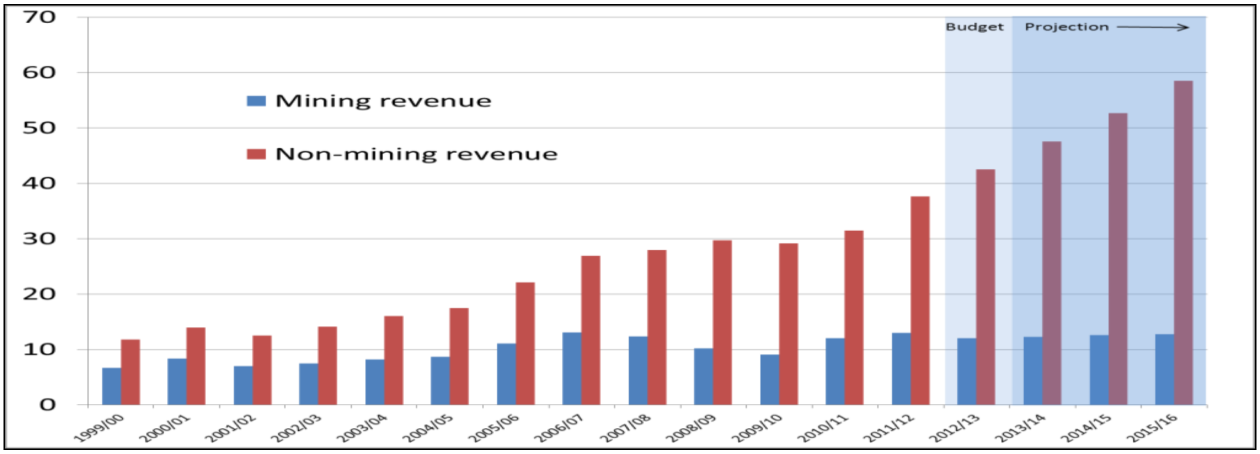
30. For several years now, the Government has been aware that the diamond industry is approaching its peak point – as costs of production are rising. Consequently total profits are likely to fall, and so will Government revenue. Adjusted for inflation, revenues in 2011/12 were 33 percent lower than those collected in 2006/07, the peak year. In response to this decreasing trend, Government has been encouraging the diamond industry to add more value within Botswana, culminating in the on-going process of relocating the Diamond Trading Company from London to Gaborone which should be completed by the end of 2013.

31. Government is also scaling back its spending and placing greater emphasis on achieving better value for money. For example, the 2010/11 budget focused on completing existing projects rather than commencing new ones. There is also greater concentration on ensuring higher economic returns to new investments in deciding where funds are directed. The 2011/12 budget set the aspiration to reduce government spending to 30 percent of GDP – 10 percentage points below the 40 percent limit mandated by the Mid-Term Review of NDP 9 fiscal rule. Further, the Government wage bill is to be cut by 5 percent each year for the next 3 years, compelling line Ministries to rationalise their workforces which in some instances have exceeded their optimal size for their priority tasks.

32. For 2013/14, the focus is on implementing the commitments made in previous years, whilst including the conclusions from the MTR of NDP 10 through a reprioritisation of currently planned projects. Furthermore, fiscal rules are being re-evaluated as part of this Review. This is to ensure they continue to support a smooth transition to a sustainable, lower Government spending post the diamond era in Botswana.

33. In cash terms, revenues from mining has been broadly flat as it was varying from P9 billion and P13 billion since 2005/06 (figure 1). However non-mining revenue (excluding grants) grew strongly in 2011/12 and this trend is expected to continue as economic diversification efforts take effect.

Figure 1 - Nominal mineral and non-mineral revenues 1999/00 - 2015/16 FY, P Billions



Source: MFDP

Improving Doing Business and Global Competitiveness Environment

34. The competitiveness of Botswana's business environment continues to play an important role in attracting businesses and investments from many countries around the world. Yet Botswana's global ranking has been slipping down over the past three years. According to the annual World Bank's Ease of Doing Business, Botswana was ranked 50th in 2010 but moved down the positions to rank 54th in 2012. A similar downward pattern was observed in the annual Global Competitiveness reports showing Botswana falling from 66th position in 2010 to 79th position in 2012. Such a trend is attributed largely to an unfavourable regulatory environment characterised by lengthy processes and procedures required as well as delays and high costs in registering businesses.

35. While appreciating that some strides have been made by Government in streamlining procedures, there are number of outstanding reforms initiatives which still need to be done. The National Doing Business Committee and Cabinet Sub-Committee on Doing Business and Global Competitiveness have been established but more can be done by allowing on-line applications for permits, licenses, payments as well as addressing labour issues in order to improve business environment. There is need to extensively implement these reform initiatives as well as those identified by the Technical Sub-Committee on Doing Business and make them priority areas for action in the coming financial year.

