ZIMBABWE ECONOMIC POLICY ANALYSIS AND RESEARCH UNIT
ZEPARU

Measures to Enhance Zimbabwe's Fiscal Space

Discussion Paper (01/10)

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1. Introduction

Zimbabwe went through a decade long of hyperinflation and successive contraction in Gross Domestic Product (GDP) between 2000 and 2008. During the period, the country's GDP contracted by a cumulative 40 percent, while inflation increased to a peak of 230 million percent in July 2008. Consequently, the country's tax revenue significantly fell from about 30 percent of GDP prior to 2000 to less than 5 percent by 2008.

The decline in Government tax revenue, resulted in almost total collapse in public services as manifested by deterioration in provision of services in key social investments in education, health, transport and energy as well as general municipal services, which led to outbreaks of water-borne diseases, such as the cholera epidemic in August 2008.

Following the implementation of the government's short-term economic recovery program in 2009, Government revenues started to recover but still remain below levels recorded prior to the decade of the economic decline. The recovery in revenues largely hinged on price stability and revenue enhancing measures introduced by government in 2009. The fiscus also largely benefited from the recovery in economic activity and a more disciplined public sector, which managed to match expenditure to revenue since the adoption of the cash budget system in 2009.

Despite the improvement in economic activity and fiscal revenue since 2009, Government remains constrained with regard to financing infrastructure development and provision of social services as much of the tax revenue and limited off-shore inflows go towards financing recurrent expenditures and the civil service wage bill. Zimbabwe continues to face challenges of rebuilding its public finances; provision and maintenance of Infrastructure that is critical for accelerated economic growth.

In 2009, for example, only 1.0% of GDP was earmarked for public sector investment programmes. This has largely negatively affected the country's growth outlook. According to the World Economic Forum's 2009 Global Competitiveness Report, Zimbabwe's economic infrastructure was ranked 101st out of 133 countries surveyed in the report, with the country's quality of electricity supply ranked among the five worst.

Thus, Zimbabwe needs to create sufficient fiscal space for non-wage expenditures in social spheres and critical infrastructure in order to stimulate economic growth. It is in that regard, the paper undertakes to assess and explore ways in which government can expand its fiscal space. The subsequent sections will examine the four pillars of enhancing the space, adapting them to facts prevailing in Zimbabwe. Ways through which government can create additional fiscal space will be suggested in each of the pillar.

2. The four pillars of Fiscal Space

Fiscal space can be defined as 'the capacity of a government to provide financial resources for a desired purpose, subject to the constraint that the fiscal position is sustainable, both over the medium and long-term' (Heller 2007). Explicit in the definition is the link to the concept of fiscal sustainability. Civil society organisations have put emphasis on the government's capacity to fund economic and social infrastructure necessary to aid growth and development, without restricting it to the aggregate resource envelop. In other words, additional resources, particularly grants that are extra-budgetary, would enhance fiscal space that could be applied to priority activities to aid development.

The incentive for creating fiscal space is strengthened where the resulting fiscal outlays would boost medium-term growth and perhaps even pay for itself in terms of future fiscal revenue. This relates to the capacity of a government, at least in the future, to finance its desired expenditure programs, to service any debt obligations and to ensure its solvency.

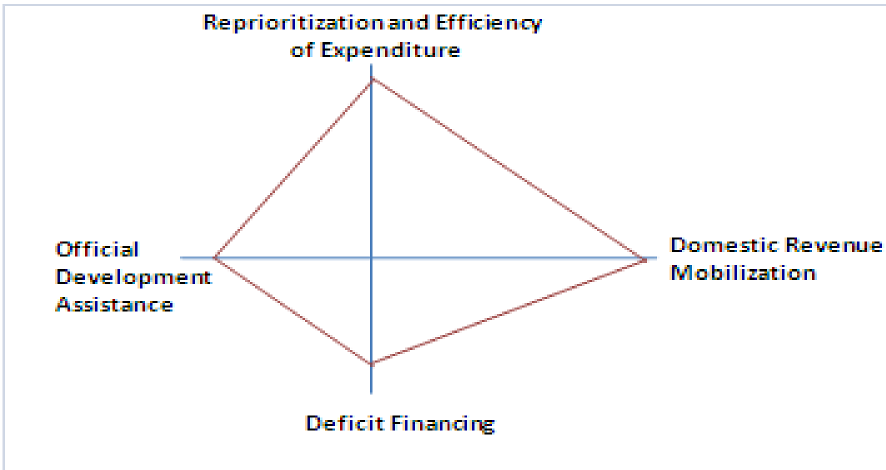
The fiscal space diamond as diagrammatically depicted in Figure 1 has four 'pillars' that collectively constitute the universe of avenues to secure fiscal space with the area of the diamond representing the aggregate fiscal space available in the country.

Governments can create fiscal space through the following types of fiscal instruments:

1. Domestic revenue mobilization through improved tax administration or tax policy reforms;
2. Reprioritization and raising efficiency of expenditures;
3. Official Development Assistance (ODA) through aid and debt relief; and
4. Deficit financing through domestic and external borrowing

The diamond does not include seigniorage, which involves issuing new currency by the Central Bank to finance the fiscal gap, as this is commonly considered to be an undesirable option due to its inflationary effects.

Figure 1: Fiscal Space Diamond



Source: Heller, 2005

The diamond illustrates the scope of a government to: (a) generate fiscal savings from improved allocative and technical efficiency of existing budget; and (b) to raise additional fiscal resources from new revenue measures, additional aid or new borrowing. To the extent that a country has already been raising a significant amount through tax revenue, has a high initial stock of debt, or receives high aid inflows, the scope to raise additional revenue from any of these sources would be small. On the other hand, the lower the allocative and technical efficiency of the existing budget, and the larger the volume of such spending, the greater would be the scope for efficiency gains as a source of fiscal space. The scope for additional aid or borrowing can in principle be estimated with reference to donor commitments or debt sustainability analysis.

Fiscal space is country-specific. The policy choices emanating from fiscal space analysis depend on a number of factors. Thus, while some countries may need to raise more revenues to finance their development programme resource envelope, others may want to reduce the tax burden. While some countries may be able to acquire more debt cheaply, others may be above their debt limits or may be able to raise funds only at high overall costs to the economy. While some countries may want to reallocate expenditure from one area to another while maintaining the same level of expenditure, others may want merely to phase out or cut programs thus, reducing the overall size of the government. Finally, fiscal space has an inter-temporal component. Essentially, the effective use of resources today is hoped to lead to increased productivity in the economy, generating a larger resource base (human and physical capital and incomes) for tomorrow's economic choices (savings, investments, consumption).
When significant public investments are required, as in Zimbabwe today, trade-off decisions are needed as to whether and by how much to reduce current or future consumption to pay for them.

Tax revenues are one important component that creates fiscal space, not only because it affects the deficit financing, but also because it has an impact on government resources devoted to achieve its high priority goals. Fiscal space can be created when additional revenues can be raised through tax measures or by strengthening tax administration to reduce tax evasion.

