Namibia
Recent Economic Developments and Prospects

June 8, 1999

Macroeconomics Unit 1
Africa Region
CURRENCY EQUIVALENTS

(as of 1st June 1999)

Currency Unit: Namibian Dollar (N$)

US$1 = N$6.26

GOVERNMENT FISCAL YEAR

April 1 – March 31
ABBREVIATIONS AND ACRONYMS

ASD Additional Tax Duty
BFP Budget Framework Paper
BoN Bank of Namibia
CMA Common Market Authority
CPI Consumer Price Index
CSO Central Selling Organization
CSB Central Statistical Bureau
DOD Debt Outstanding and Disbursed
EPZ Economic Processing Zone
FDI Foreign Direct Investment
FGI The Follgard Group Incorporated
GDF Global Development Finance
GDI Gross Domestic Investment
GDP Gross Domestic Product
GEAR Growth, Equity and Redistribution
GNI Gross National Income
GRN Government of the Republic of Namibia
GST General Sales Tax
MLHRD Ministry of Labor and Human Resource Development
MOF Ministry of Finance
MTEF Medium Term Expenditure Framework
MUN Mineworkers Union of Namibia
NAMAC Namibia Macroeconomic Model
NAMPOST Namibia Postal Service
NAPWU Namibia Public Workers Union
NDP National Development Plan
NEPRU Namibian Economic Policy Research Unit
NPC National Planning Commission
OECD Organization for Economic Cooperation Development
ORE Other Recurrent Expenditures
PAYG Pay as you go
PFP Policy Framework Paper
PPI Producer Price Index
SACU South African Customs Union
SADC South African Development Community
TFP Total Factor Productivity
UAL UAL Corporation
VAT Value Added Tax
WASCOM Wage and Salary Commission
WDI World Development Indicators
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This report was prepared by a World Bank team in cooperation with the NAMAC working group. The World Bank team consisted of: Maria-Teresa Benito-Spinetto, Dirk Hansoehm, Bert Hofman, Jacob Oranje, Serif Sayin, Jos Verbeek, and Rose Thunyani. The NAMAC working group consists of staff from the Bank of Namibia, the Central Statistical Bureau, the Ministry of Finance, and the National Planning Commission. The NAMAC is a Macroeconomic Model for Namibia, based on the World Bank’s RMSM methodology. Peer reviewers for the report are Yvonne Tsikata and Jennie Litvack. Country Director is Pamela Cox; Sector Manager is Ataman Aksoy. Helpful comments were received from our colleagues in AFTM1. The current version of the report was prepared by Mahesh Surendran and James Sackey of AFTM1.
EXECUTIVE SUMMARY

Recent Economic Performance

1. Namibia enjoys political stability, has made significant progress in reducing inflation, and is increasingly integrated into the world economy. Access to social services for previously disadvantaged groups is improving, foreign investors are starting to take an interest in the economy, and tourists are discovering the country’s vast natural beauty.

2. However, Namibia faces serious challenges. Almost half of the population lives at or below the poverty line, and over 35 percent of the labor force is unemployed. The immediate issue for government is how to manage the impact of the sharp currency depreciation and the accompanying interest rate hike, which are likely to raise inflation, further slow demand, and increase the cost of government debt financing. However, Namibia’s fundamental challenge remains growth: the country’s GDP growth rate has been disappointing since 1994. Growth rates of 2.9 and 1.8 percent for 1996 and 1997 was well below the projections of the National Development Plan 1, the targets of which no longer seem feasible. The average Namibian is becoming worse off every year: growth now falls far short of the annual 3.1 increase in population, it is insufficient to support the creation of jobs and income for a labor force that grows around 3 percent per year, and private consumption is falling, by almost 10 percent in 1997.

3. Some of the slide in growth is due to special circumstances such as drought, reduced fishing quotas, and closure of a copper mine made unviable by falling copper prices and labor unrest. However, the declining growth since 1994 reflects a worrisome underlying trend: productivity in Namibia’s economy as measured by Total Factor Productivity (TFP) is falling; thus, for every unit of capital invested smaller increments of output are received in return. The fundamental issues underlying this productivity decline include: the large share of GDP consumed by Government; the inadequate skills level of the labor force, and the gradual shift to high-cost deposits in Namibia’s mining industry. Low productivity translates into low investment returns, and it is therefore no surprise that Namibia’s savings continue to be invested elsewhere, despite the fact that a recent survey found Namibia to be perceived as quite a competitive economy in terms of infrastructure, investment regulation, and tax incentives.

4. Namibia’s short term prospects are far from rosy: there is an unusual degree of uncertainty due to the current volatility in the world economy. East Asia is in a deep recession, Japan is not growing, and the US economy is showing signs of a slow down. World growth for 1998 stood at 1.7 percent, and the projected growth rate in 1999 is 1.9 percent. Lower growth will drag down world trade and further depress commodity prices. The South African economy, closely linked to the economies in the region, grew 0.1 percent in
1998 and growth in 1999 is likely to be no more than 1 percent. Continued international
financial market volatility will keep Namibian interest rates high, and could cause further
slides in emerging market currencies, including the Rand and therefore the Namibian Dollar.
Fortunately, Namibia's financial sector and corporate enterprises are financially sound, and
able to withstand the financial shocks it experienced in 1998. But exchange rate uncertainty
could lead to a muted response of exports to the 30 percent depreciation of the Namibian
Dollar.

5. Namibia's growth for 1998 is far less than expected at the start of that year. The
larger fishing quotas and accompanying fish processing growth and the likely increase in
tourist arrivals are offset by the closure of the TCL mines, the cutback in diamond sales
imposed by the Central Selling Organization, depressed construction due to high interest
rates, and a restocking of the herds after the recent droughts. Growth in 1998 therefore
dipped to about 1.5 percent, well below the 4.5 percent assumed in the 1998/99 budget, and
less than half of the growth in population. For 1999, prospects are slightly better, because
diamond and copper production will not decline further, agriculture may show more normal
production patterns if the weather normalizes, and tourism would be spurred by a favorable
exchange rate, and continued growth in Europe. Yet, Namibia's growth for 1999 will remain
below its population growth.

6. Falling world commodity prices are diminishing the inflationary pressures resulting
from the N$ depreciation, but not completely. Inflation, which dropped below 5 percent
year-on-year only a few months ago, picked up to an average of some 8 percent for 1998, to
peak at over 10 percent year-on-year by December. Following South Africa's inflation, this
trend has already started to show up in the most recent inflation numbers. These numbers
show a more worrisome development, however: prices of nontraded goods such as municipal
services are rising faster than those of tradables, thereby eroding Namibia's competitiveness.

7. For the fiscal year 1998/99, growth is likely to fall well below 1 percent, because the
exceptional growth in the first quarter of the calendar year 1998 is not included in the budget
year. On the other hand, budgetary diamond revenues may actually be higher than budgeted
despite the cut in production, because of the depreciation of the N$. And rising inflation
could mean that nominal income growth is actually not that far off the 10 percent underlying
the budget, thus increasing income tax revenues much in line with what the budget presumes.

8. The Government has reacted to the disappointing growth by passing a surprisingly
modest additional budget. As a consequence, the deficit for fiscal year 98/99 is likely to slip
only slightly, from a budgeted 3.9 to 4.2 percent of GDP. For 1999, the Government should
carefully review its projections in light of the changes in the economic environment, and take
corrective action to reduce the Government's share of GDP as planned in the last budget.
Moreover, the government should aim for lower deficits in the medium run. One key reason
for doing so is that there is an apparent lack of interest from investors to buy Government
bonds. Overshooting the budgeted deficit now could lead to renewed monetary financing of
the deficit, and result in undue pressures on the balance of payments. On a practical level,
the unusual uncertainty in the economy requires conservative budgeting, and Government
should allow for sufficient budgetary reserves to accommodate revenue shortfalls or spending
overruns, and regularly review its economic projections to see whether the assumptions
underlying the budget are still valid.
Policies for Medium Term Growth

9. Namibia needs to grow to create jobs for the unemployed and income for the poor. Because of Namibia’s high savings rate, the balance of payments will not be a constraint on growth for some time to come. But Namibia’s GDP growth depends crucially on higher investment and higher productivity of that investment. Until productivity, and therefore profitability increases, savings will leave the country to find investment opportunities elsewhere.

10. The Government’s current policy is aimed at keeping savings in the economy, which is probably ineffective in the case of the domestic investment requirement, and outright damaging in the case of the recently passed re-insurance corporation bill. And savings itself could be affected by plans for a National Pension Plan, if this is not carefully designed, because unfunded pension plans have a tendency to depress savings when initiated.

11. Rather than forcing savings to stay in the country, Government should focus on increasing productivity of investment. If investing in Namibia becomes more profitable, savings will stay. International experience shows that government policies are a strong determinant of productivity and growth. In the short run, the depreciation of the N$ offers an opportunity to grow faster through export-led growth, but the CMA—which has given Namibia relative monetary stability since independence—bars the use of monetary policy as a tool. But the Government has several powerful instruments to reinforce the productivity and competitiveness of the economy. These are: fiscal policy, labor market policy, and competition policy.

