BIDPA Briefing

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Overview

Botswana is going through an exciting period. The 9th National Development Plan is under preparation. Such a plan provides an opportunity for all stakeholders to address the most critical policy issues facing the nation. The fight against HIV/AIDS and the need for sustainable diversification are some of these issues. The country is also gearing towards the introduction of the Value Added Tax (VAT) to replace the Sales Tax. VAT is seen as a tax system that is fair, effective and administratively easier. In addition, it is expected to help in the drive towards diversifying the sources of government revenues. Over the last 12 months, the pula has risen from 1.43 to an unprecedented high of 1.70 against the rand. Given the implications that significant exchange rate movements can have on Botswana's objectives for sustainable economic diversification, the authorities need to better inform the public, particularly non-traditional exporters, regarding the issue.

Preparation of National Development Plan 9

The preparation of the 9th National Development Plan (NDP 9), following on from the Mid-Term Review of NDP 8, provides an opportunity for government, the private sector, labour and non-governmental organisations to address the most critical policy issues facing the nation. These issues include, *inter alia*, the battle against HIV/AIDS, the high level of unemployment, widespread poverty, the need for sustainable economic diversification, the need for fiscal discipline and sustainable budgeting, public sector reform, citizen economic empowerment and environmental conservation. Addressing these challenges in the process of preparing the National Development Plan can result in a policy framework that is logically consistent and attainable, within the constraints set by the resources available for development. Many of the critical policy issues for NDP 9 are intertwined, and thus require a comprehensive, integrated approach if they are to be successfully resolved. Perhaps the most critical development challenge is posed by HIV/AIDS, which threatens to erode economic prospects by reducing the nation's pool of skilled labour, decreasing its productivity, reducing the returns to domestic investment and absorbing fiscal resources in programmes to combat the pandemic and care for the afflicted that might otherwise have been used in development projects.

The slowdown and uncertainties in the global economy heighten the challenges facing the nation in addressing these development issues. It is against that backdrop of sluggish and uncertain demands for its major exports that Botswana must formulate its strategies and chart its course for NDP 9. It is difficult to be very optimistic about the prospects for NDP 9 and the resources that will be available to implement the Plan.

While there has been some progress in diversifying the economy during NDP 8, Botswana remains highly dependent upon the export of diamonds, which accounts for about one-third of GDP, 80 percent of exports receipts and 50 percent of government revenues. This leaves the nation vulnerable to fluctuations in international markets, such fluctuations have occurred over the past few years. Because diamonds are a non-renewable resource, it is even more critical that the country find and develop other sources of sustained income. Reducing the country's vulnerability to what happens to the diamond sector through sustainable economic diversification remains a key objective; but this requires that local firms be internationally competitive. Yet diversification into non-diamond mining, non-government activities has been inadequate.

It has long been recognised that Botswana has the potential to diversify beyond diamond mining into non-traditional agriculture, manufacturing, tourism, financial and business services, as well as non-diamond mining. However, in order to do so, Botswana must not only have the requisite economic infrastructure in place and human resources available, it must also have a supportive policy framework; one that is effectively implemented by an efficient public sector, which promotes an internationally competitive private sector.

In order to diversify the economy and promote the growth of the non-diamond sectors, Government must urgently and vigorously implement its development policies and strategies. Yet the diversification programmes Government pursues to encourage broad-based sustainable development must lessen dependence on government assistance, since increasing levels of government expenditures and subsidies cannot be sustained without commensurate increases in private sector incomes and profits, which can provide the bases for additional revenues to government. Thus, for example, the Citizen Entrepreneurial Agency (CEDA), with its training, monitoring and mentoring components, will be critical in achieving projects that become viable, taxpaying enterprises beyond the period of financial assistance.

Government's strategies for economic diversification require maintaining a sound and supportive macroeconomic policy framework, including fiscal balance with low tax rates, monetary stability, competitive exchange rates and positive real interest rates. Such a policy environment is crucial for investors' confidence in the economy, which can attract needed foreign direct investment, as well as foster increased investment in productive activities by citizens.