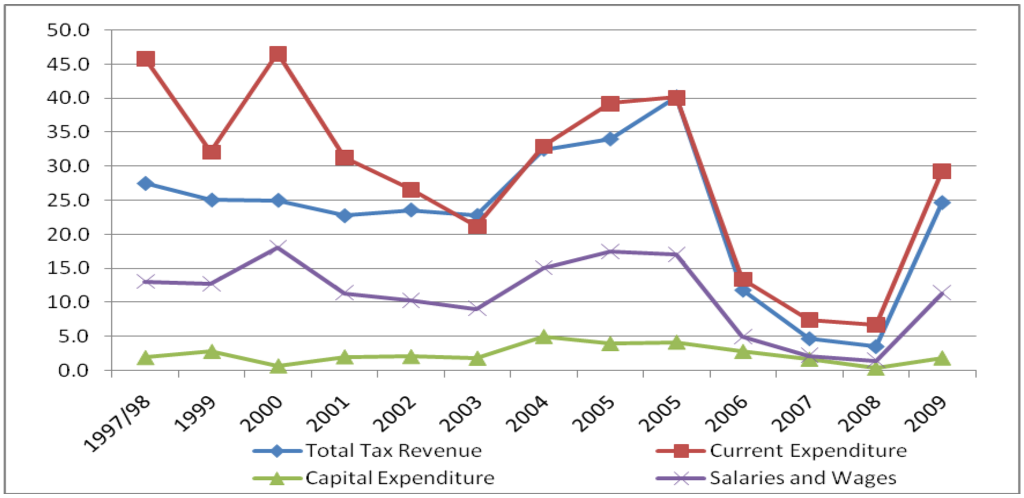
2.1 Domestic Revenue Mobilisation

A government can enhance fiscal space through more effective tax and expenditure policies. Taxes as a source of domestic revenue vary depending on the development context. Further, tax policies require detailed assessments at the country level since the level of development, trade openness and other structural factors determine the tax base. Over the long-term, resources to finance development must rely primarily on domestic revenue because international borrowing is not reliable.

The structure of the tax system also plays a role in determining the progressivity of the tax and transfer policies. Progressive taxation can foster inclusive growth through redistributive income transfers and by more effective targeting to improve access of poor and vulnerable groups to public goods. In Zimbabwe Pay as You Earn (PAYE) is progressive with a tax free threshold of US$175. Tax rates vary from the minimum tax rate of 25% to the highest marginal tax rate of 35%. Corporate tax rate and Value Added Tax (VAT) are charged a flat rate of 30% and 15% respectively. Since higher tax rates lead to higher tax evasion, there is need to reduce the tax rate to reduce evasion and smuggling as lower tax rates encourage willingness to pay.

Figure 2 shows a declining trend in government expenditure and tax revenue over the period 1998 to 2008. Spiraling inflation and contraction of output over this period undermined government revenue collection. Consequently, tax revenue fell from more than 28% of GDP in 1998 to less than 5% in 2008. Public sector capital expenditure which is critical for growth also under-performed during this period. This compromised government’s capacity to provide support to infrastructure provision and stimulate economic recovery. There is need to prioritise investment in capital expenditure to improve efficiency in the manufacturing sector. Also tax revenue collected did not cover recurrent expenditure except for the year 2003, hence there is need for streamlining of government expenditure. The declining trend in government salaries and wages is likely to have had adverse implications on aggregate demand, given that government is a major employer in the economy.

Figure 2: Tax Revenue, Capital Expenditure and Current Expenditure as Percent of GDP



Source: Ministry of Finance and IMF Staff Estimates

Decline in tax revenue over the period under review can also be attributed to the growth in the informal sector[1]. Resources available are inadequate for the resource needs of the economy hence there is need to increase the productive base since tax revenue is a function of tax base. Currently about 50% of GDP is not being accounted for due to the informalisation of the economy. Given that corporate and personal income taxes are created by the taxation of the productive sector when the sector is not operating at full capacity, restoration of production is key in increasing fiscal space through its effect on widening of the tax base. As the economy recovers the government should consider incentivising informal sector businesses to the formal sector through targeted loans and setting up of designated trading points only to those who are registered and are current on their tax obligations.

In 2009 there was a modest recovery in revenues largely due to the conducive policy environment under Short Term Economic Recovery Programme (STERP, 2009) that ushered in price stability, improved capacity utilization in industry; improved efficiencies in revenue collections and modest salaries/allowances for civil servants whose salaries had been witled down by hyperinflation. Government, however, remained under pressure as total tax revenue, excluding foreign grants, still fell short of total capital and current expenditure requirements by an estimated fiscal gap of 6% of GDP in 2009. This continued fiscal vulnerability points to the fiscal space challenges that need to be addressed.

The 2010 Mid-year fiscal policy review projected to improve revenue to 29.2% of GDP, through a host of measures including, review of the mining taxation, introduction of VAT Fiscalised Electronic Registers and Fiscal Memory Devices with enhanced security features that minimise fraud and leakages, review of the duty exemption on some basic commodities among others.

[1] Businesses not registered to Zimbabwe Revenue Authority (ZIMRA) and hence are not declaring their tax profits.

In the short term, Government could also consider the introduction of a land tax on all commercial land ownership. This could help not only mobilize additional budgetary revenues but also encourage production on farms. However, production and productivity enhancing land taxes are good but there is need to take into account the timing, as ill-timed production of such taxes could be counterproductive. Such taxes can be preceded by capacitation of farmers.

However, in the medium to long term **r**evenue performance could be further increased through strengthening tax administration and reducing the number of items that qualify for tax exemptions**.** For example, Zimbabwe's tax system has a multiplicity of concessions, exemptions, allowances, reliefs, deductions and rebates. The Income Tax Act [Chapter 23:06] itemizes more than 100 different exemptions and too many goods that are zero-rated or exempt from the VAT that includes agricultural items, basic foodstuffs and household commodities. Some of the exempted products are not contributing towards their intended objective, that is, cushioning the poor and the vulnerable groups since these exemptions benefit everyone. In fact beneficiaries of safety nets should access them through the Social Welfare Ministry and departments to ensure that only intended beneficiaries benefit.

Reforming the tax systems will inevitably improve the efficiency of the country's tax system as well as government revenue through minimizing loopholes for tax evasion and avoidance.

The Customs Tariffs system also has too many customs duty bands, ranging between zero and 100 percent. This disregards the fact that more than 90% of the customs tariffs revenue is raised from bands that are below the 40% duty band implying that duty bands of more than 40% are scaring away imports. This structure discourages trade, growth and creates loopholes for corruption.

A decade of high inflation and economic decline had weakened many of the key tax administration functions of the ZIMRA and delayed its modernization. The taxpayer register became outdated, while core audit and investigation activities were made redundant because of rapidly declining real values of corporate balance sheets and incomes under hyperinflation. Persistent economic difficulties and significant restrictions on prices and goods markets that existed prior to 2009 led to widespread informal activity, making it more difficult to collect taxes. Despite recent improvements to tax legislation, the tax regime with multiple rates and exemptions make it excessively complex.