12. Fiscal Policy. Government spending is at the level of an OECD country, about 10 percentage point higher than most neighboring countries, and more than twice the average for Newly Industrializing Countries. While the Government’s emphasis on human resource building is the right one, both for equity and efficiency reasons, it spends more on social services than any country in the region, and almost 50 percent more than South Africa, which faces similar problems of previously disadvantaged groups. Most of government spending is on consumption, and most of this in wages: Namibia now has one of the largest civil services in the world, and, except for Botswana, the largest in Africa. Government consumption drives up taxes and the domestic price level, which in turn reduces competitiveness, return on investment, investment and growth.

13. To reduce spending in the short run, Government has to do surprisingly little: every year, more than 3 percent of civil servants leave the Government. Thus, by hiring fewer people, not by firing people, Government can already meet the WASCOM committee’s recommendations. Over the medium term, improving public expenditure management is crucial to achieve a leaner, less expensive and more productive government. The Finance Minister has already identified several deficiencies in his latest budget speech, and Government has started work to improve financial management. However, perhaps the key problem in expenditure management is the lack of political commitment to the budget itself. Therefore, the budget process requires change such that the budget becomes a true policy document, owned by the Cabinet and with spending limits commensurate with macroeconomic conditions, and enforced by a Finance Ministry that can revert to harsh measures against overspending ministries. The revision of the Budget Law is therefore long overdue, and the recent initiative of the NPC regarding the macroeconomic setting of the budget are commendable.
14. But public expenditure reforms should go further: budget processes and systems should obtain an increased focus on efficiency and effectiveness of spending. This requires a fundamental reorientation of the budget process towards that goal, and budget planning, documentation, reporting, and review should be focused towards that goal. Ongoing initiatives in the Government's Efficiency and Charter Unit therefore deserve support.

15. **Financing Expenditures.** Namibia defeats international trends by relying increasingly on direct taxes rather than indirect taxes. And in the medium run, trade liberalization may erode a significant part of the country's traditional tax base. The decision to introduce a VAT by next fiscal year is therefore commendable. However, although the administrative preparations are well on track, several important policy decisions are still outstanding, which require the Government's immediate attention. Also, a VAT that would rightly allow some exemptions for equity reasons is unlikely to generate as much revenues as the GST and ASD it replaces. Fortunately, additional revenues could be found by increasing taxes on pollutants and health hazards, and by demanding that parastatals in commercial activities pay dividends and taxes to Government according to law.

16. **Labor Market Policy.** The scarce data on wage level and wage increases available suggest that wage rises outpace inflation and productivity gains. Such wage development does not create the needed jobs, but destroys them. The Government plays no direct role in employer-employee negotiations, but its own wage policy sets an example for the private sector, and this example is not a good one. After the round of public sector wage increases in 1998, wage moderation is long overdue. To further improve competitiveness, Government should address the issue of labor conflict resolution: too many workdays, and in the end too many jobs, are lost because labor conflicts continue in the absence of mediation procedures. Namibia's unemployed cannot afford the lack of procedures in this area.

17. **Competition Policy.** Government can contribute most to competition through its parastatals. Designing and implementing the regulatory framework that enables commercialization and in the end privatization of parastatals will take time, but many initiatives are already underway. They are needed: price increases in public services are now a key cause for inflation in domestic prices which erodes competitiveness of private business, and reduces growth. Over the medium run, Government should explore how it can increase competition for these parastatals, and for other sectors in the economy that show signs of uncompetitive behavior, and it may want to consider establishing a formal policy in this area.

18. Efficiency gains in government would allow lower taxes for all businesses, not just for those in EPZs. Lower taxes on labor would in turn reduce wage pressures in the private sector, and could spur employment creation. Combined with a better educated population enabled by better education and health services, and competitively priced utilities and transport services, Namibia's vision of a successful transition from a resource based economy to a diversified economy could come true.

19. Finally, good macroeconomic policy requires good data and good analytics. The Government's interest in improving its macroeconomic modeling and forecasting capacity is therefore commendable. However, the database for analysis is still too weak, and essential data in areas central to the government's concern are missing. Specifically, quarterly national accounts data and more frequent data on the labor market are a must for designing the policies that will increase growth, and reduce unemployment and poverty.
1. NAMIBIA: REVIEW OF RECENT ECONOMIC PERFORMANCE

A. GROWTH AND OUTPUT

1.1 Namibia's recent growth has been disappointing (Figure 1.2). Promising developments in tourism, and growing interest in EPZs could not prevent growth from sliding since 1994. GDP grew by only 2.6 percent in 1996, and 1.8 percent in 1997. This is well below the projections in the first National Development Plan for 1996-2000, the targets of which no longer seem feasible. Growth now falls far short of the annual 3.1 increase in population, and cannot provide jobs and income for a labor force that grows around 3 percent per year. As a consequence, unemployment and poverty is on the rise, and the average Namibian had to cut consumption sharply in 1997.

Figure 1.1: Sector performance

1.2 Some of the slide in growth can be explained by special circumstances such as adverse climatic conditions which affected fisheries and agriculture, and by falling commodity prices which reduced mining output. However, the trend decline in growth since 1994 reflects more worrisome underlying developments. As detailed in Annex A, Total Factor Productivity (TFP), a measure of how efficiently resources are used in Namibia's economy shows a decline as well. It is therefore no surprise that Namibia's savings continue to flow out of the country: the returns elsewhere are higher. Falling productivity and the outflow of savings keep Namibia's growth far below potential.

1 The annual data mainly come from the Central Statistical Bureau. The Bank of Namibia publishes annual and quarterly reports that regularly review Namibia's economic developments. The Bank also has a very useful quarterly database. Outside Government, NEPRU publishes quarterly reviews. However, quarterly data remain scarce, and their absence are an impediment to good policy making.
Figure 1.2: Namibia's Declining Growth

Namibia's growth is slowing down....

... and living standards are falling

Note: Agriculture includes fishing and Industry includes mining.

Productivity decline is at the core of the problem...

... and investment returns are leveling off.

Falling returns chase away savings....

... and leave more people unemployed.

Note: For details on total factor productivity see annex A. The ICOR is defined as the change in Capital Stock over the change in GDP.

Source: CSB, BON, and Staff Estimates.
Sector Performance

1.3 Agriculture and fisheries led the decline in growth. After exceptional growth in 1994, smaller contributions to GDP in 1995 and 96 followed below the steep drop last year. Agriculture, whose share in GDP has been declining in the last 20 years, fell by over 7 percent in 1997, a sharp turnaround from the 4.9 percent growth in 1996. The brunt of the decline was borne by commercial cattle farming, while subsistence agriculture, the main livelihood of the poor, limited its decline to 1.7 percent.

1.4 Agriculture has shown a curious performance during the recent drought years. As expected, droughts cause crop production to fall and one would expect that agricultural output would do the same. However, due to cattle production, agricultural sector output increases in drought periods and decreases when weather conditions improve. In a drought year, farmers sell much more of their cattle than normal increase drastically and that is counted as increases in value added. Immediately afterwards, sales fall significantly and agriculture value added shows a sharp decline. In 1998, agriculture which last year fell sharply in response to the 1996 large sales of cattle is not expected to recuperate given recent cereal production declines due to climate conditions. Rains early this year were practically non existent and most of the crop planted died.

1.5 Fisheries shows sharp ups and downs reflecting changing environmental conditions. Fisheries' contribution to GDP has varied between 1.3 percent and 3.7 percent during the 1990s, driven by the Total Allowable Catch quotas, which helped put the industry on a sustainable path after the free-for-all catch before independence. But these quotas also cause sharp swings in growth for the sector. During 1997 unprocessed fishery value added declined by 2.8 percent compared with a growth of 6.1 percent in 1996. For 1998, prospects are better: quotas have already been increased twice this year, and if fully filled, they could add some 1.5 percentage point to growth in 1998.

1.6 Mining contributed most to GDP growth in 1997, although growth in value added grew by 4.9 percent, down from 5.7 percent 1997. Despite these growth rates, mining's share in GDP continues to fall because of the secular decline in commodity prices. Mining's current share in GDP of 13.5 percent of GDP is less than half the almost 30 percent in the 1980's. Much of 1997 growth in mining was due to the 20 percent jump in uranium output. Diamond production remained flat at 1.35 million carats, and dropped with 0.7 percent in value added terms. But diamond sales were up, because inventories were drawn down, causing a windfall gain for the treasury (see below). But mining prospects for 1998 do not look good: the CSO has cut production quotas for diamonds with some 20 percent. A new offshore venture operating outside the CSO has significant startup problems, and 1998 production is likely to fall far short of expectations. And

| Table 1.1: Total Allowable Catch, 1994-1998 ('000 Tons) |
|-----|-----|-----|-----|-----|
| Pilchard | 125  | 40   | 45   | 25   | 65   |
| Hake     | 150  | 150  | 170  | 110  | 165  |
| Horse Mackerel | 500 | 335  | 400  | 250  | 275  |
| Crab     | 4.9  | 4    | 2    | 2    | 2    |

Source: Ministry of Fisheries.
because world market copper prices are declining, and production costs are rising in Namibia, TCL closed its mines in the spring of 1998, laying off some 2,000 workers.

