Briefing

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Consolidated Cash Flow Presentation of the Budget (Pula millions)

	1983/84 Actual	1997/98 Actual	2000/01 Actual	2003/04 Revised Est.s	2004/05 Budget Est.s	Growth % p.a. 1997/98 -2004/05	2003/04 -2004/05
Revenue and Grants	**563**	**8,281**	**14,115**	**16,182**	**18,209**	**11.9%**	**12.5%**
Revenue	**515**	**8,169**	**14,051**	**15,982**	**18,009**	**12.0%**	**12.7%**
Tax Revenue	**441**	**6,767**	**12,078**	**13,044**	**16,097**	**13.2%**	**23.4%**
Mineral	194	4,681	8,368	6,721	8,070	8.1%	20.1%
Customs Pool	157	1,186	2,188	2,263	3,294	15.7%	45.6%
Non-Mineral Income Tax	79	537	925	2,234	2,554	24.9%	14.3%
Sales Tax/VAT (I)	8	328	524	1,725	2,070	30.1%	20.0%
Miscellaneous Taxes	3	35	72	101	109	17.6%	8.0%
Non-Tax Revenue	**74**	**1,402**	**1,973**	**2,938**	**1,912**	**4.5%**	**-34.9%**
Interest (PDSF/RSF/Other)	14	252	205	170	59	-18.8%	-65.6%
Other Property Income	37	984	1,195	1,136	470	-10.0%	-58.7%
Of which, BOB revenue	37	947	1,167	755	434	-10.5%	-42.5%
Fees, Charges & Sundry	21	133	508	959	1,051	34.3%	9.6%
Sale of Property	2	32	65	673	333	39.4%	-50.6%
Grants	**48**	**112**	**65**	**200**	**200**	**8.6%**	**0.0%**
Expenditure & Net Lending	**460**	**7,406**	**11,536**	**16,207**	**18,140**	**13.7%**	**11.9%**
Recurrent	**271**	**4,827**	**8,383**	**13,258**	**14,571**	17.1%	9.9%
Personal Emoluments	109	1,686	2,743	3,941	4,776	16.0%	21.2%
Other Charges	148	3,054	5,557	9,097	9,442	17.5%	3.8%
Public Debt Interest	13	86	83	220	353	22.3%	60.4%
FAP Grants	**2**	**102**	**120**	**0**	**0**		
Development Expenditure	**141**	**2,696**	**3,135**	**4,000**	**3,610**	**4.3%**	**-9.8%**
Net Lending	**47**	**-218**	**-101**	**-1,051**	**-40**		
PDSF/RSF Loans	53	68	129	86	0		
Repayment of Loans	-6	-286	-230	-1,137	-40		
Overall Surplus/Deficit (-)	**103**	**875**	**2,579**	**-24**	**69**		
Financing	**-103**	**-875**	**-2,579**	**24**	**-69**		
External loans	34	234	34	135	97		
Internal Loans	0	0	0	1,880	0		
less Amortisations	-14	-148	-193	-255	-177		
IMF Transactions	-1	0	-18	-10	-10		
Pension Liability Fund			0	-4,000	-980		
Other Financing	-3	13,381	690	-10	-10		
Change in Cash Balances	-119	-14,342	-3,092	2,284	1,011		

Source: Ministry of Finance and Development Planning; Financial Statements, Tables and Estimates of the Consolidated and Development Fund Revenues 2004/05.