Promoting employment creation that can result in sustained reductions in unemployment and poverty levels requires new and/or expanded business activities that are internationally competitive, in terms of price, quality, timeliness and service. That means the businesses must have average costs, which are less than the prices at which foreign businesses can sell comparable outputs, either in Botswana or in markets to which Botswana firms could export. To achieve that, the costs of Botswana's resources labour, land, capital, etc. and their productivity in making quality outputs must be competitive with those of foreign producers. Botswana's wages must not be out in line with labour productivity, whether that productivity is high or low; otherwise Botswana firms will not be able to compete, and productive jobs that can be sustained will not be created.

The high level of unemployment and the lack of income generating opportunities remain the major cause of poverty in Botswana. However, a substantial number of destitutes and orphans suffer poverty for reasons other than inadequate job opportunities: solving such poverty will require an effective and well-targeted social safety net system.

A key element in creating a suitable environment needed for rapid private sector development is having a transparent, credible macroeconomic policy framework, with fiscal discipline and a sustainable government expenditure programme. The Government has traditionally avoided large, unsustainable budget deficits and the build-up of a large burdensome debt through sound financial management, which restrained expenditures to levels in line with expected revenues and implementation capacity. However, much of Government's revenue comes from the sale of diamonds, which are not a renewable resource. In essence, Botswana has been selling off part of its national wealth to fund government expenditures. Unless the diamond wealth is replaced with another form of productive wealth, such funding of government is not sustainable, and will leave Botswana poorer at the end of the day. It has been suggested that much of government expenditure, especially development budget spending and recurrent budget spending on education and health, is productive investment of the diamond revenues, and thus amounts to sustainable budgeting. However, it can be argued that much of that expenditure will not be creating new income generating assets; some of that expenditure may just amount to consumption (health care for the terminally ill and aged), and some may just be replacing other assets that have depreciated, become obsolete, died or retired (old buildings and roads, previously educated and trained labour).

The issues regarding public sector reform likewise involve improving the environment for rapid private sector development, through raising government productivity in the provision of public goods and services, reducing regulatory impediments to business activities, enhancing cost recovery and the targeting of government subsidies, and empowering citizens to participate and benefit more fully in the country's economic development.

An essential part of Botswana's national development strategies is the focus on Citizen Economic Empowerment, as reflected in the set of policies and programmes designed to enable Batswana to participate meaningfully in every aspect of the economy, while also benefiting the broad spectrum of society in a socially just way. The empowerment philosophy aims to foster entrepreneurship which will unleash the potential of citizens, who will take risks to benefit themselves and other Batswana by creating globally competitive businesses and new wealth. In order to achieve this, Government is expected to provide the requisite macroeconomic policy framework, needed infrastructure and public goods and services, as well as incentives that are based on sound and credible principles. In so doing, Government must ensure the incentives it puts in place do not create distortions that could disadvantage society, encourage dependency on government subsidies and handouts or create opportunities for fraud, abuse or rent-seeking.

Environmental conservation, utilising the nation's natural resources in beneficial ways that do not diminish future generations' ability to benefit equally from the resources, is at the core of sustainable development. Raising the productivity of the country's natural resources and reducing wastage and pollution of natural resources are key environmental issues for NDP 9. Ensuring that environmental issues are fully addressed in the formulation of national development plan policies, programmes and projects remains a challenge for the planning process.

Addressing the various critical development policy issues for NDP 9 will invariably encounter policy conflicts and necessitate trade-offs of some objectives for others. The consultative processes of preparing the Plan provide opportunities to address those conflicts and trade-offs, and reach an acceptable balance. One the nation can live with for six years and beyond.

A Change in Exchange Rate Policy?