1.7 **Manufacturing** recovered in 1997 from the 6.6 percent decline of 1996, and expanded with 8.1 percent. This recovery is mainly attributed to the increase in TAC for pilchard which is canned in Namibia. Other manufacturing which includes furniture, soft and alcoholic drinks establishments grew at the steady pace of 4 percent in 1997, helped along by the newly founded enterprises in the Economic Processing Zones. But perhaps the most successful of Namibia’s enterprises is outside this zone: Nambrew, which increased output by 22 percent in 1997, is a true Namibian success story, with strong expansion in the highly competitive South African market, and a healthy profit margin. Manufacturing prospects look good for fish processing, which benefits from the increased TACs.

1.8 **Construction** during 1997 was depressed by higher interest rates and lower government orders. Value added fell by 10.9 percent in 1997, in sharp contrast to the 7.4 percent gain in 1996. Prospects for 1998 are equally dismal: Government investment is planned to drop further, and interest rates have recently shot up because of the international financial turbulence. The central bank expects construction to fall by almost 50 percent this year.

1.9 **Services** grew by 4.1 percent in 1997 well above the 2.7 percent growth in 1996. Government is the major contributor to the sector (over 25 percent) which grew 3.0 percent during 1997. Other service activities that contributed were financial intermediation (9.3 percent) and financial services (7.1 percent) and hotels and restaurants (10.2 percent). Tourism, which is not a sector on its own, has been constantly growing since independence. The number of tourists arriving in Namibia has increased from less than 100,000 per year in 1990 to over 400,000 between 1990 and 1996.

B. INCOME AND DEMAND DEVELOPMENTS

1.10 **Terms of Trade.** Gross national income (GNI) in the Namibian economy has lagged behind GDP for most of the 1990s. The gap reflects a steady decline in the country’s terms of trade, with the exception of 1994, the year in which the N$ depreciated some 20 percent (Figure 1.3). Household incomes followed the developments in GNI, as the share of wage income remained relatively stable. But disposable household income has seen a decline as a share of GDP, because direct taxes took an increasing cut in recent years as Government expanded. The slowing world economy depressed commodity prices in US$ in 1998. But diamond prices are holding up until now due to the marketing strategy of the CSO, which restrict outputs to maintain prices. Due to the sharp depreciation of the N$ export prices are sharply up in domestic currency terms. On the import side, about 25 percent of goods are commodities, the prices of which have been falling even sharper than the N$. Much of Namibia’s other imports come from South Africa, and prices in that country are expected to increase by some 10 percent this year. Thus, Namibia will obtain a hefty terms of trade improvement this year, and GNI will grow more rapidly than GDP.
1.11 **Consumption.** Lower income and high real interest rates suppressed private consumption in 1996 and 1997. In 1996, consumption already lagged behind GDP growth, but 1997 saw a steep drop on the back of higher real interest rates and lower income. Consumers now spend some 19 percent of their available income on interest payments, up from 8 in 1992. Every percentage point increase in interest rates therefore costs households some 0.2 percent in purchasing power, and the rise in real interest rates over 1997 cut back consumption.

1.12 The effects of higher incomes may outweigh the negative effects that higher interest rates and taxes have on 1998 consumption. Consumption may get a boost in 1999 from the planned demutualization of Sanlam and Old Mutual. But although long-term interest rates have not yet risen sharply, short term rates suggest that they could be up by some 4-5 percent by the end of the year, if current financial turmoil surrounding the Rand remains. In addition, Government has raised the rates of GST and ASD, which is likely to further slow private consumption, especially of consumer durables such as housing and cars.

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2 Calculated as the sum of all bank and building society lending to households times the average interest rate as a share of wage income minus taxes on household income and wealth.
1.13 Government consumption, on the other hand, continues to take an unhealthy share of GDP. Fueled by wage increases, Government consumption remains above 30 percent of GDP, among the highest of all developing countries, and much more than Namibia's income level warrants (Figure 1.4). This topic is further treated below.

Savings and Investment

1.14 Savings remain reasonably satisfactory at 25 percent of GDP. But investments lag behind savings, causing a constant outflow of capital from Namibia, and a matching current account surplus. Gross fixed capital formation fell again below 20 percent of GDP, which was last seen in 1991. Much of investment merely goes to replace existing production capacity, as replacement investment takes a significant cut of total investments.

1.15 Investment's share of GDP has been on the decline since its 23.1 percent peak in 1994 and is now below 20 percent. Both private and public investment share in GDP fell in 1997, but for different reasons. Government investment fell short of budget because of overspending on other items (see below). In addition, recent declines in Government can be explained by the completion of some major infrastructure projects and new government buildings.

1.16 After a 7 percent growth in 1996, private investment fell by over 7 percent in 1997 because of higher real interest rates, a slowdown in growth, and the slowdown in government investment. Recent research found that each of these factors influences investment levels, and all of them pointed towards lower private investment. Notably, despite Namibia's good level of infrastructure, there still seems to be a complementarity between public and private investment. The gradual decline in public investment may therefore add to the low level of investment.

1.17 Savings-Investment Gap. The increasing gap between savings and investment is a major concern of Government. The perception is that savings invested abroad do not contribute to Namibia's growth and the Government tries to keep savings in the country.

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5 For further detail, see Shiimi, I.W., and Gerson Kadhikwa, Savings and Investment: An Empirical Approach for Namibia, Bank of Namibia, Mimeo.
This perception ignores the fact that Namibian investments abroad, which now amount to almost one year of GDP, yield a healthy return: income on the outstanding N$ 9.7 billion was, according to BOP statistics, some N$1.2 billion. Nevertheless, Government has put investment restrictions on pension companies to stem the outflow. The 35 percent domestic asset requirement for insurance firms and the proposed reinsurance bill aim to keep the savings in the country. The effect of both measures is likely to be minimal, if not detrimental.

1.18 Domestic Asset Requirement. The domestic asset requirements for pension and insurance funds indeed increased the share of domestic assets in the companies' portfolios, probably encouraged the dual listing on the stock exchange, and yielded a windfall gain for those already holding Namibian assets at the time the 35 percent requirement was introduced. However, this did not bring more investments in Namibia. Rather, it is now the listed companies that take out the resources to other CMA countries, instead of the insurance companies. Moreover, banks are exempted from the requirement, and therefore can become an easy conduit for exporting capital: the insurance company places its funds in an entrusted account with a Namibian bank, which in turn invests it according to the insurance companies requirement for a small fee. Thus, at most, the domestic asset requirement adds up to a small tax on savings. It is therefore not surprising that the savings-investment gap remains large as ever, after a short blip in 1994. What the requirement probably did achieve was stimulating the local non-bank financial institutions, because the number of listings and the volume of trade on the Stock Exchange went up strongly since its inception in 1994.

1.19 Re-insurance Bill. The recently approved reinsurance corporation act is potentially more damaging, not just because it taxes savings, but also because of the way the bill is conceived. The act sets up a 100 percent government-owned reinsurance company which by law obtains a percentage of not just reinsurance business, but all insurance business in Namibia. Moreover, the act gives the reinsurance company the right to change the terms under which it accepts this reinsurance. In other words, it can breach into the contract agreed between two third parties. And finally, at the time of the second reading, it was still hotly debated whether the private insurance companies would get any compensation for the services provided to the state-owned company.

1.20 The act provides little detail on how the state owned reinsurance company has to invest the resources under its control. However, the debate surrounding the act suggests that most of these resources are to be invested in Namibia. For the reinsurance business, this defeats the purpose: a small resource based economy such as Namibia can gain substantially from international diversification of its assets. Bad domestic years, e.g. through drought, can be hedged by investments in countries with a very different risk profile.

1.21 The key reason for the outflow of savings is the low return on savings invested in Namibia (see Figure 1. 1 and Chapter 2). This is the other side of the coin of the falling productivity of investment: Namibia's economy offers few investment opportunities. If government forces saving to remain in Namibia, this is likely to result in lower savings in the longer run, because of falling returns. Rather, Government should work to increase
the returns on investment by building an adequate human resource base, creating a fair and stable tax regime, and continue to provide adequate infrastructure.

1.22 **Social Security.** A further threat for Namibia’s savings could come from the current plans for a national pension fund. The Social Security Commission presented a plan to provide all formal employees with an old-age pension. The plan foresees a “partially funded” defined benefit plan, financed from contributions to be paid by employers and employees. Premiums would, according to the plan, be 4.2 percent of the wage bill to start with, and then gradually increase over time. Although still in draft, the Ministry of Labor has indicated that the plan is to be the basis for revising the 1994 Social Security Act.