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2004/05 Budget Briefing

Introduction

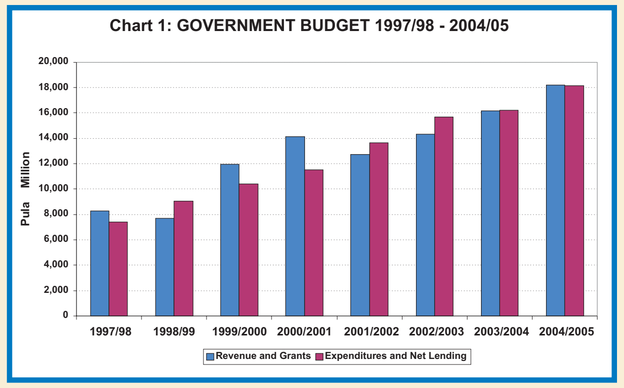
This special BIDPA Briefing takes a historical look at government budget performance, highlighting the changing fiscal outlook and its implications for future macroeconomic policies. The first part of the Briefing considers how revenue prospects are becoming less buoyant at the same time that serious pressures are emerging for large increases in public expenditures for programmes such as combating and coping with HIV/AIDS. The "crossover" into fiscal deficit territory will necessitate difficult public choices and more stringent budgetary practices, along with revenue enhancement measures. The second part of the Briefing looks at the functional classification of the budget, highlighting the reduced shares going to economic services. The review raises concerns about the implications this may have for achieving National Development Plan and Vision 2016 objectives for sustainable economic diversification, international competitiveness, employment creation and poverty reduction.

Government Revenue Prospects vs. Public Expenditure Pressures

The 1998/99 government budget signalled a turning point in the soundness and sustainability of the country's fiscal position. For 16 years prior to that budget, the government recorded budget surpluses and built up its cash balances at the Bank of Botswana, which had their counterparts in the accumulation of foreign exchange reserves, which the Bank invested and managed. The 1998/99 budget heralded the "Crossover" in expenditures being greater than revenues, something that had long been anticipated by government planners (see Chart 1). While government revenues and expenditures are both subject to shocks that can lead to sizable deficits or surpluses in the short run, Botswana's fiscal position has entered a new era where for some time to come Government will need to more cautiously manage the public finances.

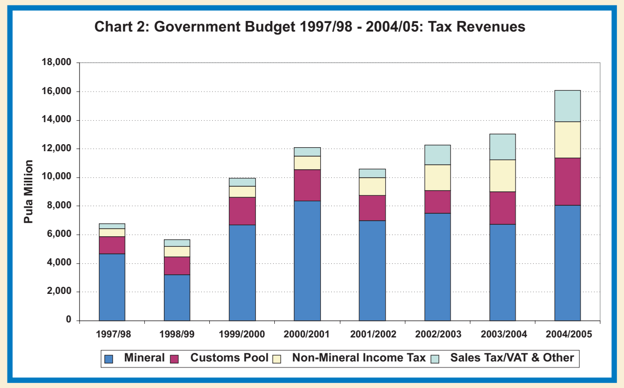
The continued rapid growth in government expenditures occasioned by the development of additional public infrastructure and the increased provision of public goods and services to the population was inevitably expected to surpass the level of revenues, which had been buoyed up by the discovery and exploitation of diamonds at Orapa, Letlhakane and, especially, Jwaneng. With limited prospects for government revenues outside of mineral revenues, especially with lower Southern African Customs Union (SACU) tariffs expected, as a result the new customs union agreement, trade liberalisation and the World Trade Organisation (WTO) bindings, and the new Bank of Botswana Act, which removed exchange rate valuation gains as a source of government revenues, the fiscal outlook was sobering, and expected to put increasing strain on public policy-making.

However, the Orapa 2000 expansion, along with exchange rate depreciation occasioned by the collapse of the South African rand, forestalled budget deficits in 1999/00 and 2000/01. However, the limited, even negative revenue growth since 2000/01 has brought back the spectre of long term fiscal imbalances which threaten the country's reputation for sound economic management and macroeconomic stability. While a developing country like Botswana has some capacity to incur debts that can contribute to raising the rate of national investment, such debt needs to be kept within manageable proportions, at the same time that the country maintains it ability to cope with adverse economic and fiscal shocks.