36. Hence the next Budget Speech should emphasise the goal of ensuring that that there is no further deterioration in the business climate. This calls for a closer collaboration among utilities corporations (telecommunications, power and water) and other service providers such as local authorities, Ministries of Trade and Industry, Lands and Housing, Minerals, Energy and Water Resources as well as Botswana Investment and Trade Centre.

Accelerating the Poverty Eradication Programme

37. Despite several poverty eradication initiatives that have been put in place in Botswana, abject poverty levels have only reduced in aggregate form but remain high in certain rural areas and groups such as youth and women. The recent results from the Botswana Core Welfare Indicator Survey (BCWIS) 2009/10 showed that poverty rate stood at 20.7 percent in 2009/10, a 9.9 percent decline from 30.6 percent recorded in 2002/03. However, poverty rates in certain districts and sub-districts were found to be higher than the national average. The sub districts of Kweneng East, Central Serowe/Palapye and Central Tutume have the largest number of people living below the poverty datum line.

38. The same survey shows that the number of people living below the poverty datum line (i.e. below US$ 1.25 a day at purchasing power parity prices) decreased from 23.4 percent to 6.5 percent for 2002/03 to 2009/10, respectively. To deal with this, Government has declared war on abject poverty through the Poverty Eradication Programme by implementing lately initiatives such as backyard gardening, small livestock and kiosks. This programme has increased expenditure on poverty from 0.08 percent of GDP in 2011/12 to 0.11 percent of GDP in the 2012/13 budget. The same BCWI survey estimated an overall unemployment rate at 17.8 percent of the total labour force, up by 0.3 percent as compared to the last reported figure of 17.5 percent reported in the 2005/06 Labour Force Survey. The survey reiterates the previous surveys' findings by showing that unemployment and poverty rates remain high among females and the youth. Hence the poverty eradication programme should target particularly women and youth in Botswana.

39. The poverty eradication measures can only happen when the economy is capable of creating more employment opportunities in both the formal and non-formal sectors. The informal sector has also grown and plays a critical role in providing employment for many people who are not formally employed. In the midst of slower growth, unemployment level is increasing as new entrants into the labour force are not all absorbed on account of limited industrial base and investment opportunities in the country. The current empowerment schemes should continue to favour the poor and unemployed. The poverty eradication programme should also be accelerated to reach the applicants in terms of numbers and the impact. A robust monitoring and evaluation process should be built in each programme and project for quality assurance in administering and delivering schemes to the deserving individuals so that wealth and employment opportunities are created for the poor. The evaluation will undoubtedly reveal some projects and approaches which are highly successful and should replicated. Others will reveal weakness which suggests either scaling back or redesign. Where loans are disbursed such as in SHHA, CEDA and Youth Grants, repayments must be made to ensure that these programmes will benefit other poor people.

Fiscal Policy Options

40. In brief, the key policy options to be followed in the budget formulation are premised on the broad strategies of NDP 10 and are outlined as:

- Modest surplus on each of the remaining years of NDP 10 including 2012/13 financial year;
- Continue addressing the relatively large wage bill through privatisation and merging of some public enterprises, and outsourcing of non-core services;
- Exercising restraint on Government spending on new programmes and projects but increase the maintenance and repair budgets of existing infrastructures;
- Continue to support diversification programmes with emphasis on improving doing business environment as well as providing for poverty eradication; and
- Enhancing the revenue base by strengthening non-mineral revenue collection including improving efficiency in tax collection.

41. The primary objective of the fiscal policy in Botswana is to maintain macroeconomic stability through running a balanced budget over the medium term. Following budget deficits in the first three years of NDP 10, it is important to continue with modest budget surplus for 2013/14 and beyond in order to restore Government's reserves. This implies that new commitments should be identified within the available resources.

42. A number of reasons support this fiscal stance. On the onset, the global economy is likely to go through a second phase of an economic downturn. This has a bearing on the prospects of developed economies which our mining sector is dependent on for exports. Given that the mining sector declined in both 2011 and 2012, risks remain that the same may occur to this sector in 2013, fuelled by slower pace of recovery in advanced economies.