1.23 Social security legislation can have profound effects on Namibia’s economy. Savings, investment, capital markets, labor markets, and income distribution—both within and across generations—may all be affected by the plan. International experience shows that at the start of a social security scheme which is not fully funded, savings may drop. Individuals perceive that they now have to save less, because the Government plan is taking care of their old age income needs. But Government savings do not go up by the same amount, because the plan is not fully funded. The lower savings could, in turn, lower investments.

1.24 The public pension plan may also restrict capital market development: since the public pension is not fully funded, and in part substitutes for existing pension savings, there will be less investment funds available. Moreover, if the public plan is to be managed by Government, this is likely to result in lower returns than private pension funds deliver. This would force future pensioners to pay much higher premiums for the same amount of retirement income.

1.25 With a high PAYG component in the plan, current retirees are likely to be better off. They never paid for their public pension, and could therefore experience a windfall gain at the cost of current workers, unless a strict means testing is introduced. Current retirees may not be the poorest people in Namibia, and providing them with a transfer may not be the best use of scarce resources. The current social pensions suffer from low coverage and poor administration especially in the poor North, and if not carefully administered, the newly designed pension may suffer from the same weakness. The plan may also redistribute income from better off workers to less well off workers. If premiums are progressive, or if benefits are not proportional to premiums, such redistribution may take effect. While this in itself may be desirable in light of the current income distribution in Namibia, the question is whether a pension plan is the best means of doing so.

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Figure 1. 6: Rates of Return on Pension Assets: Private Pensions do Better
In the future, the budget could be affected as well: if not carefully designed, the proposed national pension fund can end up heavily underfunded, just like many of the OECD pension plans set up in the 1950s, and those of the transition economies set up under socialism. In this context, the 4.2 percent premiums seems low by international comparison, and suggest a risk for future underfunding from the outset. This risk is increased with a rising share of the wage bill in National Income. Funding rising wage-related pension obligations in the future could lead to unsustainable contribution levels, which could have detrimental effects on the labor markets, as premiums paid increase labor costs.

Namibia’s current plans are presented as a “partially funded system” but an initial review of the plans suggest that this is not the case. Funded systems normally have individual accounts that fund the future pensions of current workers from current savings. This seems not the case in Namibia’s current plans: the system is “partially funded” only in the sense that at the start of the plan the social security fund will have surpluses rather than deficits.

It is a concern that the plans say little about how these funds will be managed. The returns on these surpluses are a crucial determinant of the contribution rates: the higher the investment returns, the lower the contribution rate needs for a given pension, and thus the lower the labor market distortion from those contributions. International evidence shows that, in general, privately managed pensions do better (Figure 1.6). The reason for this is not incompetence of public managers, but the restrictions on investments those managers usually have to live with. Namibia has the benefit of an already existing, and thriving, private pension market, and of well developed financial markets. Government should consider how it can use these in some form to the advantage of the new pension scheme.

Before deciding on a National Pension Fund, Government should carefully consider the effects of the various models on its goal variables. Rushing into a pension scheme that will prove to be unsustainable in the longer run seems an unwise course of action.

C. LABOR MARKET DEVELOPMENTS

The Namibian government identified employment generation as one of four key policy objectives. A policy framework was created, including a labor act, a social security act, and employment policy, an affirmative action bill, and incentives for investment and training. However, the balance of eight years independence has remained disappointing: unemployment and underemployment remain high (although EPZ starts to expand), the spread between low and high wage earners has increased, and, despite high expenditure on education, skill shortages remain severe.
Box 1.1: Labor Market: The Policy Framework

In 1990 the Ministry of Labor and Manpower Development (now: Ministry of Labor) was established. Government enacted policies and legislation aimed at furthering labor relations conducive to economic growth and improved wages and conditions of employment through the promotion of an orderly system of free collective bargaining (GRN 1995: 129-30). This includes policies and legislation to:

- advance persons who have been disadvantaged by past discriminatory laws and practices;
- ensure equality of opportunity for women, particularly in relation to remuneration;
- provide maternity leave and employment security for women;
- promote sound labor relations and fair employment practices by encouraging freedom of association by way of, inter alia, the formation of trade unions to protect workers' rights and interests, and to promote the formation of employers' organizations;
- lay down certain obligatory minimum basic conditions of service for all employees;
- ensure the protection of the health, safety and welfare of people at work and to prevent the abuse of child labor;
- where possible, adhere and give effect to international labor conventions and recommendations of the International Labor Organisation.

The Ministry of Labor was given the lead responsibility for developing and implementing labor and employment policies. Its responsibilities include (GRN 1995: 131):

- promoting employment, sound labor relations, equitable conditions of employment, and a safe working environment;
- carrying out research on human resources availability;
- planning, designing, and implementing basic skills development and artisan training; and
- protection of workers against the loss of income as a result of work-related accidents or diseases.

Relevant policy instruments include:

- the Labor Act (1992)
- the National Vocational Training Act (1994)
- the Social Security Act (1994)
- the Export Processing Zones Act (1995)
- the Public Service Act (1995)

Other relevant policies include the promotion of labor based works (a Green Paper has been published which is the basis for a White Paper under preparation) and employment in government and parastatals. Namibia has no minimum wage legislation, but collective agreements that include such clauses can be made binding for the industry.

The Labor Act (1992) establishes a Labor Advisory Council (tri-partite), labor courts, sets out basic conditions of employment (including minimum working hours, overtime, annual, sick, and maternity leave), regulates termination of contracts and unfair disciplinary actions, trade unions, employers' organizations and collective agreements. Despite some exceptions, the Act is basically valid for all employment. No information is available of the actual coverage, but it can be assumed that it is largely confined to employment in the 'formal sector'. Activities as domestic service, farm work and informal business are largely not covered in reality. The ability of the Ministry to enforce the Act remains limited due to the small number of Labor Inspectors.

The Social Security Act (1994) provides that every employee has to register himself/herself and every employee. Every employee registered is a member of the Maternity Leave, Sick Leave, and Death Benefit Fund. Every employee registered is also a member of the National Medical Benefit Fund and the National Pension Fund, except where he is a member of any other respective fund approved by the Minister on recommendation of the Social Security Commission.

The EPZ Act of 1995 and other laws provide generous incentives for investment in Namibia and especially for training.

Currently under discussion is the Affirmative Action (Employment) Bill. This bill defines affirmative action as "measures designed to ensure that persons in designated groups (including racially disadvantaged groups, women and disabled) enjoy equal employment opportunities. The bill establishes an Employment Equity Commission to supervise employers on the implementation of a required affirmative action plan.

1.31 Employment growth. Although data are scarce and sometimes inconsistent, they suggest that employment is hardly growing (Table 1.2), and that unemployment is on the rise (Figure 1.7). Employment is growing most rapidly in services, driven by the rapid expansion in the Government's payroll. But financial services and transport are adding...
employees as well. And although trade
and hotels on aggregate lose employees,
the hotel subsector is taking in more
people as a consequence of expanding
tourism. Manufacturing employment has
only been growing slowly, and from a
very small base. In contrast, agriculture,
fisheries, and mining have been shedding
labor at a rapid pace.

1.32 Official figures show that unemployment grew from 12% (1975) to over 20%
(1984), and remained at this level until the 1990s (GRN 1995: 129). Unemployment in a
wider sense -- taking into account underemployed as well as unemployed -- has been on
the increase since independence: from less than 33 percent in 1994 to almost 35 percent
of the labor force in 1997.

1.33 Wage Developments. Namibia’s unemployment has particularly stark
consequences: compared to other sub-Saharan African countries, the reliance on wage
income is very high (MLHRD, 1994). However, data on wages and wage developments
are even scarcer than those for employment, and little can be said about overall
developments in wages. Earlier research suggest that average wages in parastatals were
by far the highest, almost double as high as those in government. Wages in private
companies were higher than in government, but much lower than in parastatals.