Upgrading of ZIMRA's IT infrastructure; strengthening post clearance audits; simplifying the tax structure; the creation of a large tax payers unit and reducing nominal tax rates need to be given due consideration. The recommended reforms would reduce distortions, improve the business environment, and contribute to higher economic growth.

A comprehensive reform package of administrative improvements, streamlined tax exemptions, and a lower number of customs duties tariff bands could yield additional revenues per year**.** The objective of such reform efforts is to raise effective rates on the main revenue-raising taxes, such as the VAT, personal income tax and corporate income tax.

While these reforms would generate additional revenues, there would also be a potential growth dividend from simplifying the tax structure and reducing nominal tax rates. The recommended reforms would reduce distortions, improve the business environment, and contribute to higher economic growth.

It is also worth assessing whether some additional revenue can be raised by disposing of some idle public sector assets. There is a lot of pressure on the fiscus, given that year in and year out there are demands for new assets across all Ministries. When new assets are purchased, the old ones remain idle, even at a time when they can be transferred to other Ministries that are in need of them. It is therefore important that an audit be carried out to assess the extent to which the current assets that were rendered excess upon arrival of new ones, can be disposed of or transferred across other Ministries, which would either raise some revenues or remove pressure on the fiscus from new demands from other Ministries.

2.1.1 The structure of the tax base in Zimbabwe

The bulk of government revenue is collected from VAT, personal income tax and customs duty. VAT outperformed the single largest traditional source, personal income tax from 2005 reflecting the efficiency of the VAT system which reduced revenue leakages that prevailed under the sales tax regime. Traditionally corporate income tax performed well before the economy crisis deepened. The decline in the contribution of corporate income tax can be attributed to the unstable economic environment which led to the closure of companies, low investment, low capacity utilisation of firms that remained in operation, the shortages of foreign currency and fuel on the formal market, and liquidity constraints. The reduction in capacity utilisation by companies translated into a reduction in revenue contributed to the fiscus.

The successive Confederation of Zimbabwe Industries (CZI) manufacturing sector surveys have shown that industries are operating at below full capacity levels (see Table 2). Capacity utilisation in the manufacturing sector dropped from 60% in 2002 to 51.1% in 2003 and to below 15% by 2008. This translated into a drop in contribution of corporate income tax to total revenue. Although the economy started to recover in 2009, most companies were still operating below capacity mainly due to liquidity constraints to recapitalise production units, power outages and high cost of utilities. Most companies operated at around 10% capacity contributing merely 5% to total revenue. The contribution of corporate income tax in June 2010 increased to 11% as capacity utilisation also significantly increased from 10% to 35-50%. The survey results indicate that companies in the manufacturing sector are generally grossly underutilized hence impacting negatively on the tax base.

To enhance capacity utilisation in industry, banks need to lend in line with the business cycle as short term loans for projects with longer gestation periods, will not achieve the desired growth. The current 30 day facilities cripple businesses given that, the lag time taken to procure equipment and production is normally longer than the 30 day tenor of loans offered by banks. Hence the need to match loan tenor with project cash flows. Since tax collection is directly correlated with industry production/output, the increase in industry capacity utilisation would lead to more tax revenue collection and create fiscal space for the government.

To boost production there is also need to address issues around security of investment and security of tenure as a way of enhancing investor confidence. Full enforcement of Bilateral Investment Protection Agreements (BIPAs) already in place and the finalization of those at various stages of negotiation will enhance foreign investment attraction. Property rights must be respect and rule of law must be observed.

2.2 Reprioritization and efficiency of expenditure

Increasing expenditure efficiency is often suggested as the main instrument for enhancing fiscal space (Tanzi 1998). Expenditure switching and efficiency enhancing reforms can create fiscal space through a reallocation of resources from lower to higher priority sub-sectors and through productive efficiency gains. However, this should not mean that governments should simplistically earmark some percentage of their budgets to basic social services since it is difficult to specify ex ante the size of the potential gains from expenditure reallocation and the sectors where efficiency can be improved.

The potential for additional fiscal space varies for three related reasons: (i) the scope for expenditure switching is determined by the size of the public sector; and (ii) productive inefficiency can be addressed through long-term capacity development programmes that limit low income countries' ability to secure fiscal space through active expenditure switching policy over the short-run.

Capacity strengthening of the public expenditure management system is clearly important, since such reforms can enhance the scope for raising fiscal space. However, the range of options that are available with regard to tax and expenditure policies is necessarily restricted in the short to medium term.

Reprioritisation and increasing expenditure efficiency is often suggested as the main instrument for enhancing fiscal space, particularly at a time when an economy is recovering from a downturn as the case with Zimbabwe. Reprioritisation involves a rethink on the part of government, where priorities are set in budget allocation, with those areas considered not too critical receiving fewer allocations than those that are critical in economic transformation. Increasing efficiency of expenditure entails coming up with strategies to ensure that expenditure is allocated where it is best needed in terms of achieving and generating growth.

Some studies have shown that there is a positive correlation between public sector investment and expenditure in education, healthcare and infrastructures on one hand and factor productivity on the other (see Kramarenko *et al* (2010)). Contrary to this observation, Zimbabwe has been devoting much lower shares of its budgetary allocations towards capital expenditure. This could have negatively affected the country's growth potential.

According to UNDP (2010), there are some factors that determine the ability of government to create fiscal space through reprioritisation. This includes the size of the public sector, which determines the scope for expenditure switching and addressing political economy constraints to reforms, which often represents a binding constraint to sustainable development. On the other hand, efficiency of expenditure largely calls for both policy and institutional reforms, with policy reforms helping to direct expenditures according to envisaged priorities and institutional reforms helping in the implementation and monitoring of expenditure programs.

It is within this context that Zimbabwe's fiscal space is being assessed. Some important issues that could be addressed in determining the extent to which Zimbabwe's fiscal space can be enhanced through reprioritisation and increasing expenditure efficiency include the following:

- The size and cost implications of Zimbabwe's public sector;
- Policy and institutional reforms which call for reform for increased expenditure efficiency.