Pursuit of Economic Diversification has played a central role in Botswana's economic policy framework for the last three decades. In fact, the theme for the eighth National Development Plan (NDP 8) is *"Sustainable Economic Diversification"*. To help achieve this, exchange rate policy had been directed at maintaining a stable and competitive exchange rate against Botswana's major trading partner, South Africa. Evidence of this can be found in the pula exchange rate against the rand, which stayed within the range of R1.24-R1.36 per pula from September 1991 to August 2000. However, over the last 12 months, the pula has risen from 1.43 to an unprecedented high of 1.70 against the rand (see figure1 below), an increase of 19%.

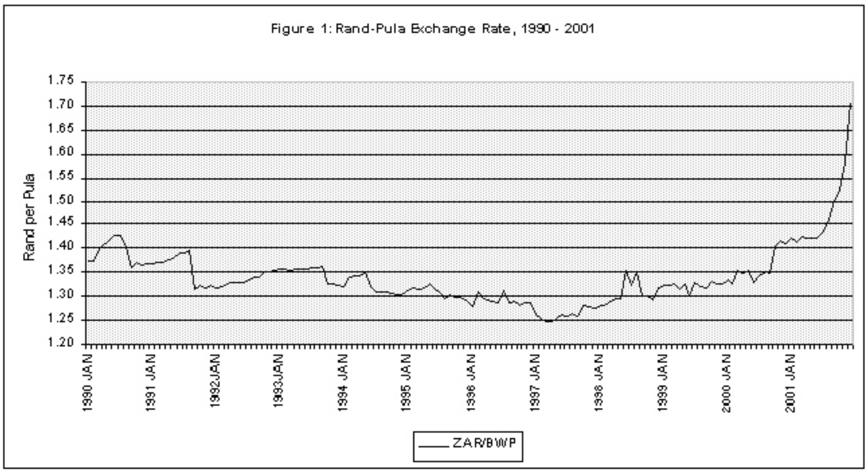

Figure 1: Rand-Pula Exchange Rate, 1990 - 2001

The unchecked appreciation of the pula shows that the maintenance of the stable pula/rand rate, and the drive to ensure the competitiveness of Botswana's goods vis-à-vis their South African competitors are no longer the priorities they used to be. This is likely to undermine Botswana's objectives of sustainable economic diversification, since domestic producers exporting to South Africa and other markets, as well as those competing in the local market with South African producers, are likely to lose their competitiveness. If the Pula appreciates against the currencies of countries with which Botswana must compete (e.g., South Africa), without commensurate increases in the productivity of Botswana's labour and natural resources, business profitability will fall, international competitiveness will be eroded, less private sector investment will occur and fewer jobs for Batswana will be created or sustained.

For some time, there has been speculation that the authorities will devalue the pula/rand rate to its earlier level of R1.30 - R1.40. Such devaluation has not happened, and the Minister of Finance and Development Planning has indicated that the Government has no indications of doing so.

The exchange rate is just one of the many factors that influence competitiveness, and indeed business decisions. In the face of an appreciating pula against the rand, government policy would have to improve the other aspects of the economic environment to help ensure the competitiveness of Botswana's exports in South Africa and other markets. Among the other important determinants of overall competitiveness, it is labour productivity that has a major and perhaps lasting impact on manufactured exports. With high productivity levels, Botswana may be able to keep up the momentum of non-traditional exports to South Africa despite sustained real appreciation of the Pula against the rand. Unfortunately, this is unlikely to be the case, as productivity levels in Botswana are not that impressive, and do not appear to be increasing rapidly.

However, if Botswana cannot achieve high and rising levels of productivity, another policy option would be to restrain wages to be in line with productivity. But wage restraint to promote exports would not only generate some social costs, such as worker dissatisfaction and labour unrest, it could have adverse effects on long term productivity growth.

If Botswana is to build a sustainable non-traditional export base, a return to the original policy of maintaining a stable pula/rand exchange rate would seem to be inevitable. It would seem logical to devalue the pula in order to promote and restore competitiveness of domestically produced goods. If the authorities are not prepared to restore the pula's alignment with the rand, a much more concerted effort by government and the private sector is required to increase levels of productivity to remain competitive in the South African and international markets. The development of a lasting non-traditional export base is key for the success of NDP 9's theme of realising Vision 2016 through internationally competitive sustainable economic diversification.