1.34 Reliable figures on the
development of individual wages are
missing. However, the share of wages
in income has been fairly stable over
time at around 40 percent. The
increase in wage level and public
sector employment has in part been
compensated for by the falling number
of employed in the private sector.
Policy researchers agree that two
trends can be distinguished: incomes
of informal sector workers are largely
market determined and probably
stagnating, while formal sector
workers, which are highly organized in
various trade unions, have seen their
wages rise.

| Table 1.2: Employment distribution 1991 and 1997 |
|-----------------|-----------------|
|                 | 1991            | 1997            |
| Agriculture and fisheries | 168835          | 135940          |
| Mining and quarrying        | 12960           | 5485            |
| Manufacturing              | 20316           | 22719           |
| Electricity/gas             | 2452            | 3920            |
| Construction               | 16463           | 17705           |
| Trade/hotels               | 33627           | 32333           |
| Transport and communication | 8407            | 11848           |
| Finance/real estate         | 7706            | 25342           |
| Services                   | 79514           | 101887          |
| Total                      | 350280          | 357179          |


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* From mission interviews.
1.35 Recent examples of wage agreements confirm this informal evidence:

- 1995 salary agreement of the Mineworkers Union of Namibia (MUN) and Roessing Uranium Ltd.: 10% across the board (75% of this for some employees).
- 1996 salary agreement of the Mineworkers Union of Namibia (MUN) and Roessing Uranium Ltd.: 9% across the board, plus 24% one-off bonus and rental allowances.
- 1997 and 1998 salary agreement of MUN and Roessing Uranium Ltd.: 11% for 1997 and 10% for 1998; this to be adjusted by income group (120% for lowest, 60% for highest).
- 1998 Government wage increases with 12, 8, and 5 percent for low, medium, and high level staff.
- Municipality Otjiwarongo and Namibia Public Workers Union (NAPWU): 18% for lowest, 15% for medium, and 12% for highest income groups.
- Namwater and MUN salary agreement (1997/98): 8% across the board.
- Nampost and NAPWU 1998/99: 9.25% for lower, 8.25% for higher income groups.
- Gendor and NSAWU wage increases in the fishing industry from 11-29 percent.

1.36 These figures suggest that the labor costs in the formal sector in Namibia are increasing faster than the inflation rate by a considerable margin. As the labor market is not unduly regulated (there is no minimum wage, although this is under discussion), a main factor determining high labor costs is the strong influence of the trade unions in the formal sector (public and private). The trade unions are very vocal and influential because of their close link to the ruling party. Because they largely represent only the relatively high-paid employees of the public sector and large private firms, Namibia conforms to the picture of a 'labor aristocracy', rather than that of an 'informalisation' of the labor market. Moreover, although there is no formal minimum wage, some industry-specific wage agreements do contain such a minimum wage, which is then extended to all employees in the industry. A trade union of the domestic workers has been established, which helps to publicize the case of this low paid group who often works under exploitative conditions, but it does not have a significant influence yet on wages or working conditions.

1.37 There is conflicting evidence whether Namibian wages are too high. A survey done by the Ministry of Trade and Industry in 1994 suggests that wages are considerably higher than most comparators in the region, with the exception of South Africa (Table 1.3). Wages of semi-skilled employees are more than 4 times as high as in Zimbabwe, while managers earn almost double as much. However, wages tend to be lower than in South Africa, but due to the low skill level in Namibia this difference may be overcompensated by higher skills in South Africa. The same survey suggests that unit labor costs in manufacturing are high as well (Table 1.4).
Table 1.4: Unit Labor Costs in Specific SADC Countries, 1994

<table>
<thead>
<tr>
<th>Country</th>
<th>Fish processing</th>
<th>Meat processing</th>
<th>Machinery &amp; Equipment</th>
<th>Total Manufacturing Sector</th>
</tr>
</thead>
<tbody>
<tr>
<td>Namibia</td>
<td>0.20</td>
<td>0.06</td>
<td>0.21</td>
<td>0.16</td>
</tr>
<tr>
<td>Botswana</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
</tr>
<tr>
<td>Zimbabwe</td>
<td>0.13</td>
<td>0.09</td>
<td>0.11</td>
<td>0.12</td>
</tr>
<tr>
<td>Mauritius</td>
<td>0.17</td>
<td>0.16</td>
<td>0.15</td>
<td>0.16</td>
</tr>
<tr>
<td>South Africa</td>
<td>0.17</td>
<td>0.16</td>
<td>0.15</td>
<td>0.16</td>
</tr>
<tr>
<td>Swaziland</td>
<td>..</td>
<td>..</td>
<td>0.10</td>
<td>0.09</td>
</tr>
</tbody>
</table>


1.38 However, other studies show that Namibia's productivity is higher than all of its neighbors, except South Africa. Again, a scarcity of data blurs the debate, and leaves Government at a loss on what to focus its efforts on. A first step in seriously addressing the unemployment problem is therefore to improve labor market data.

1.39 **Skills Shortage.** Skills shortages remain a problem in Namibia. Overall, it is estimated that some 10 percent of all positions either do not employ the person with the right skills, or remain unfilled because of lack of skills (Table 1.5). Lack of skilled labor is mentioned as one main constraint to business expansion (after lack of capital and inadequate market; MLHRD 1994: 53). Skills deficits result in a high percentage of foreign skilled labor - 18.1% of senior officials and 13.9% of professionals are non-Namibian (MLHRD 1994: 33). Observations during field work suggest that real skill deficits may even be much higher than that in private business.

Table 1.5: Less qualified, vacancies and additional requirement
(as % of employed by occupation)

<table>
<thead>
<tr>
<th>Occupation</th>
<th>Employed with less than required qualification</th>
<th>Vacancies</th>
<th>Additional required for expansion</th>
<th>Total skill deficit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Senior officials/managers</td>
<td>6.1</td>
<td>6.4</td>
<td>4.3</td>
<td>10.7</td>
</tr>
<tr>
<td>Professionals</td>
<td>7.0</td>
<td>15.1</td>
<td>9.3</td>
<td>24.4</td>
</tr>
<tr>
<td>Associate professionals and technicians</td>
<td>6.8</td>
<td>12.2</td>
<td>6.2</td>
<td>18.4</td>
</tr>
<tr>
<td>Clerical</td>
<td>4.6</td>
<td>4.2</td>
<td>3.0</td>
<td>7.2</td>
</tr>
<tr>
<td>Sales/services workers</td>
<td>11.8</td>
<td>3.6</td>
<td>6.9</td>
<td>10.5</td>
</tr>
<tr>
<td>Skilled agricultural worker</td>
<td>3.5</td>
<td>1.7</td>
<td>17.2</td>
<td>18.9</td>
</tr>
<tr>
<td>Craft and related worker</td>
<td>4.7</td>
<td>3.7</td>
<td>4.6</td>
<td>8.3</td>
</tr>
<tr>
<td>Plant and machine operator</td>
<td>3.5</td>
<td>4.6</td>
<td>2.2</td>
<td>6.8</td>
</tr>
<tr>
<td>Elementary occupations</td>
<td>6.2</td>
<td>5.6</td>
<td>3.2</td>
<td>8.8</td>
</tr>
<tr>
<td>Total</td>
<td>6.0</td>
<td>6.0</td>
<td>4.4</td>
<td>10.4</td>
</tr>
</tbody>
</table>

Sources: CSB, NPC and staff estimates.

1.40 Skills shortage is projected to grow: The NPC in its draft Human Resource Plan, has identified skills shortages for the next 25 years, and projects that, notably in science, technology, and engineering, skills deficits will take alarming proportions, despite the efforts already underway in education institutions. Education institutions are not geared towards requirements of the labor market: in particular, they are strongly oriented at paid

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6 All 1994 figures except for South Africa and Swaziland (both 1993).
employment opportunities, to the exclusion of self employment. Among the underlying reasons are (NPC 1998a: 83):

- inadequate institutional and infrastructure facilities to help create/strengthen entrepreneurial skills;
- absence of out-of-school training exposure to develop industrial skills and culture;
- lack of cooperation and interaction between industry and educational organizations;
- inadequate financial incentives to encourage self-employment.

1.41 As a remedy for the skills shortage, the NPC proposes a massive training effort abroad. The question is whether the resources needed for such an effort could in some cases not be better spent on increasing the capacity of domestic schools and universities, and on subsidizing industry-sponsored training programs. Nevertheless, for some specialized disciplines it will not be cost-effective to develop training and education capacity in Namibia, and training abroad would be the policy of choice. But irrespective of whether domestic or foreign training is appropriate, building skills takes time. In the mean time, Government could alleviate bottlenecks in the labor market by reviewing its restrictions on hiring foreigners.

1.42 Confrontational labor relations. The World Economic Forum's first 'African Competitiveness Report', ranked Namibia highly (4th out of 23 countries). However, the chief liabilities identified are in the area of labor: supply of educated workers, quality of university education, unions and strikes, labor regulations including minimum wages, government interference, government regulation of hiring and firing. The long protracted strike at TCL in 1996 is the most obvious example for the difficult labor relations in Namibia.

1.43 Prospects. Short term prospects for employment creation remain limited. Recent growth rates have not been enough to maintain the current employment level, let alone absorb the new entrants in the labor force. With current technologies, and with efficiency gains of 1-1.5 percent per year, Namibia needs to grow by at least 4.5 percent per year just to maintain current unemployment levels. Current initiatives in EPZs mainly favor capital-intensive industries because of their corporate tax exemptions, and have thus far created about 1500 jobs, or 0.3 percent of the labor force. For more rapid employment creation, a major shift to more labor-intensive technologies seems to be required.