2.2.1 The size of the public sector

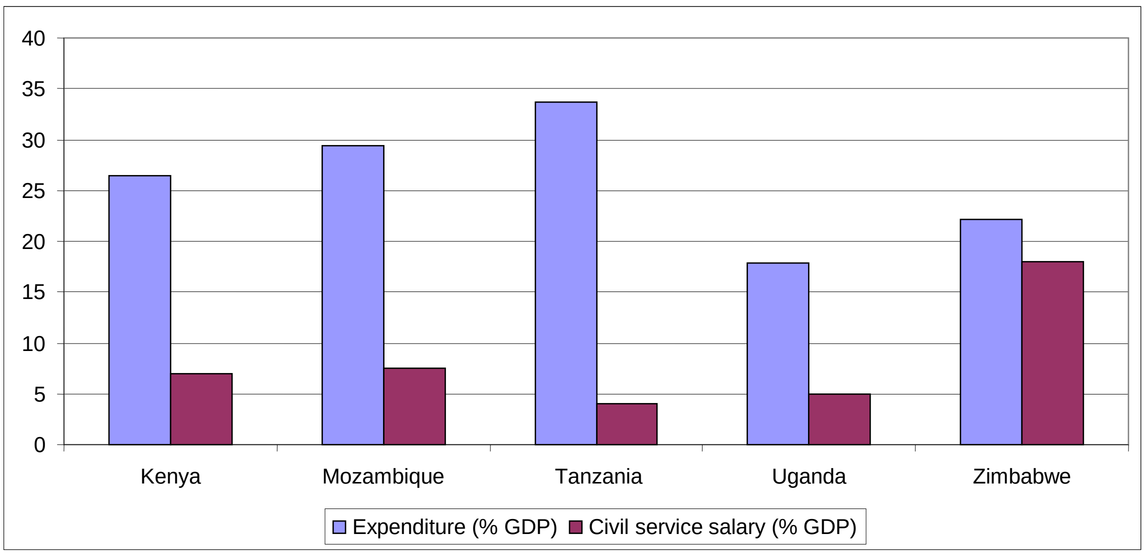
The public sector generally refers to government units, together with public corporations (Carrizosa, 2007). While the size of the public sector on one hand determines the amount of resources needed for the public sector, on the other hand it also shows the extent to which the public sector is big enough to influence economic activity. This brings to the fore the issue of an 'optimal' public sector size. Whether the public sector is too big or not can only be determined relative to its role in the economy. The optimal size of a government with poor effectiveness in the delivery of public sector goods would be smaller than that of a government with a good institutional capacity (Carrizosa, 2007).

There are various ways through which the size of the public sector can be determined. This includes the number of the public sector employees, the size of the public sector wage bill and the size of the public sector expenditure/demand for goods and service (Ngowi, 2008). For comparative purposes, variables used as potentially representing the size of the public sector include (i) share of government consumption in GDP; (ii) government consumption plus investment as a ratio of GDP; (iii) total public expenditure as a ratio of GDP and (iv) share of public sector in total labour force.

It is the total public expenditure (excluding spending on transfers) as a ratio of GDP that has an important implication; it assesses the potential macroeconomic effects of public expenditure Carrizosa (2007). In other words, it shows the effectiveness of the public expenditure in generating GDP. While a lower expenditure/GDP ratio might imply efficiency, it is largely the composition of such expenditure that is more indicative.

The total expenditure for Zimbabwe in 2009 was at around 22.2% of GDP (Kramarenko *et al*, 2010). This rate would compare relatively well with other countries in the region at face value as indicated in Figure 3.

Figure 3: Expenditure Composition in Selected African Countries[2]



Source: Constructed using data from Kramarenko et al (2010) and Ministry of Finance (2010)

A study among countries in the Americas revealed that government expenditures range between 10% and 20% of GDP in most countries (Carrizosa, 2007), except for some small countries or territories with ratios exceeding 20%. Zimbabwe, together with all the countries in Figure 3, except Uganda, would, therefore, be considered to be overspending.

It is however the breakdown of the above total expenditure that is more revealing in distinguishing among countries. While the rest of the countries devoted some relatively larger portion of expenditure towards public sector investment, Zimbabwe devoted only 1% of GDP to capital expenditure in 2009[3]. It can further be established that of the 21.2% of GDP recurrent expenditure, about 18% of GDP was spent to finance the civil service

[2] Expenditure to GDP ratio is based on 2009 figures whereas civil service salary to GDP ratio for Zimbabwe in based on June 2010 figures.

[3] Of this total expenditure, capital expenditure was 7.1% of GDP in Kenya; 7.2% for Uganda; 8.2% for Tanzania and 11.7% for Mozambique

wage bill, which constituted about 70% of the government revenue for 2009 (Ministry of Finance, 2010). A comparison with the other countries shows that at 18% of GDP, Zimbabwe's civil service salaries chew up the largest chunk of the budget compared to all the countries, with best practice being at around 7%. This shows that the total expenditure can hardly be considered effective in generating GDP as it caters largely for salaries.

While this large wage bill to GDP ratio can be regarded as reflecting that salaries are too high, a comparison with other countries in the region would reveal that at an average salary of less than US$200 per month, the Zimbabwe civil service employees are among the least paid[4]. This rules out overpayment as the reason for the large ratio, leaving out overstaffing and low capacity to generate GDP and revenues as the only plausible explanation.

The Ministry of Finance has already noted the need to align the public service wage bill to the capacity of the economy by reducing the wage bill from the current 70% to below 30% of total domestic revenues and from 18% to around 8% of GDP (Ministry of Finance 2010). Reducing the meager salaries further is not a viable option for this alignment. The results of the civil service staff audit, which was intended to pinpoint ghost workers and overstaffing, particularly under allegations of non-critical positions established under some Ministries to siphon money from the treasury, would therefore be key in this regard in addition to other methods of raising revenues and GDP. Depending on the magnitude, removal of ghost workers and these non-critical staff, who are employed but not doing any service for the benefit of the economy, from the payroll, could see some expenditure being diverted to capital expenditure. It is estimated that the payroll audit could reduce headcount in the civil service by about 10%.

Although not much has been allocated towards capital expenditure, it is also important to ensure that the little resources available are availed on a prioritisation basis, with those sectors that are too critical for facilitating private sector growth receiving more attention. It is therefore important that growth enhancing sectors such as power, water, railway and construction sectors receive priority in capital expenditure allocation.

2.2.2 Other possible cost-cutting measures

Heller (2005) suggests other possible methods for seeking fiscal expansion, which would be aimed at reducing recurrent unproductive expenditure. These include (i) revising existing subsidy programmes; (ii) cutbacks on defence and internal security and police; (iii) reduce foreign travel or embassy expenses; and (iv) rationalising of elements of the civil service that are of low productivity, such as having more staff for health and education sectors compared to other sectors.

[4] While countries such as Kenya pay an average wage of Sh35,275, equivalent to about US$439, even a country classified as an LDC like Zambia can also afford to pay an average salary equivalent to US$300 per month ("Civil servants given huge salary increase", Daily Nation, August 14, 2008, Kenya and "How MMD government improved education", the Times of Zambia, 2005).

The Ministry of Finance has already noted the need to reduce foreign travel and diplomatic missions abroad as a possible means of cutting expenditure. There has been a noticeable decline in foreign travel costs, under tight monitoring procedures introduced by the Ministry. Poor working and living conditions among the defence and police institutions have also been reported, reflecting poor funding from the fiscus, hence compromising this further by further cutbacks might not be feasible.

The option of rationalising the civil service as a possible cost cutting measure therefore calls for consideration. The inclusive government was mostly a compromise agreement, and more Ministries were created, resulting in some noticeable duplication of roles between them. This calls for rationalisation of staff, as a cost cutting measure. There are two possible options in rationalising; either merging Ministries with overlapping mandates, or rationalising by using the same level of staff to carry out similar mandates, even when Ministries remain separate. Given the political sensitivities surrounding this issue, merging could be difficult at the moment; hence mechanisms of consolidating and harnessing expertise among the staff might be worth pursuing now.