The trend in the Government's tax revenues basically tells the story (see Chart 2 and Table 2 at the end). Since 2000/01, there has been no growth in mineral revenues, even in nominal terms, and several years witnessed falls in mineral revenues. Mineral revenues were P8,367 million in 2000/01, and declined P6,721 million in 2003/04. They are expected to recover to P8,070 million in 2004/05. Mineral revenues, which basically come from the sale of Debswana's diamonds, should vary in line with mineral production and the exchange rate of the Pula vis-à-vis the US dollar (the currency in which diamond prices are denominated). Since mineral production, especially diamonds, is not expected to expand much in the foreseeable future, and diamond prices are not expected to rise much in real terms, mineral revenues can only be expected to grow modestly in the future. Other tax revenues vary in relation to their tax bases. For example, under the SACU agreement, customs union revenues vary in relation to dutiable imports and excisable production; non-mineral income tax varies mainly in relation to the income generated outside mining; and VAT likewise varies in line with non-mining GDP, given almost all the minerals are exported. While growth of non-mining GDP, especially of non-traditional exports, is recognised as essential for rapid economic growth and diversification, lack of international competitiveness threatens to keep such growth modest in the years ahead.

SACU revenues did not show much of an upward trend from 1999/2000 to 2003/04, increasing from P1,931 million to P2,263 million. But, the budget for 2004/05 indicates a very large increase in SACU revenues to P3,294 million. However, SACU revenues should fall with the introduction of the new SACU Agreement and the ongoing trade liberalisation as a result of the WTO, the European Union-South Africa Free Trade Agreement, the SADC Free Trade Protocol and the SACU-USA Free Trade Agreement. With respect to other major tax revenues, non-mineral income tax has increased from P537 million in 1997/98 to P2,234 million in 2003/04, an average increase of 27 percent per annum. Non-



mineral income tax is expected to increase by 14 percent to P2,554 million in 2004/05. The introduction of Value Added Tax (VAT) has also boosted revenues substantially from the P520 million collected in Sales Tax in 2001/02 to P1,725 million collected in VAT in 2003/04. The budget expects P2,070 million to be collected in VAT, an increase of 20 percent over the previous year.

While there are, undoubtedly, some opportunities to enhance tax revenues through improved tax administration and compliance, Government does not want to raise taxes and reverse the private sector-friendly environment it has worked hard to create. Tax increases would reduce the international competitiveness of businesses operating in Botswana; and Botswana is not competitive enough at present, either locally, regionally or globally. At the same time, reversals of tax policy would erode the policy credibility of Government, create uncertainty regarding future tax policy and tend to discourage investment in Botswana.

While exchange rate devaluation can serve to boost some of Government's major revenues sources (e.g., mineral revenues, SACU revenues and earnings from the BoB on the international reserves) in the short run, such a policy intervention has its pitfalls in terms of raising the costs of needed imports and aggravating inflationary pressures in the economy. Unless supported by complementary fiscal, monetary and wage policy, exchange rate devaluation is not likely to lead to sustained improvements in international competitiveness or the government budget.

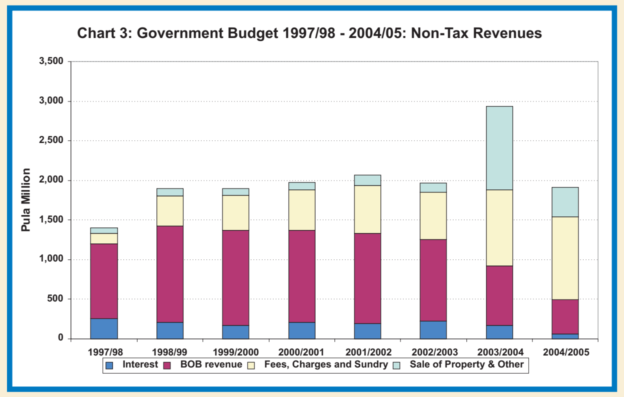


Chart 3: Government Budget 1997/98 - 2004/05: Non-Tax Revenues

Non-tax revenues have basically been flat since 1998/99, when they reached P1,900 million, except for a spike in 2003/04, when they reached P2,938 million, mainly due to a large sale of public property of P673 million. For 2004/05, the budget envisages P1,912 million in non-tax revenues. The major components of non-tax revenues comprise interest, mainly from Public Debt Service Fund (PDSF) loans, other property income, mainly Bank of Botswana revenue, and fees, charges and sundry items. The sale of property has also been a significant revenue source occasionally.