D. Fiscal Developments

1.44 Fiscal developments have been volatile over the last few years (Figure 1. 8). The record deficit in 1996/97 would have been even higher, if not for the emergency austerity package in November 1996. Nevertheless, the deficit of over 6 percent of GDP strained the economy, and jacked up the Government's interest bill. In fiscal 97/98, Government set out with a deficit target of 3.5 percent. This target soon seemed unfeasible due to continued overspending by line ministries and slowing revenues due to much lower growth. The supplementary budget warned that the budget deficit would reach 4.5 percent of GDP, but a serendipitous last quarter of 1997 brought in more revenues that expected, and in the budget speech, a preliminary deficit of 4 percent of GDP was announced. The actual turnout was even better: a windfall tax on diamonds sold from
inventory brought the final number to 3.1 percent of GDP, a level which seems sustainable for Namibia, given its open capital account with the CMA, and thus a limited risk of crowding out of private investment through interest rate increases.

1.45 Fiscal worries are not over yet. Because the surprise rise in revenues was mainly due to one-off revenues, and spending pressures are not subsiding, additional revenue measures were announced for the 1998/99 budget year. These measures, which have already been implemented, include: an increase in the GTS on goods from 8 to 10 percent while those on services was reduced from 11 percent to 10 percent; an increase in the additional sales duty (ASD) on beer from 10 percent to 15 percent, and for spirits and tobacco from 15 percent to 25 percent; an increase in the income tax on non-mining companies by 5 percent points to 40 percent; and a 5 percentage point increase on individual earnings above $N100,001, pushing the marginal rate to 40 percent. Taxes on mining except diamond were also raised by 5 percent points.

1.46 The additional revenue measures were not enough to counter the revenue effects of a slowing economy, and the additional spending necessitated by interest rate increases and currency depreciation. However, the Government reacted prudently, and passed a surprisingly modest supplementary budget in October. The deficit for the fiscal year is now planned to be 4.2 percent, higher than the 3.9 percent of the March 1998 budget speech. From a cyclical perspective the slight increase seems warranted, because it would be unwise to follow a restrictive deficit targeting in times of economic slowdown. However, from a structural perspective a deficit of over 4 percent, combined with high real interest rates and low growth is unsustainable: at current trends, the Government's debt would over time be an ever rising percentage of GDP. Thus the Government needs to either raise more revenues, or cut spending.

Revenues

1.47 The revenue measures implemented in 1998 are intended to be temporary. However, given the pressures on the expenditure side and the expected lower growth of GDP in 1998, it would become increasingly difficult to reduce the tax rates without additional measures on the spending side. Even with the additional revenue measures for FY1998/99, the deficit was still projected to reach 4.2 percent of GDP, which is probably too high in light of the implications for interest payments.

1.48 VAT. The measures on the GTS and ASD will be temporary since they will be replaced by the VAT which is planned to be introduced by fiscal year 99/00. However, while the administrative preparation for the VAT is on track, the introduction of the tax could be delayed for several reasons. One of them is the limited information thus far provided to industry on the VAT. Such taxpayer information is crucial for successful
introduction of a VAT, as experience in other countries showed. In Ghana, for example, the VAT introduction had to be retracted by Government. The key reason for this was that suppliers misunderstood the VAT, and increased their prices by the same amount as the tax rate, even though VAT replaced other taxes. The subsequent riots cost the Finance Minister his job.

1.49 Delays in VAT introduction could also come from lack of political resolve. Among the key outstanding issues are those of the VAT rate, whether it should have one rate or more, whether certain goods should be exempted or zero rated, and whether VAT paid over investment goods should be credited or not. International experience shows that a single rate, consumption based VAT with only limited zero ratings rather than exemptions is the preferred choice in terms of revenues and neutrality on economic activity. The rate should be set such as to minimize the incentive for invasion, and in general, countries with better tax administrations can sustain higher rates.

1.50 For Namibia, earlier calculations show that a 16 percent rate for the VAT could be revenue neutral with respect to GST and ASD revenues. However, this rate assumes hardly any exemptions, and does not reflect the increases in GST and ASD rates made since the calculations were made. Moreover, the GST exempts some items that are prominent in the consumption basket of the poor. It is calculated that exempting or zero rating those would lower the VAT tax base by some 4 percent, with a revenue loss of some 0.5 percentage points of GDP. From an equity perspective this seems a fair price: because most of the poor earn too little to pay income tax, no equity improving measures can be taken by lowering income taxes. Thus, not taxing certain items under VAT is justified for this reason.

1.51 The less than perfect compliance with the GST is a further reason to be concerned about the equity impact of VAT. In the North, where most of the poor reside, tax enforcement is considerably weaker than in the in the rest of the country. One observer even described the North as a “tax free zone.” However, the VAT has much stronger incentives to comply, because taxes paid on inputs can be credited against taxes on outputs. Thus, even with similar exemptions, the VAT is likely to increase the tax burden on consumption, and therefore disproportionately affect the poor. This reinforces the argument for not taxing some of the goods heavily consumed by the poor, even if it costs some revenues.

1.52 Nevertheless, introducing a VAT remains highly desirable, and the tax should become one of Namibia’s key revenue generators. Revenue composition during the last

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few years has changed. Direct taxes has been increasing in relation to total tax revenues, while indirect taxes and non-tax revenues have decreased. This trend goes against international developments, which increasingly relies on taxes on consumption rather than income (Figure 1.9).

1.53 **Additional Revenue Opportunities.** A VAT tax rate of 16 percent seems to be the limit of what Namibia’s tax administration could enforce. Thus, any shortfall due to exemption will have to be compensated for by additional revenues. Fortunately, revenue opportunities abound in Namibia.

1.54 First and foremost, non-tax revenues should increase, and dividends from parastatals could be a first target. While international experience shows that parastatals are in general a less efficient way to deliver public goods, Namibia has decided that they will not be privatized for now. Given that decision, however, Government should get a much better return from its investment than at present. The number on dividend payments of parastatals, which are kept from the public eye, show that dividends from these enterprises are dismal, even if they are profitable. And several parastatals, even the profitable ones, are exempted from paying any taxes whatsoever. Even the Bank of Namibia pays only modest dividends into the treasury, in fact less than the interest Government would receive on its balances it holds interest free at the central bank.  

1.55 For parastatals that operate in commercial activities such as transport, energy generation, and tourism, there is no reason for Government not to demand returns on its investments at least as high as the Government’s own opportunity costs of capital, i.e. the 18.5 percent or so it pays on treasury bonds. Enforcing such returns through performance contracts could yield significant benefits to the treasury, and benefit the efficiency of the economy at the same time.

1.56 Tax revenues could be increased by increasing taxes on pollutants and health hazards. Taxes on petrol products, cigarettes and alcohol are still low by international comparison. Increasing them further could not only benefit the treasury, but would have positive effects on the environment and health budget as well. Moreover, since most of these goods are consumed by the better off, increasing these taxes would have beneficial equity effects as well. The Treasury Cabinet Committee is considering the introduction of capital gain tax, estate tax, land tax and stamp duty on share dealings in the Namibian Stock Exchange. In its deliberations, the commission should consider whether some of these taxes may not bring more nuisance than revenues, and whether some of these taxes do not go against some of the Government’s own policy objectives, such as capital market development.

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8 In 1997, the central bank paid N$15 million in dividends. The Government deposits at the end of the year amounted to some N$360 million, which would have fetched some N$54 million in interest in a commercial bank.
Expenditures.

1.57 A rapidly rising wage bill and mounting interest payments have been driving Government spending upwards in recent years. Rising current expenditures which now amount to 34 percent of GDP came at the cost of investment, which is now below 5 percentage points of GDP. These levels of spending are similar to those of OECD countries with medium-sized governments, well above the level of most other countries in the region, and far above the Newly Industrializing Countries Namibia is competing with in world markets (Table 1.6).

1.58 Some of Namibia's high Government expenditures can be understood in the context of historical patterns that disadvantaged large parts of the population. It is only natural that Government takes an active role in correcting these disadvantages by means of higher social expenditures. In particular, education expenditures can be helpful in reducing Namibia's large income inequalities over time. But South Africa, which faces the same problems, seems to cope with spending almost 5 percentage points of GDP less on health and education than Namibia. This suggests that Namibia has ample options for saving on Government spending without reducing Government services.

Table 1.6: The Size and Composition of Government Expenditures Different Countries and Country Groups
(Percent of GDP, 1990, except Namibia and South Africa: 1997/98)

<table>
<thead>
<tr>
<th></th>
<th>Big Governments</th>
<th>Medium Governments</th>
<th>Small Governments</th>
<th>Newly Industrializing Countries</th>
<th>South Africa</th>
<th>Namibia</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(a)</td>
<td>(b)</td>
<td>(c)</td>
<td>(d)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Expenditures</td>
<td>55.1</td>
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<td>7.9</td>
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<td>1.9</td>
</tr>
</tbody>
</table>

Notes:
- a Belgium, Italy, Netherlands, Norway, Sweden (public expenditure more than 50 percent of GDP in 1990).
- b Austria, Canada, France, Germany, Ireland, New Zealand, Spain (public expenditure between 40 and 50 percent of GDP in 1990).
- c Australia, Japan, Switzerland, United Kingdom, United States (public expenditure less than 40 percent of GDP in 1990).
- d China, Hong Kong, Korea, Singapore, 1990 or nearest available year.