Efficiency can also be enabled by enhancing the quality of staff in the public service. Since 2000, the public sector has suffered greatly due to brain drain, which has seen experienced staff leaving to seek employment, mostly out of the country. This implies that the effectiveness of public expenditure has been compromised, particularly due to the shortage of some critical skills to enhance expenditure efficiency, such as engineers, accountants and economists. In 2005, it was estimated that 15% of all professionals[5] who had left Zimbabwe since 2000 to seek economic refuge in UK, USA, Australia, New Zealand and South Africa were skilled workers such as accountants, engineers, doctors and nurses. In addition, the Association of Chartered Certified Accountants (ACCA) was reported as estimating that at least 200 of their members had left the country between 2002 and 2005 (Chimanikire D. P, 2005). The study was also consistent with the earlier findings of a survey of people in the diaspora by Chetsanga C.J *et al* (2003), which had also established that most of the respondents held bachelors degrees, followed by those who were polytech graduates. About 20% held masters degrees, while 5% held Ph.D degrees. Among the respondents, the health and teaching professions were the most, while accountants constituted a significant proportion (16.9%) of the total number of Zimbabweans in the Diaspora. This brain drain trend worsened during the period 2007-2008 when the economy was at its worst moments.

Thus, efficiency of expenditure can also be enhanced by investing in incentives to attract and retain such skills and rebuilding the lost capacity.

2.2.3 Policy and institutional reform

Enhanced efficiency of expenditure might also entail policy and institutional reform. The government is already pursuing some policy and institutional reforms which could result

[5] Percentage of professionals and not all economic refugees

in enhanced efficiency in the economy. This includes policies fostering efficiency of the private sector in resource allocation, which is recognised as the engine of growth. This includes infrastructure provision, which would enhance returns to private investments. Infrastructure provision is mainly done through parastatals and public bodies; hence efficiency can only be enhanced if such bodies are efficient. Thus, parastatal reforms become critical in creating fiscal space.

The need for investment in infrastructural provision by government, which is mismatched by the inability of the government to raise funds, has already been noted by government through the Zimbabwe Investment Authority (ZIA). Consequently, ZIA has already devised some mechanisms to attract private players to inject new capital in parastatals through the build, own, operate and transfer (BOOT) mechanisms[6]. In terms of this model, a private investor enters into a contract with a parastatal or government to construct some infrastructure item for the parastatal. After constructing the Infrastructure, the contractor is given the right to own and operate it for a specified period (mostly more than 20 years). After the period, control and ownership is ceded to the State or the Parastatal, with the contractor exiting the market. The incentives during the project period, for example, include:

- A tax holiday for the first 5 years
- Income tax at the rate of 15% for the second five years
- 20% for the third five years
- Thereafter tax is paid at the rate of 30%[7].

This is inevitably attractive to investors. What is needed is popularising the model, as well as encouraging the ailing parastatals to seek partners.

Zimbabwe has 78 parastatals and state enterprises, which can be used to raise revenue for the government. Three options have already been suggested for reforming them, namely restructuring, commercialisation and privatisation[8]. Restructuring entails changing the structure of the enterprises, which might see some more costly units in the enterprise being disbanded or spruced up to minimise costs. Commercialisation implies that the enterprise would start operating on profit basis (like a private sector player), which might necessitate increase in service charges and user fees. Privatisation implies state withdrawal in decision making, particularly in terms of ownership or control, with the private sector players taking over the running of the enterprise. This would be preceded by the state selling its stake, either wholly or partially to the private sector. Of the 78 parastatals, 15 are earmarked for privatisation; 18 for commercialisation and 34 for restructuring, with 11 still to be decided.[9]

The effect of privatization on the fiscal space is two fold. It lessens the burden of yearly needed fiscal outlays towards the parastatals and at the same time raising additional

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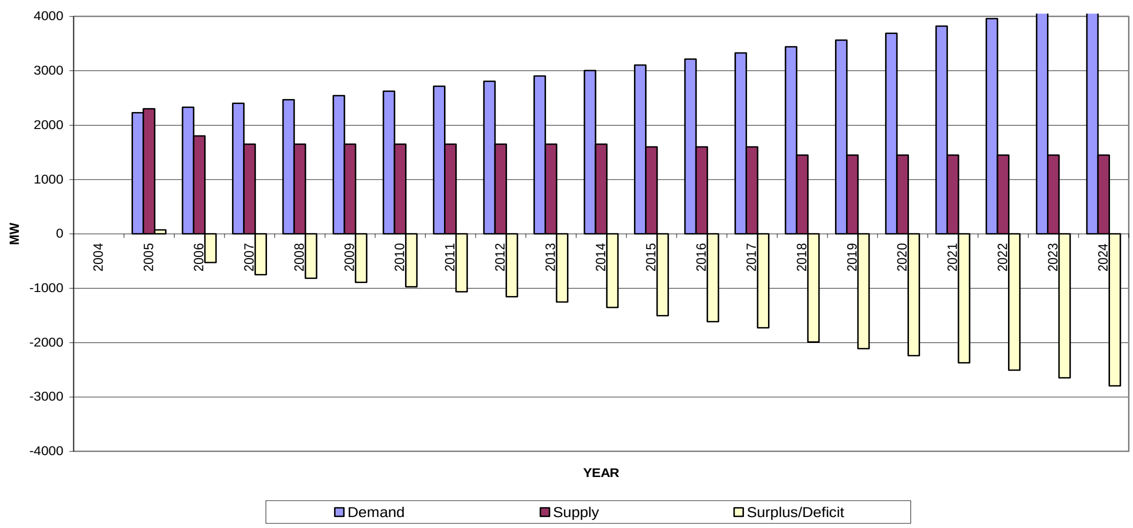
[6] This is a form of Public Private partnership arrangement, discussed later in this section.
[7] Details on the BOOT for Zimbabwe have been taken from "Incentives Applicable to Investors", available on ZIA website.
[8] Minister of Parastatals and State Enterprises, Zimbabwe in The Herald, August 13 2010.
[9] Ibid

revenue for government through proceeds from the sold shares. The fact that the parastatals have got other far reaching positive linkages with the other industries as providers of utilities and private producers' major customers, improved efficiency in the privatised or commercialized enterprises will foster accelerated economic growth. In Zimbabwe, key parastatals that are critical for growth include Zimbabwe Electricity Supply Authority (ZESA) and water and sewer reticulation units of municipalities, which are natural monopolies.

Success stories of privatization and commercialization of parastatals in Zimbabwe include Dairibord Zimbabwe Limited, Cotton Company of Zimbabwe, Commercial bank of Zimbabwe, Zimbabwe reinsurance Company etc, where the state withdrew and remained with some stake, although leaving the control to the private sector. These companies are now operating more efficiently, implying savings on the part of government after weaning them off, with dividends to government by these companies also coming as additional benefits of privatisation.