Value Added Tax

The value added tax (VAT), an indirect tax on consumer spending, is similar to the sales tax. However, instead of implementing one tax (of a certain percentage) at the time of retail sale, there is a tax imposed each time value has been added to a product; hence the name "value added tax".

For example, a supplier of a raw material may sell his produce to a manufacturer for P100, to which is added P10 of VAT. Thus, the total price, including VAT, charged to the manufacturer is P110. The supplier is obligated to pay P10 to the Tax Authority as VAT. The manufacturer in turn adds P100 of value (in the form of wages and profits), is able to claim P10 from the Tax Authority as an input tax paid, and has a sales price before VAT of P200. The manufacturer adds 10% to this to have a total charge to the retailer of P220, of which P20 is to be paid to the Tax Authority. Given the P10 of input tax the manufacturer can claim from the Tax Authority, the manufacturer has a net VAT payment of P10 to make. The retailer, in turn, adds P50 in value, can claim back P20 from the Tax Authority, and has a sales price before VAT of P250, to which is added P25 in output tax. The net VAT obligation of the retailer is P5. The final consumer pays P275 for the product, of which P25 is the VAT. This VAT consists of P10 collected from the supplier, P10 from the manufacturer and P5 from the retailer.

Table1: Illustration of the VAT Process

	Purchase Price of Inputs (including VAT)	**Less Input Tax Paid by Firm**	**Value Added by Firm**	**Sales Price before VAT**	**Output Tax @10%**	**Sales Price Charged to Buyer (including VAT)**	**Net VAT Paid by Firm (Output Tax less Input Tax)**
Supplier	-	-	100	100	10	110	10
Manufacturer	110	10	100	200	20	220	10
Retailer	220	20	50	250	25	275	5
Total VAT Paid to Tax Authority							**25**

Many countries in the world have recognised the benefits of VAT over other tax systems and moved towards it. The Government of Botswana, in accordance with the general trend, decided to replace the existing sales tax by the VAT, with effect from July 2002. The reason for this switch, according to the Government, is to implement a tax system that is fair, effective and administratively easier. In addition, the Botswana Government has long sought out means of diversifying its revenue sources away from dependence on minerals (particularly diamonds). The VAT will assist in diversifying government revenue and reduce its dependence on and vulnerability to fluctuations in mineral revenues.

The sales tax was first introduced in the country in 1989. Despite its similarities to the VAT, the sales tax has some significant limitations. One of its most prominent limitations is its coverage. The sales tax, by and large, excludes many goods and services that would otherwise be covered under the VAT. For example, in Botswana, various products are not liable for sales tax, such as raw materials purchased for manufacturing goods and many food items and building materials. An additional weakness of the sales tax is the problem of "tax cascading". This occurs in instances where producers purchase taxed inputs and produce final products that are again subject to sales tax, leading to 'tax on tax' in the final consumer price.

In contrast, the VAT being introduced in Botswana attempts to address these shortcomings. Firstly, the VAT will be broad-based, and apply to virtually all goods and services, thus not discriminating between industries. Secondly, unlike the sales tax, Botswana VAT has a registration threshold obliging all enterprises with taxable turnover of P250,000 or more per annum to apply VAT at a rate of 10 percent on sales of taxable goods and services. This means that many small businesses will drop out of the tax net. However, voluntary registration is permitted for companies with taxable turnover falling below the stipulated threshold. Despite the exclusion of small enterprises earning taxable turnover of less than P250,000 per annum, the inclusion under VAT of more goods and services that were previously excluded from sales tax should hopefully enhance the revenue base. Thirdly, the fact that VAT is imposed at all levels of production enables it to provide a better audit trail than a single-stage retail sales tax, making it administratively easier than the sales tax in this regard. Furthermore, the fact that VAT is only collected by a registered person, provides an incentive for enterprises to report VAT in order to reclaim the VAT paid on earlier stages of production. When a registered person purchases goods and services he pays *input tax*. When he supplies goods and services he charges *output tax*.