Interest received is expected to fall with the sale of PDSF loan book and repayment of other Government lending outstanding. Bank of Botswana revenues have fallen dramatically over the past seven years, from P1,700 million in 1996/97 to P755 million in 2003/04. Revenue from the central bank is expected to fall further in 2004/05 to P434 million, due to the drop in Government balances at the Bank, occasioned by the funding of the Public Officers Pension Fund, government budget deficits and a downturn in international markets where the foreign exchange reserves are invested. Fees, charges and sundry have grown rapidly, from P112 million in 1997/98 to P959 million in 2003/04, an average increase of 35.9 percent per annum. These revenues are expected to increase by 9.6 percent in 2004/05, to P1,051 million. With respect to the sale of property, this can include land, shares invested in companies (e.g., Anglo-American) and other assets. Most of such revenue generation measures are a one-off affair, since Government does not have an unlimited supply of such property.

There has been steady growth in recurrent expenditure over the past seven years (see Chart 4), with total recurrent expenditure increasing from P3,972 million in 1996/97 to P11,581 million in 2003/04, an increase of 16.5 percent per annum on average. The 2004/05 budget envisages recurrent expenditure growing a further 14.5 percent to P13,258 million. With respect to development expenditure, there has been a plateauing of such expenditure over the past three years, albeit at quite a high level (approximately P4,000 million). With a lag, the tapering off of development expenditure should give rise to a slowing down in the rate of growth of recurrent expenditure. As shown in Chart 4, net lending has been basically zero over the past six years, except for the sale of the PDSF loan book, which the Minister of Finance and Development Planning announced would occur in 2003/04.

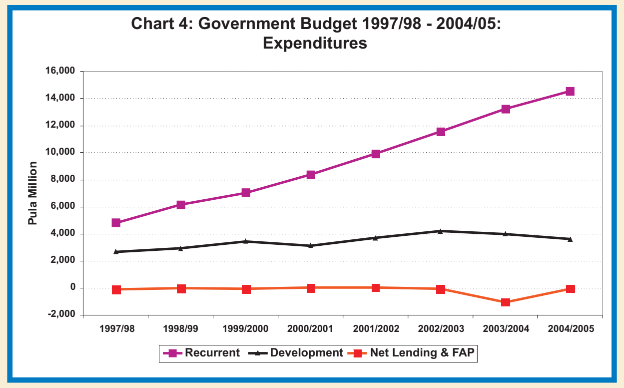


Chart 4: Government Budget 1997/98 - 2004/05: Expenditures

Functional Classification of Government Expenditure and Net Lending

Government expenditure can be broken down into nine broad functional categories, including: (1) General Public Services; (2) Defence; (3) Education; (4) Health; (5) Food and Social Welfare; (6) Housing, Urban and Regional Development; (7) Community and Social Services; (8) Economic Services; and (9) Unallocated Expenditure, which is comprised mostly of revenue support grants to local authorities and interest on the public debt.

Table 1 presents some summary functional expenditure breakdowns for the years 1983/84, 1997/98 and 2004/05, the last year showing the budget estimates for the current year. Over the period from 1983/84 to 2004/05, total Government expenditures and net lending increased from P460 million to an estimated P18,140 million, an increase of 19.1 percent per annum. Even over the more recent period from the start of National Development Plan 8 (1997/98) to 2004/05, the second year of National Development Plan 9, growth of total expenditure and net lending has averaged 13.7 percent per annum.