Privatisation can however easily become counter-productive, especially for monopolies, as changing an enterprise from public to private hands in the absence of competition when profiteering is normally the incentive for the private sector could have dire consequences for downstream users. Enterprises providing critical services such as ZESA and water and sewer reticulation units of Municipalities should not, therefore, be considered for privatization. Such institutions, which are natural monopolies, may result in dire negative consequences for the downstream industries as they incorporate service costs into their pricing structures. As a way of recouping their investments, private investors in these entities would raise service charges, thereby contributing to inflation. However, leaving the institutions to continue operating under total state control is also not desirable, given that these institutions have been a constant drain to the fiscus over the years in terms of funding. For example, in a study, Dube *et al* (2007), discovered that the future electricity outlook is not ideal, as demand will continue to outstrip supply, resulting in a constantly rising deficit, estimated at close to 3000 megawatts by 2024. This is shown in Figure 4 below. A centrist approach is rather preferable, and this could be public-private partnerships (PPPs).

Figure 4: **Future Electricity Supply and Demand in Zimbabwe without Investment in Local Generation**



Source: Dube *et al.* (2007)

A public private partnership is a legally-binding contract between government and business for the provision of assets and the delivery of services that allocates responsibilities and business risks among the various partners. (Partnerships British Colombia, 2003). PPPs are already under consideration by the government, although it is not yet clear which entities are targeted. If properly managed, PPPs can play a very important role in creating fiscal space. On one hand, they help lessen the burden on the fiscus, as the government would get an opportunity to devote resources originally used to subsidise the public entities towards social services or other productive areas. On the other hand, PPPs result in the creation of commercially, technically and economically viable projects which not only benefit the state through taxes, but also results in accrual of benefits to downstream private sector firms using the services provided. Efforts should therefore be made to operationalise PPPs, preferably for natural monopolies.

Again, care should be taken as savings by government due to capital injected by private sector through PPP arrangements might be offset in future when the private sector partner incorporates the costs in service charges (Heller, 2005). It would be thus necessary to split the various functions under these entities, and assign some to the private sector partner while the public sector retains the critical part. For example, electricity generation can be given to the private sector, while the transmission is retained by Zimbabwe Electricity Transmission and Distribution Company (ZETDC). This model is already being pursued in other countries, e.g Gambia and India. The rest of the parastatals, which do not exhibit natural monopoly characteristics can be easily privatised, with the state either wholly or partly withdrawing.

A lot still needs to be done however to make the PPP route attractive in Zimbabwe. The success of a PPP project typically depends on among other things, the political climate and the legal and regulatory environment. Due to the fears associated with the current political climate, it is therefore important that specific legislation be introduced to drive the PPPs process forward in Zimbabwe. The legislation would act as both insurance and assurance to the private sector, where fears of policy reversals and political interference abound. It can also be established that a similar approach, where a specific (and not general) legislation is enacted to guide the PPPs was done in other countries that used the PPP route to generate investment in key economic sectors. In Nepal for example, an Act Relating to Private Sector Investment in the Construction and Operation of the Infrastructure, which started as an Ordinance before being ratified as an Act in 2006 was produced to drive the PPP programme in construction of road networks[10]. In Malaysia, the Public Private partnership Unit was established in the Prime Minister's Department in April 2009, under the Malaysia Ninth Plan and it established Public Private Partnership Guidelines to outline the key principles of the Malaysia PPP programme[11].

Thus, the Government also has to make extra efforts to establish the legal framework and institutions to move the PPP agenda forward.

2.3 Creating fiscal space using ODA and Deficit Financing

Official Development Assistance (ODA) remains an important source of external financing for public investment, especially for the low income countries. The under performance of vote of credit in Zimbabwe is revealed by the $810 million pledged by donors for the 2010 National Budget has not come through. There are factors relating to under performance. To unlock more lines of credit there is for clearance of all the arrears to pave way for opening of new lines of credit. However, ODA should be seen as a transitional strategy for financing development because it is highly volatile. Recent studies on aid effectiveness indicate that the developmental impact of spending by donors is weak. Since aid flows for financing development will remain important over the medium-term, donors should commit aid over the medium-term to reduce volatility and align aid with the longer-term objectives of growth, improved equity and poverty reduction.

According to the standard definition of fiscal space, an expansion of public expenditures is only desirable when it does not compromise short-term macroeconomic stability. This is also why borrowing is considered to be the least desired option for securing finance in low-income countries (Heller 2005). The condition for borrowing is set by the debt/GDP ratio since it is a measure of fiscal solvency. Concern is that scaling up public expenditure through borrowing can raise fiscal deficit and jeopardize macro-economic stability. However, borrowing for investments that are productive in the long-term should not be ruled out because of short-term stability concerns.

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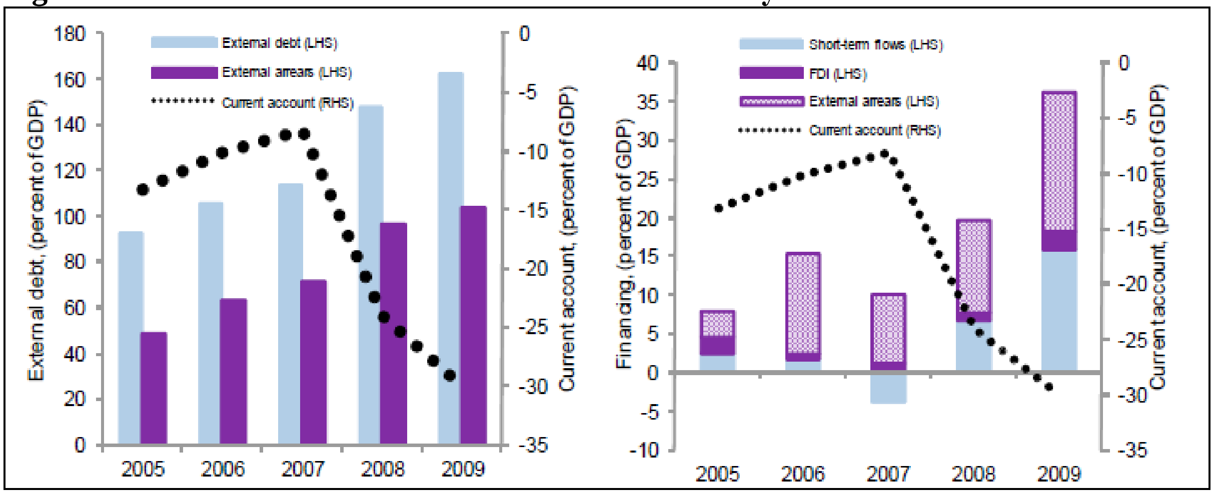
[10] United nations report on Nepal's PPPs found online at website
http://www.unescap.org/TTDW/ppp/PPP2007/mm_nepal_statement.pdf
[11] PPP Guidelines, Public-Private Partnership Unit, Prime Minister Department, Malaysia, 2009

External borrowing or efficient use of donor funding are some of the ways in which Zimbabwe can create more fiscal space. However, Zimbabwe is currently faced by two broad tensions: debt sustainability and macroeconomic pressures. The 'debt tension' for Zimbabwe according to the debt sustainability analysis by the International Monetary Fund, stands at 162.5% of the 2009 GDP figure and 320% of the exports receipts. Figure 5 shows the country's deteriorating balance of payments position as reflected by the huge current account deficit of more than 30% of GDP.