43. The second point is that at the current Government's debt and reserves levels, it will be difficult to finance growth in Government spending from borrowing and depletion of reserves as it was the case during the global recession that occurred in 2008. As a policy option, it is only prudent for Government to start reducing expenditure towards 30 percent of GDP. The initiatives however need to be supplemented by other efforts aimed at improving efficiency and cost effectiveness in public spending which should not be done at the expense of growing the economy. Indeed, every Government Ministry must articulate it priorities and allocate its budget accordingly. This is the only for the same spending level can contribute to growth and improve the welfare of all Batswana.

44. The commitments towards privatisation and merging of some of the public enterprises as well as outsourcing non-core Government services to the private sector need to be enhanced and completed. The privatisation of Botswana Telecommunication Corporation should be completed as well as other enterprises. Some of these policy options have potential of reducing the burden on public spending and can also benefit the society through employment creation and tax revenue once fully operational. There is need for speeding up outsourcing activities including establishment of the Public Private Partnership Unit that has been in the offing for a while. In this connection, it is crucial for close monitoring by relevant authorities to ensure that these measures are carried out within next year's budget process.

45. Lack of regular maintenance and repair over time is depriving the society of maximum benefits from the existing infrastructure. Against this background, provision should be made for maintenance and repair in order to restore the functionality of existing facilities and improve the service delivery to the public.

46. Furthermore funds should be allocated to continue to support diversification programmes with emphasis on supporting initiatives for improving the environment for doing business. This is done on the understanding that to maintain long term fiscal sustainability in the economy, many activities currently being undertaken by the public sector have to be hived off to a vibrant, efficient, and properly regulated private sector. A developed private sector is capable of creating more job opportunities and thereby reducing the routine reliance on social safety nets. This is important as social infrastructure and safety nets are currently largely supported by Government expenditure. However some social safety nets will still be needed to cater for the vulnerable groups (e.g. elderly, disabled and sick) as job creation is not an option.

47. As stated before, collection of revenue from non-mineral taxes remains the most sustainable way of financing Government's spending. While revising tax rates upwards could be an option, a review of tax holidays and periodic review of appropriateness of tax incentives is also necessary.

E. IMPLICATIONS FOR 2013/14 BUDGET CEILINGS

48. The projections of GDP and budget in appendix 1 are extrapolated from the preliminary GDP estimates of 2011 and the fragile economic developments in both the domestic and global economy. The indicative ceilings will be updated and may change as more recent data become available. Consistent with the underlying objective of balancing the budget in the medium period, next year's budget surplus is set to add to the one in the current financial year, bearing a clear testimony of Government commitment to a tight fiscal stance.

49. Modest growth in expenditure requires that in addition to delaying mega projects which demand more capital injection, we need to be cautious and avoid more debt as well as contain costs through prudent budget allocation and expenditure management. For this to happen, project implementation and execution is one area that needs close monitoring and will require updating of our systems for monitoring financial transactions. Ministries can capitalise on this by using audit and inspection teams which were instituted in 2011 by the Department of Building and Engineering Services. Change of scope, delays in starting and completing projects and cost overruns must be avoided.

F.CONCLUSION

50. This Paper has given policy options and priority areas within the context of the global and domestic economic developments characterized by slow recovery and weak global demand, and declining Government revenue. Hence the underlying goal of the Paper is to instill fiscal discipline in public sector spending in line with resources can be generated by the economy. At the core is a tight fiscal stance taken but this should not be done at the expense of economic growth. Hence, the guiding principle should be that of continued implementation of self-liquidating projects, improving the investment and business climate, as well as scaling up the maintenance and repair of existing infrastructure. Poverty and unemployment initiatives should also be continued but with discipline, carefully targeted to ensure that the programmes are achieving the objective of poverty eradication in most cost effective manner.

Annex 1: GDP and Budget from 2008/09 to 2015/16, P millions (actual and projections – Base case scenario)

FY	GDP, current prices	Growth Rate	Revenues & Grants	Recurrent Expenditure	Development Expenditure	Net lending	Total Exp& Net Lending	Balance
2008/09	72 104	7.3%	30 455	23 889	11 458	-197	35 151	-4 696
2009/10	74 263	3.0%	30 023	26 484	13 006	752	39 489	-9 466
2010/11	95 320	28.4%	31 909	27 046	11 372	14	38 417	-6 508
2011/12	106 919	12.2%	38 031	30 448	11 343	-124	40 403	-2 248
2012/13B	114 648	3.7%	42 906	31 751	10 058	-54	41 809	1 151
2013/14F	121 629	6.1%	44 846	33 017	8 710	0	42 754	2 096
2014/15F	133 273	9.6%	46 102	34 334	9 129	0	43 353	2 750
2015/16F	145 958	9.5%	50 139	35 704	9 548	0	45 252	4 890

Source: MFDP, 2012
B symbolises budget estimate
F symbolises forecast