Over the 21 year period from 1983/84, there have been some major shifts in the composition of Government expenditure. General public services, which covers things like the legislature, foreign affairs, financial administration, government transport, courts and legal administration, the police and prisons, because it has grown at nearly the same rate as total expenditure and net lending, has maintained its share at about 19 percent over the period. Defence, which has grown at an average annual rate of 20.9 percent, has seen its share of total expenditure and net lending increase from 6.1 percent in 1983/84 to 8.3 percent in 2004/05. Education, which constituted 16.9 percent of total expenditure and net lending in 1983/84, because it has grown 21.5 percent per annum on average, has experienced dramatic growth, with its share of the total rising to 24.1 percent in 1997/98, and further to 25.8 percent in 2004/05. Even more dramatic growth has been recorded in the health sector, with government expenditure on health growing at an average annual rate of 23.2 percent over the 21 year period, increasing health's share of the budget from 4.9 percent in 1983/84 to 5.6 percent in 1997/98, and further to 10.0 percent in the 2004/05 budget. Expenditure on health has grown dramatically since 1997/98, averaging 23.7 percent per annum to 2004/05, the highest growth of any functional category over the period (see Chart 5).

Expenditure on the three functional categories of Food and Social Welfare, Housing, Urban and Regional Development, Community and

Table 1: Functional Classification of Government Expenditure and Net Lending, 1983/84 – 2004/05, Pula Millions

Functional Category	1983/84	1997/98	2004/05	Share 1983/84	Share 1997/98	Share 2004/05	Growth p.a. 1983/84 -2004/05	Growth p.a. 1997/98 -2004/05
1. General Public Services	87.7	1,402.1	3,393.3	19.1%	18.9%	18.7%	19.0%	13.5%
2. Defence	27.9	625.8	1,503.8	6.1%	8.4%	8.3%	20.9%	13.3%
3. Education	77.9	1,787.8	4,681.9	16.9%	24.1%	25.8%	21.5%	14.7%
4. Health	22.6	411.2	1,819.9	4.9%	5.6%	10.0%	23.2%	23.7%
5,6,7. Food & Social Welfare, Housing, Urban & Regional Dev't., Community & Social Services	51.6	721.8	1,713.2	11.2%	9.7%	9.4%	18.2%	13.1%
8. Economic Services	154.6	1,701.8	2,986.0	33.6%	23.0%	16.5%	15.1%	8.36%
9. Unallocated Expenditure	37.8	755.7	2,042.2	8.2%	10.2%	11.3%	20.9%	15.26%
Total Expenditures & Net Lending	460.1	7,406.1	18,140.1	100.0%	100.0%	100.0%	19.1%	13.65%

Source: Ministry of Finance and Development Planning, Financial Statements, Tables and Estimates of the Consolidated and Development Fund Revenues 2003/04 and 2004/05.

Social Services has grown at an average rate of 18.2 percent per annum since 1983/84; and, as a result, the share of total expenditure and net lending on these categories has declined from 11.2 percent in 1983/84 to 9.7 percent in 1997/98, and further to 9.4 percent in 2004/05. However, the big loser in terms of budget share has been spending on economic services, which covers items such as agriculture, mining, water and electricity, roads, air transport, rail transport, posts and telecommunications and promotion of commerce and industry. As a result of expenditure growth of only 15.1 percent per annum over the 21 year period, its share of total expenditure and net lending has fallen from 33.6 percent in 1983/84 to 23.0 percent in 1997/98 and further to 16.5 percent in 2004/05, a decline in share of more than 50 percent. Over the last seven years from 1997/98 to 2004/05, expenditure on economic services recorded the lowest growth rate of any of the functional categories, with growth of only 8.4 percent per annum.