Figure 5: Zimbabwe's Fiscal and External Sustainability



Source: Kramarenko *et al.* (2010)

The IMF describes Zimbabwe's debt situation as severe and highly unsustainable in the foreseeable future. Even a highly ambitious growth forecast will not in the foreseeable future lead to considerable debt reduction, this is also happening under the projected growth for the period 2010 – 2015 of about 6% and 5.5% thereafter. According to IMF, even the envisaged flow of private capital flows will not cover more than a fraction of the gross external financing requirements. Even though revenue is projected to grow to about 25% of GDP given the dollarisation and some increased capacity utilisation in the mining and manufacturing industries, the country still suffers from unsustainable public service wage bill. Infrastructure requirements such as repairs and maintenance costs will also account for a big chunk of the national budget making it difficult to set aside funds for productive sector ventures.

2.3.1 Increasing fiscal space through Hybrid Debt Strategy Model

Given the highly unsustainable debt situation for Zimbabwe, external borrowing is highly unlikely. The country, therefore, need to resolve the debt situation through seeking debt relief, in line with the Government adopted hybrid Debt Strategy model in order to unlock financial resources to enhance fiscal space. The hybrid model, which encompasses some elements of the Highly Indebted Poor Country Initiative (HIPC) will require the country to to meet a set of standardised conditionalities . Debt Relief under the HIPC Initiative would free additional budget resources and boost spending as it allows the Government to retain general budget resources that would have otherwise been spent on debt repayment. The fiscal space generated by debt relief will, therefore, provide additional scope for increased social spending for poverty reduction.

A study by the IMF (2010) shows that before the HIPC Initiative, eligible countries were, on average, spending slightly more on debt service than on health and education combined. Now, they have increased markedly their expenditures on health, education, and other social services. On average, such spending is about five times the amount of debt-service payments across all the countries that received debt relief under the HIPC Initiative.

A good example is that of Burundi which reached the decision point under the enhanced HIPC initiative in August 2005 and was granted interim debt relief of about US$82 million in 2005–2007. On average, the annual amount of debt service savings represented 8% of the government's budget. The resources generated by debt relief were set aside in a separate bank account and managed outside the general budget. The health sector was granted a very significant share of HIPC funds, receiving on average 35% of annual resources generated from 2006 to 2008. Health and education together accounted for three-quarters of total HIPC allocations.

For Liberia, debt relief freed up resources for the rebuilding of its social services following years of civil war, as well as rebuild the road network and the electricity supply system, providing the infrastructure needed to allow economic growth, while continuing to expand the health care and education systems. Liberia was also able to further develop its own financial market and channel private savings to productive uses.

The HIPC initiative reduced Liberia's debt by 90 percent, according to the IMF (2010), hence relieving US$4.6 billion of the US$4.9 billion it owes. Liberian President Ellen Johnson- Sirleaf has said that the country's 2009-10 budget is only US$350 million, meaning it would have taken the equivalent of 14 years of paying the country's entire budget to repay the US$4.9 billion debt.

Furthermore, once the debt issue is resolved, the country's credit rating will improve hence, allowing the country access to Official Development Assistance (ODA) and other forms of developmental aid from International Financial Institutions and other developmental partners.

The combined effects of debt relief and ODA will broaden the country's resource envelop for growth enhancing expenditures. The Independent Evaluation Office (IEO) report of the International Monetary Fund recommends that the use and effectiveness of ODA as a fiscal tool depends critically on a country's initial condition and where the aid released from the HIPC initiative is channeled to.

For example if external reserves are low (less than 2.5 months of imports), almost all the aid that is given to the country is programmed to be saved in the form of higher reserves.

This is exactly what happened when Zimbabwe was given an SDR allocation of US$510 million. Pressure emanating from escalating expenditure commitments forced government to convert part of the SDR funds to finance budgetary expenditures and in the process straining its levels of international reserves.

In this regard, once the debt issue is resolved, ODA released should target productive areas of the economy that generate shorter cycles of revenue for the country rather than the social areas that have longer cycles. In an interesting argument in Rathin Roy and Antoine Heuty (2010), two premises of thought that amply describe Zimbabwe's situation were given:

"If ODA is aimed at public investment programmes that exhibit public good characteristics such as health and education, then there is less precision and predictability of the fiduciary payback, but more of the development payment. However, if the public investment programme exhibits less of the public good characteristic, such as the financing of companies, then there is more precision and predictability of the fiduciary payback, and less of development payback".