Since the VAT system enables enterprises to reclaim input tax, the tax paid does not become a cost to the producers. This implies that VAT may improve international competitiveness since prices can be kept low, particularly for goods that had previously been subject to sales tax. The VAT system has high compliance costs due to the fact that it depends to a large extent on good record keeping and self-reporting.

Policymakers may be particularly interested in the potential impact of the VAT on, amongst other things, revenue yield, equity, inflation and administrative costs. The broad-based nature of the VAT system gives it *enormous revenue potential*. This revenue potential varies with the comprehensiveness of the tax base. The VAT (or any other major tax increase) could have contractionary effects on the economy unless it is offset by other countervailing economic policies to neutralise this effect.

Equity Considerations:

It has been found that lower-income households spend a greater proportion of their incomes on the consumption of goods and services than higher-income households. Furthermore, since it is consumer spending that is the main item being taxed, the tax is collected indirectly from producers who then pass it on to consumers in the form of higher prices. Thus, a consumption tax would tend to be regressive in nature. The implication of VAT on consumer equity is of paramount importance, given the skewed nature of the income distribution in Botswana, as well as the substantial proportion of the population still living in poverty. For these reasons, equity considerations for consumers would argue against a broad-based VAT. While these arguments may be valid, consumer equity is not best dealt with by weakening the robustness of the VAT system. Instead, this regressive consequence of VAT could be reduced or even eliminated by channelling the collected VAT revenue to well-designed social support programmes.

If more revenue is collected in tax (assuming everything else remains the same), the macroeconomic effect can be deflationary as individuals are left with less disposable income. But for the newly included goods and services in the tax net, the final price to consumers will be higher. However, for goods and services no longer subject to tax cascading, the final price will be lower. In both cases, these are one-off short-term price effects, which can be counteracted by the central bank and Government actions to eliminate any long-term effect on the rate of inflation.

Neutrality of a major source of government revenue is of great importance. From a macroeconomic point of view, if a source of revenue, such as the VAT, is neutral, it has little effect on economic decisions. The greater a source of revenue's neutrality, the more it should be preferred. On this note, VAT is a relatively, but not completely neutral tax, since it is never levied on all goods. The selective nature of a VAT system implies that prices of taxed goods would rise relative to untaxed goods. This price difference would influence households' decisions on which goods to purchase, and consequently would affect firms' decisions about which goods to produce, and what resources to use.

The success of VAT systems has varied considerably across countries. Past experiences from other countries indicate that a high level of political commitment, careful planning, mass participation and extensive taxpayer education campaigns are important elements in introducing VAT successfully and in enabling the nation to reap the benefits of a VAT system. As Botswana looks towards introducing VAT, it is important that businesses, consumers and other civil society institutions are fully brought on board so they can understand what needs to be done to implement the new tax regime smoothly and efficiently.

ECONOMIC FACTS AND FORECASTS

Quarterly

	1999		2000				2001			
(end of period)	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Interest rates (%)										
BOBC (3 month)	11.68	11.98	12.43	12.49	12.49	12.71	12.67	12.89	12.82	12.64
Prime	14.75	14.81	15.25	15.25	15.25	15.75	15.75	15.75	15.75	15.75
Inflation (%)	9.1	8.4	7.8	8.9	8.2	8.7	7.5	7.1	6.1	5.8
Rand-Pula	1.320	1.329	1.354	1.330	1.385	1.411	1.426	1.429	1.500	1.709
US$-Pula	0.220	0.216	0.206	0.195	0.190	0.187	0.177	0.174	0.167	0.145
BSE index	1417	1399	1471	1435	1475	1454	1733	2037	2214	2455