Note: The functional classification numbers from Namibia are budgeted numbers.
Sources: Schuknecht and Tanzi (1995); China: Managing Expenditures for better results, World Bank Mimeo, 1998; MOF, South Africa Department of Finance.
1.59 The wage bill share in total expenditures is the main cause of the high and increasing current expenditures, and the high level of social spending. For instance, over 85 percent of spending on education is on wages, not just for teachers, but increasingly for administrators, janitors, and other non-teaching personnel. Despite the acceptance of the WASCOM recommendations, there seems little chance that Government reduces the number of civil servants any time soon, and Namibia now has the highest share of Government workers in the labor force of any African country. Unemployed former combatants have been putting pressure on Government to hire them, and all indicators show that Government will cave. Although it is clear that an obligation exists to these people, it is less clear that such obligation should consist of a Government job, rather than, say, enrollment in a training program which would provide the ex-combatant with skills in high demand in the private sector.

1.60 The additional wage bill in 1998/99 amounted to a real increase of almost 19 percent over last year's budget and 10 percent over actual outcome. This increase is mainly the result of the Cabinet decision to reduce inequalities between management and lower paid personnel through increasing the lower level civil servant's salaries by 12 percent. This is a political decision in response to complaints of the labor union and shows how difficult curbing down personnel expenditures will be.

1.61 Capital expenditures last year fell short of expected budgeted amounts by more than 11 percent. For the current fiscal year, capital expenditures are budgeted to remain low but slightly higher (3.7 percent) than the actual outcome of last year. Compared to the original budget of last year, the forecast is lower by 8.2 percent, while current expenditures will rise by 24.9 percent. This assumes a decline in real public investment growth of more than 15 percent and at least a 15 percent real increase in current expenditures over last year's budget.

1.62 **Deficit Financing.** Namibia's deficit is mainly domestically financed. In 1997, domestic financing accounted for 85 percent of total financing, up from around 70 percent in previous years. Domestic debt has now risen to around 21 percent of GDP at the end of 1997/98 fiscal year. Treasury bills account for 64 percent of this debt while long term bonds finance the balance.

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* Over the last two years, Government has hired more education administrators than teachers.

10 Sciavo-Campo et al, 1997
1.63 Government foreign debt fell during the last fiscal year because of debt forgiveness by South Africa. Because of the debt forgiveness, government external debt declined from US$116 million in March 1997 to US$70 million a year later. Government remains reluctant to borrow in foreign currency because of its dislike of exchange rate risk it entails. The price for this policy is the hefty domestic interest rate it has to pay. The latest bond auction resulted in an 18.6 percent interest rate, or some 10 percent real. However, individuals are not taxed for interest income from government bonds. At a marginal rate of 40 percent on income tax, the effective nominal interest rate government pays is therefore a whopping 31 percent. This is effectively a transfer to the rich, because the minimum amount of bonds one has to buy is N$10,000, an amount far out of reach of the poor.

1.64 The 18.6 percent yield in the last treasury bonds auction in considerably higher than budgeted for, and financing cost will rise. Total financing requirements, for the deficit and for refinancing previous years' deficits, will add up to some N$770 million. For that sum, the hike in interest rates since the passing of the budget will cost about N$40 million extra. But even at higher interest rates, financing is not guaranteed: the August auction raised only N$70 million out of an expected N$170 million.

1.65 To increase liquidity in the secondary market, Government consolidated its outstanding 11 bonds issues into three in the first quarter of 1998. The conversion was highly successful for Government: almost 90 percent of outstanding bonds was converted, at a negotiated rate of 90 basis points over the corresponding South African rates (which are taxable). However, it did not increase liquidity in the bonds, and trading is still virtually absent.

E. FISCAL MANAGEMENT

1.66 Part of the relentless upward pressure on government expenditures stems from insufficient expenditure control. Government is well aware of this problem, and has already taken steps to correct this. Among others, it has moved to a system of monthly warrant releases from the Treasury, but this does not seem to stop the overspending. A reason for this is that payments for goods and services and those for wages have a

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11 To earn 18.6 percent after tax, an individual that falls in the highest income bracket would have to earn 18.6/0.6 = 31 percent in interest before tax.

12 Part of the reason for the limited success in the auction was that it took place just before a holiday. This allowed only for settlement two days after the auction. Such a lag increases the uncertainty for the bidders, and therefore reduces interest. In fact, the day after the auction, interest rates in South Africa shot up, and bidder ended up with Namibian yields below the South African ones.

-21-
separate paymaster. For the former it is the Treasury, for the latter the prime minister’s office.

1.67 The Government’s problems go beyond financial management. Overbudgeting, weak cash management, overspending and overcommitment, and little spending adjustment in response to a changing economic environment seem to be other causes for overspending. Chapter 3 provides a detailed analysis of Namibia’s expenditure management system. The key conclusions are that overspending has two fundamental causes: (i) lack of political commitment to the budget as a constraint on decision making and spending; and (ii) insufficient powers of the Ministry of Finance to intervene in cases of overspending. Chapter 3 proposes a redesigned budget process that would separate bureaucratic processes from political decisions, thereby increasing the political commitment to the budget. It also proposes to strengthen the State Finances Act with a clause that would allow the Ministry of Finance to appoint a controller for a line ministry in case of repeated overspending.

F. MONEY, PRICES AND EXCHANGE RATE

1.68 The velocity of money in Namibia has seen a steady decline since independence (Figure 1.14). This development reflects a monetization of the economy, which is in part due to reduced use of the South African Rand—legal tender alongside the Namibian dollar—in transactions. It could also reflect the increased participation in the money economy of previously disadvantaged groups. Whatever its cause, declining velocity has allowed for rapid growth in monetary aggregates without undue inflationary pressures in the economy. Moreover, it has allowed the Bank of Namibia to issue currency and reserve money from which it reaps an increasing amount of seignorage.

Because of the Common Monetary Area, inflationary pressures show in current account developments rather than CPI changes.
1.69 The central bank's foreign assets cover currency in circulation more than 4 times over. This lends credibility to the stability of the currency board arrangement with South Africa, although the international reserves remain vulnerable to swings in liquidity. Reserves came under pressure in the third quarter of 1996, because the Government's deficit was much higher than expected, and had to be financed by drawing down deposits. Since the Namibian interbank market is small, the injected liquidity was used by the banks to invest in the South African market. To do so, banks demanded foreign exchange from the central bank, which saw its international reserves fall rapidly. Since then, Government deposits and reserves have recovered, and the central bank and the Treasury have agreed on minimum balances in the Government accounts. However, because cash management in Government is still rudimentary, a repetition of the 1996 events is not impossible.14

1.70 Despite the rebuilding of international reserves, growth in M1 and M2 slowed over the last two years. Growth in M2 came down from a level of over 20 percent year-on-year for most of 1996 and 1997 to 8.6 percent in the first quarter of 1998. This slowdown is driven by a slide in the money multiplier, which mirrors a slowdown in credit growth (Figure 1.15). In part, this is due to Government rebuilding its deposits, but growth in credit to the private sector has been falling as well on account of higher real interest rates. Credit to the private sector grew by only 13 percent year-on-year by the first quarter of this year, down from 19 percent at the end of 1996.

1.71 Inflation. Because of the currency link with the Rand, inflation has come down in line with declining inflation in South Africa. Measured over a period of 12 months,
Namibia's inflation has been decelerating progressively over the last 5 years, from the peak of 18 percent in 1992 to the 8.9 percent in 1997. However, this is about to change. The sharp depreciation of the Rand in the first half of 1998 promises rising inflation. Although several factors determine Namibia's inflation, a good early indicator for Namibian inflation is the South African PPI.

1.72 Namibia's inflation follows developments in the South Africa production price index with a lag of approximately 3 months. This means that imported prices which enter the calculation of the CPI changes in the same direction 3 months after the change in the South African PPI although at a different rate. The recent sharp rise in this PPI in the wake of the Rand depreciation suggests that Namibian inflation is bound to rise rapidly before the end of the year. The latest month on month inflation figures confirm a rising trend in inflation. They show an increase of almost 2 percent in July compared to nearly zero at the beginning of the year. Fortunately for the poor, food price increases lagged overall inflation.

1.73 Expectations are that inflation will continue to rise in 1998 given the pressure on prices of the income and sales tax increases and the effects of the depreciation of the Rand and N$. A worrisome trend in the latest figures is that nontradables such as municipal services and telecoms rise faster in price than those of tradables. Such a development threatens to erode the newly regained competitiveness resulting from the Namibian $ depreciation.

1.74 The East Asia crisis has reiterated the importance of a strong financial sector. In East Asia, the sharp depreciations triggered a financial crisis which squeezed liquidity to the heavily indebted enterprises, which in turn caused a sharp contraction of output and employment. 