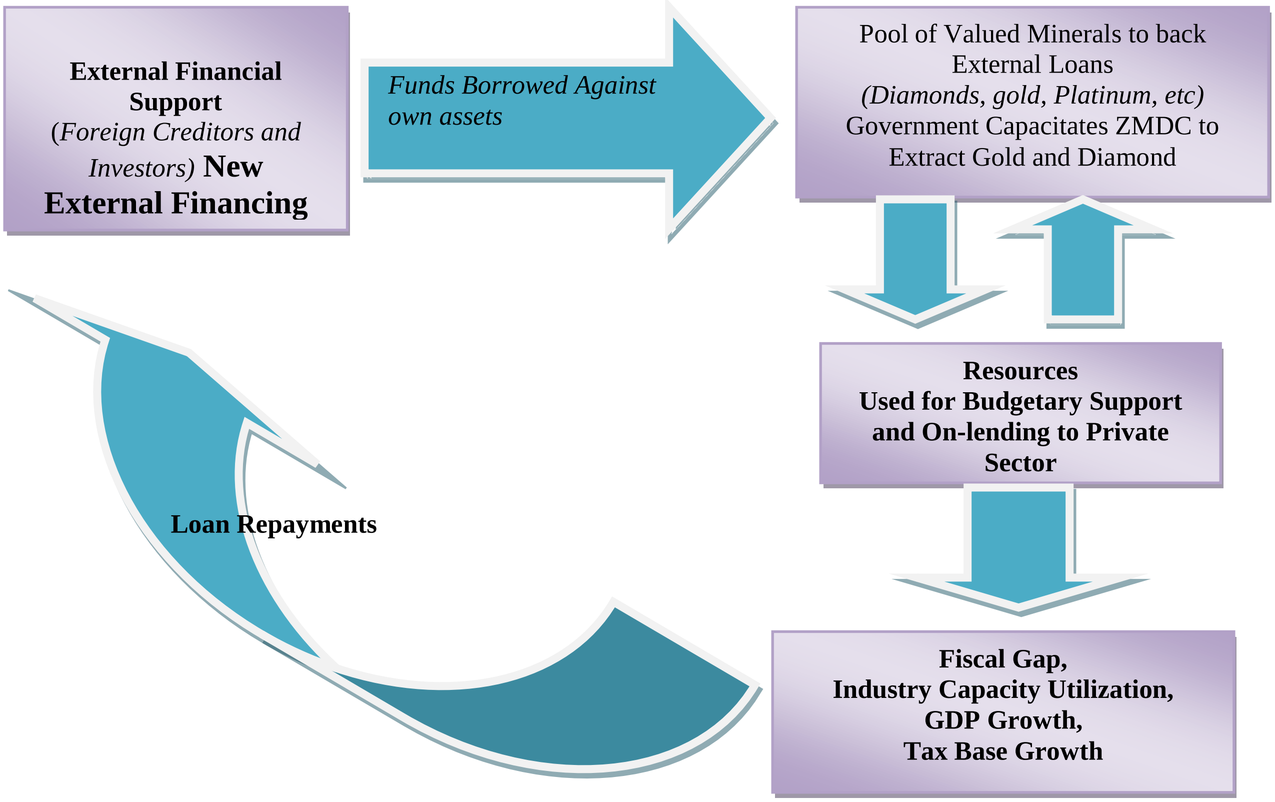
2.3.2 Securitized Borrowing

Difficulties in accessing international capital markets and the limitations of official emergency financing during financial crises as exemplified by the experiences of Mexico in 1994, East Asia 1997, Argentina 1998 and Brazil 1999, forced developing countries to think outside the box in terms of looking for ways to mobilise external financing. According to Ketkar and Ratha (2005) future flow asset-backed securitisations are an attractive instrument to investors because of their investment grading ratings and good performance in both good and bad years.

Asset backed securitisation of future-flow receivables is a form of financing that is often touted as one way developing countries facing liquidity constraints could use to raise external financing. Securitisation flow involves the country selling its future product (receivables) directly or indirectly to an offshore Special Purpose Vehicle (Ketkar and Ratha 2001). If structured innovatively, this financing mechanism can be obtained at significantly lower costs and for longer periods.

Zimbabwe has vast deposits of minerals, which can easily be converted into reserves. These include gold, diamonds and platinum. In light of the arrears, which continue to act as an impediment for Zimbabwe in accessing financial support from the International Finance Institutions, the country can consider the option of asset-securitizing and borrowing against its mineral resources. Figure 6 shows a typical structure of how this can be done:

Figure 6: New External Financing through Asset-Securitization



While new borrowing through asset-securitization may be a possibility, the country's current high debt levels will require that such financial resources be put to productive use. This will create needed repayment capacity for the country. Without prudential borrowing and application of the borrowed funds, the country may entrench itself in a further debt crisis. Securitised borrowing should be done when all the necessary valuations of resources to be pledged are complete. In the short-term there might be some challenges relating to valuation of mineral reserves, low investment in new exploration and liquidity constraints among other factors.

2.3.3 Domestic Debt Market Development

Prior to the 2000-2008 economic crisis, much of Zimbabwe's budget deficit was financed by domestic borrowings from individuals and corporations through the issuance of government paper – treasury bills, bonds and securities. Zimbabwe's domestic debt market has since collapsed since the adoption of the multi-currency system due to liquidity challenges.

Domestic borrowing remains constrained by inadequate liquidity in the formal sector. The Central Bank has lost the function of the lender of last resort hence banks are lending money in the short term (30 days). The lend cycle of 30 days is crippling because the period does not permit companies to source inputs, produce and repay the loan within the requisite time period. Whilst deposits have increased to about US$2 billion, it is estimated that close to US$2.5 billion (50% of GDP) is circulating outside the banking and formal system hence the need to bring money back in the formal system. This will enable an increase in bank deposit base and bank lending. However, the current low interest rate on deposits and exorbitant bank charges are prohibiting people from keeping their money in the formal system. Interest on borrowing charged at around 20-23% is also prohibitive. To encourage people to save the financial sector should ensure positive real interest rates on deposits to attract deposits from the informal sector.

As levels of liquidity improve in the country and deposits at local banks start to improve, government should take pro-active measures to revive the domestic debt market, which will be used as part of recourse for government borrowing. It is a fact that domestic borrowing by governments is less risky compared to external borrowing. The development of such a market will not only benefit the country with regards to additional fiscal resourcesbut will also facilitate deepening of the country's financial markets.

Issuing out a sovereign instrument or bond in the international capital markets may be impossible given the high risk rating of the country, due to negative perceptions by the international community. This leaves out the domestic debt market as the only option for increasing government fiscal space.

The current absence of treasury instruments limits investment options of individual wealth holders. More crucially, this starves institutional investors such as pension funds, mutual funds and insurance companies of relatively liquid instruments. This sector is, therefore, forced to settle for highly illiquid assets such as real estate. The development of a liquid domestic debt market will, therefore, inevitably, harness some resources from this sector.

The major hurdle facing government with regard to the issuance of treasury bills is the high levels of illiquidity in the country. The issuance of any such instrument in the current environment is likely to tighten liquidity further and consequently crowd out private sector business and investment. It, however, remains a fact that as the economy recovers and liquidity improves, government should also move in unison in developing the domestic debt market. The macroeconomic fiscal framework must ensure that confidence be restored in the financial sector to enable banks to lend according to the business cycle of companies. Banks must mop up what is in the domestic market and the government should borrow externally. Prioritisation of bank lending should be directed towards export market to improve liquidity in the banking sector.

External borrowing is currently constrained by the already unsustainable debt burden. Any new borrowing will thus worsen precarious external debt position. Any new borrowings should be regenerative i.e. it should be allowed to companies with demonstrable capacity to repay to enhance long term fiscal sustainability.

3. Conclusion

This paper has illustrated the constraints that the government currently faces with regard to creating adequate fiscal space needed for enhanced growth. It has, however, been shown that the challenge faced by the government is not without possible practical solutions. There is greater scope in enhancing fiscal space through domestic revenue mobilisation and reprioritisation and efficiency of expenditure pillars given that ODA is volatile and depends on the commitment of donors to the country's development agenda. Deficit financing is also restricted by the debt overhang and the absence of as domestic debt market.

In making a decision on the above policy options, Government need to be guided by answers to the following key questions (i) what is the extend/ level of taxation in the country, which affects willingness to pay tax (compliance issues), (ii) how can donor commitment be secured given the sensitivities of donor funds (iii) what is the cost of acquiring new debt given the current debt overhang, (iv) what will be the possible impacts on future generation (inter-generational considerations); and (v) is there scope for the overall reduction in the size of the Government while taking cognizance of the loss of critical skills through brain drain?

Recommendations that come out of this paper on alternative revenue boosting and expenditure switching for the government include:

i. Rationalization of the public service;
ii. Reforming the tax system;
iii. Prioritisation of investment in capital to improve efficiency
iv. Privatization and commercialization of some public enterprises;
v. Asset-backed external borrowing;
vi. Development of the domestic debt market and instruments;
vii. Effort to restore confidence in the banking sector should start from macro-economic fiscal framework; and
viii. There is need for Government to improve its decision making pace
ix.

Once enough fiscal leverage has been created and the economy is set on sustained growth path, the feedback effect on growth and further fiscal expansion will be far reaching.

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