Annual

		1994	1995	1996	1997	1998	1999	2000	2001	2002
Growth (%)										
GDP (real)	*d*	4.0	3.2	5.5	5.6	8.1	4.1	8.1	9.1 *p*	4.9 *f*
Non-mineral GDP (real)	*d*	5.8	6.1	5.5	7.3	7.8	6.2	3.9	6.5 *p*	6.5 *f*
Exports (nominal)	*b*	20.6	19.0	23.1	39.7	-15.4	41.2	12.5	-0.6 *e*	10.2 *f*
Imports (nominal)	*b*	3.9	21.5	9.6	44.0	19.3	3.4	22.5	-9.5 *e*	13.7 *f*
Govt. spending (nominal)	*c*	-4.6	21.5	17.3	21.6	22.4	15.0	6.6	20.9 *p*	26.8 *f*
Govt. revenues (nominal)	*c*	-16.6	22.2	35.3	12.0	-7.2	55.8	18.0	-5.4 *p*	10.4 *f*
Formal employment	*s*	1.3	1.2	2.2	-4.5	6.1	6.4	2.1	4.0	5.0 *f*
Unemployment rate	*a*	21.3	21.5	20.9	20.4	19.8	17.8	15.8	15.6 e	15.2 *f*
Domestic (bank) credit	*b*	18.2	-3.7	1.1	5.6	56.1	41.3	17.7	13.7 e	13.7 *f*
Interest rates (%)										
BOBC (3 month)	*a*	11.90	11.95	12.23	11.40	10.66	11.98	12.71	12.64	11.50 *f*
Prime	*a*	14.00	14.50	14.50	14.00	14.00	14.81	15.75	15.75	14.75 *f*
Inflation (average, %)		10.6	10.5	10.1	8.9	6.5	7.8	8.5	6.5	6.8 *f*
Rand-Pula	*a*	1.305	1.294	1.284	1.278	1.318	1.329	1.411	1.709	1.717 *f*
US$-Pula	*a*	0.368	0.354	0.274	0.263	0.224	0.216	0.187	0.145	0.140 *f*
BSE index	*a*	313	333	352	709	947	1399	1454	2455	2791 *f*
Balance of Payments (Pm)										
Exports (diamonds)	*b*	3,727	3,994	5,272	7,675	6,004	9,603	11,748	11,471 e	12,644 *f*
Exports (other goods)	*b*	1,305	1,995	2,100	2,620	2,704	2,690	2,087	2,285 *p*	2,512 *f*
Imports (goods, cif)	*b*	3,663	4,451	4,879	7,026	8,380	8,664	10,613	9,607 *p*	10,922 *f*
Current account balance	*b*	568	831	1,644	2,634	860	2,859	2,782	2,558 *p*	3,464 *f*
Foreign Reserves										
Pula m	*a*	11,961	13,249	19,076	21,619	26,485	28,852	33,880	41,182 *p*	44,678 *f*
US$ m	*a*	4,402	4,695	5,234	5,675	5,941	6,229	6,317	5,897 *p*	6,256 *f*
Govt. spending (Pm)	*c*	4,277	5,195	6,092	7,406	9,065	10,428	11,113	13,433	17,030 *f*
Govt. revenue (Pm)	*c*	4,472	5,464	7,395	8,281	7,681	11,963	14,115	13,347	14,741 *f*
Budget surplus/(deficit) (Pm)	*c*	196	270	1,302	875	-1,385	1,536	3,002	-85	-2,289 *f*
Govt. balances at BOB	*a*	6,705	6,460	7,204	15,364	19,212	20,199	24,740	31,802 e	24,175 *f*

Notes: a end of period; b calendar year; c financial year (starts March); d statistical year (starts July)
e BIDPA estimate; f BIDPA forecast; p preliminary data; s year to September
Details of assumptions underlying the forecasts can be obtained from BIDPA.
Sources: CSO, Bank of Botswana, MFDP, BIDPA

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Te.: (+267) 371750 Fax: (+267) 371748. Website: http://www.bidpa.bw The Botswana Institute for Development Policy Analysis (BIDPA) is an independent, non government research institute with two main areas of interest: development policy analysis, and capacity building. BIDPA's functions include carrying out research and consultancy in the field of economic and social policy. BIDPA's clients include government, international organisations, NGO's and companies