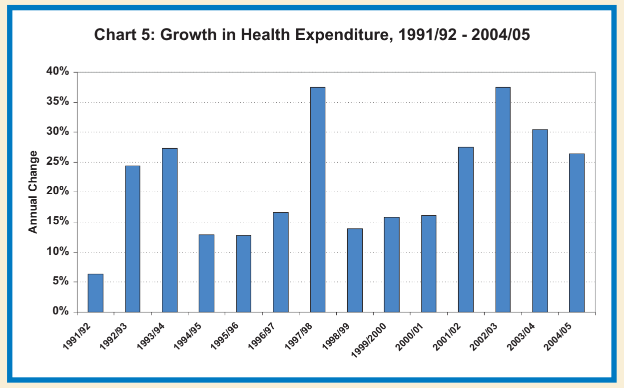


Chart 5: Growth in Health Expenditure, 1991/92 - 2004/05

With respect to the unallocated expenditure, which covers the items of public debt interest, revenue support grants and FAP (now terminated), growth of 20.9 percent per annum boosted its share of total expenditure and net lending from 8.2 percent in 1983/84 to 10.2 percent in 1997/98, and further to 11.3 percent in 2004/05. Over the period, from 1997/98 to 2004/05, mainly as a result of the growth in revenue support grants to local authorities of 16.9 percent per annum, this expenditure category registered the second fastest growth rate; i.e., 15.3 percent per annum.

As shown in Chart 6, education has been allocated the largest share of the budget in 2004/05, at 25.8 percent, followed by general public services (18.8%), economic services (16.5%) and unallocated expenditure (11.3%).

Conclusion

The different growth rates and changing shares of the different functional categories of government expenditure and net lending reflect the changing priorities and emphasis the nation has placed on the role of government in society. Those changes offer both promise and challenges to the nation. The increasing share of expenditure on health, in the context of combating and coping with HIV/AIDS, gives hope that the pandemic can be defeated and the Vision goal of an AIDS-free generation by 2016 can be achieved. Likewise, the increasing share of resources allocated to education can serve a variety of development objectives that can contribute to increases in productivity, rising living standards and an improved quality of life in Botswana.

But, the declining share of government expenditure on economic services raises concerns that the country may not be investing enough and providing enough support to create the needed environment for rapid private sector development and sustainable economic diversification. While Botswana has invested heavily in economic and social infrastructure needed for development, and may compare well with some of its neighbours, Botswana needs to have world class economic infrastructure at globally competitive costs, including an efficient road and transport system that can move goods and services around, as well as in and out of, the country quickly and at least cost, utilities that are reliably and efficiently provided at low cost, serviced land for industrial and commercial activities that is readily available at minimal cost for those willing to pay, and internationally competitive information and communications technology, also readily and inexpensively available to those who need it. There is concern that Botswana does not have such economic infrastructure in place and operating to the world class standards needed to be international competitive.

At the same time, while the sizable shares of the budget being allocated to public administration, including revenue support for local authorities, and defence are needed to create and sustain sound institutions of governance and provide security to households, businesses and civil society, such expenditures can entail a trade-off with other desired economic and social objectives. If the public sector can achieve the productivity increases needed to be internationally competitive, this can free up additional resources that can be devoted to areas that are critical for Botswana's economic development. In conjunction with efforts to improve public sector performance, it may be time to re-think the budget priorities with a view to achieving the business climate needed for Sustainable and Diversified Development through Competitiveness in Global Markets.

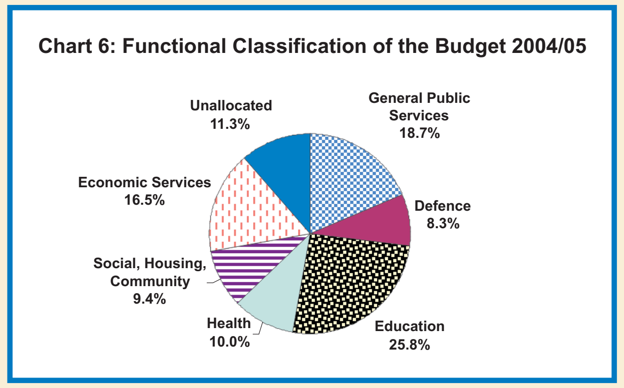


Chart 6: Functional Classification of the Budget 2004/05