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16 Rather than a quick trade-led economic recovery, the East Asian depreciations and the high domestic interest rates that aimed to stabilize the currency caused a credit crunch and widespread failure of financial institutions. The high interest rates and the fiscal burden of the financial sector collapse plummeted domestic demand, while exports failed to revive because no trade credit was forthcoming. The resulting output contractions led to massive layoffs in an environment that lacked a safety net.
Namibia seems to be far from such a scenario, but the East Asian crisis has reemphasized the need to review vulnerabilities in the financial and corporate sector, the quality of financial sector supervision and corporate governance, and contingent liabilities to the budget.

G. FINANCIAL SECTOR STABILITY.

1.75 Overall, Namibia's banks are sound. The banks, three of which are South Africa owned, are well capitalized, and profitable enough to weather the storm of the N$ depreciation and the rising interest rates. Nevertheless, several aspects of the banks' performance require the attention of the supervisory authorities in the Bank of Namibia.

1.76 The rise in nonperforming loans over 1997 is cause for concern. Nonperforming loans made up 7.3 percent of the banks' assets at the end of 1997, sharply up from the 4.8 percent recorded the year before. The key cause for the increase was the higher real interest rates over 1997 as compared to 1996. But the rapid growth in domestic credit over 1995-1997 may have contributed to the deterioration as well. The recent slowdown in credit growth may therefore slow the increase in nonperforming loans, but the increases in interest rates in the wake of the depreciation does not bode well for the banks. The rise in bad debts was in particular in the category of consumer loans and overdrafts. These consumers now face much higher debt burdens than before because of the higher level of indebtedness, and interest expenses made up almost 20 percent of disposable income. The authorities believe that the amount of nonperforming loans reported is fairly accurate. Although the nonperforming loans are not measured according to the Basle principles yet, the banks' own definitions more or less correspond to that definition. Nevertheless, some underestimation of the size of nonperforming loans may occur because of evergreening, some of which was discovered by recently introduced. However, this practice seems limited, as banks have a very conservative lending policy.

1.77 The banks' key corporate clients are well capitalized (see below). But the overall state of all enterprises in Namibia is unknown, and the banks do not report on this to the supervisor. Such practice is in conflict with the "know your client" recommendations of the Bank for International Settlements.

1.78 Despite the increase in nonperforming loans, the banks' profitability remains high. Interest margins and fees are exceptionally high, and more than make up for high administrative costs and bad debt provisioning. Namibian banks charge fees for almost any transaction from deposit to transfer. In addition, the banks seem to underprovision for the nonperforming loans, in part because until recently no strict guidelines were imposed from the central bank. However, from the current statistics reported, it cannot be determined whether the nonperforming loan is overdue, doubtful, or a loss, and consequently, the necessary provision cannot be determined. More provisioning would suppress profitability and the central bank should closely watch this indicator, as it improves its provisioning policy.
Figure 1. 19: Namibia’s Financial Sector at a Glance

**Financial Institutions**

- **Central Bank**: Bank of Namibia
- **Commercial Banks**: First National Bank, Standard Bank, Commercial Bank of Namibia, Bank Windhoek, City Savings & Investment Bank
- **Merchant Banks**: Standard Bank Merchant Bank, Huysamer Stals, First National Merchant Bank, UAL, INVESTEC, Boerland, Coronation
- **Bureau de Change**: Namibia Bureau de Change
- **Savings Bank**: Nampost Savings Bank
- **Building Societies**: SWABOU, Namibian Building Society
- **Development Financing Institutions**: Agribank, Namibia Development Corporation, Development Fund of Namibia, National Housing Enterprise, Institute of Management and Leadership
- **Long Term Insurers**: Government Institutions Pension Fund, Sanlam, Old Mutual, Southern Life, Metropolitan Life, Fedsure Life, SWABOU Life, Capricorn Life, Capital Allianz, Regent Life
- **Short Term Insurers**: Capricorn Life, Mutual & Federal, Namibia National Insurance Company, Sanlam, FGI, SWABOU, Allianz, Corporate Guarantee, INSCON, Nasra
- **Fund Management Companies**: 16 asset management companies, and 7 unit trusts
- **Stock Exchange**: Namibia Stock Exchange

**Namibia’s banks are profitable, but have high costs...**

**...and nonperforming loans are on the rise, and perhaps underprovisioned for...**

**...while illiquid government bonds are the bulk of liquid assets.**

Source: Bank of Namibia Supervision Department, Ministry of Finance Financial Institutions Supervision Department, Namibia Financial System and the GATS, report by NEPRU and Trend Line prepared for CEPAS, July 1998.
1.79 The banks' high profitability is hardly due to their efficiency. Operating costs are high and compare poorly to those of banks in neighboring countries. But competition in the banking sector seems lower than desirable, and banks in general are seen as very conservative lenders. Their net interest rate margin of over 6 percent of assets and their high non-interest income -- fees for just about everything -- point to imperfect competition in the industry.

1.80 The banks' liquidity position remains adequate. However, liquid assets consist mainly of government bonds which in practice are highly illiquid in Namibia. This poses a risk for the banks as well as the central bank: if the banks cannot sell the bonds in the market, they are likely to turn to the central bank for liquidity by discounting their Government bonds through the newly created facility. If the banks need liquidity, the central bank risks taking over much of the financing of Government debt.

1.81 The banks' foreign currency exposure is fairly small. At the end of 1997, net foreign liabilities were some N$300 million, 3 percent of total assets, or some 40 percent of capital. This is well below the legal restriction of a net exposure of no more than 15 percent of net assets. Moreover, the central bank is of the impression that most of the liabilities in foreign currencies are hedged.

1.82 Bank supervision. Bank supervision obtained a boost with the enactment of the new Banking Institutions Act (Act No 2 of 1998) and the supporting determinations (regulations) that have been issued since. The legislation closely follows the Basle Principles of Bank Supervision, and unlike the previous law allows the central bank to change prudential ratios without legislative changes, which enables a quick response by the central bank in case of unexpected events. The regulations, including those on capital adequacy, large exposures, liquidity, suspension of interest on nonperforming loans, have been duly discussed with the banking industry, and are gradually being implemented. The central bank has started on-site supervision to ensure adherence to the law and regulations. As is usual in other countries, the law gives the central bank sweeping powers to take control over troubled institutions.

Figure 1.20: Financially Stable Corporates

Source: Company Annual reports.
Corporate Financial Structure

1.83 The corporate sector seems financially stable, and capable of absorbing considerable interest rate shocks. Listed companies on the Namibia Stock exchange have in general low debt equity ratios, and liquidity is high (Figure 1. 20). Most of the listed companies are highly profitable, and show interest coverage ratios that pose no reason for concern.

H. EXTERNAL DEVELOPMENTS

1.84 Namibia’s exports remain dominated by minerals, and especially diamonds that constitute 40 percent of exports, up from 31 in 1994 (Figure 1. 21). Despite the terms of trade deterioration, the 1997 trade deficit narrowed due to lower than expected imports in light of falling consumption and investment. In real terms, merchandise imports fell by 6.0% and merchandise exports grew by 1.2%. The large inflow of transfers due to SACU kept the current account in surplus. Despite terms of trade improvements, trade prospects look worse, mainly as a consequence of the cut in the CSO diamond quotas.

Figure 1.21: External Developments

Exports still rely heavily on minerals

...but the trade balance improved as imports fell.

Source: CSB.

Trade is likely to improve further due to a depreciated Real Exchange Rate...

...although the trade-weighted numbers may not be the right indicator for competitiveness

Note: Real Exchange Rate Index 1990=100

Note: Index 1994Q1=100.
Source: BON and World Bank estimates.

1.85 In the short run, the trade balance in nominal terms may react negatively to the 30 percent currency depreciation—not least because the instability in the currency restrains a supply response from exporters who face uncertainty on the future price of their exports. This J-curve effect is likely to have run its course by 1999. Thus, if Namibia can
Namibia: review of recent economic performance

maintain its improved competitiveness by holding the real exchange rate at competitive levels, the 1999 trade balance is likely to show a larger surplus. In this respect it is noteworthy that the trade-weighted real exchange rate may not be an accurate reflection of the true relative price of tradables and non-tradables. The latter relative price is the relevant one for Namibian producers who have to decide on their production pattern. But this relative price shows a distinctly different evolution over time than the trade-weighted real exchange rate (Figure 1. 21). For example, over 1994-1996, the trade-weighted real exchange rate showed hardly any change, whereas the relative price of tradables first showed a sharp depreciation (good for exports) and then a sharp appreciation. Although the reasons for this divergence between the indicators are unclear, the authorities would be well advised to review both indicators in assessing whether the country is losing or gaining competitiveness.

1.86 Long term capital outflows, mainly from pension and insurance companies, surged to N$ 1.4 billion in 1998, up from 1 billion in 1996. This seems a catch up effect: the companies have now fulfilled the 35 percent domestic asset requirement, and now only need to invest at the margin rather than to reshuffle their portfolio as in 1995 and 1996. At the same time, FDI could not equal the record N$ 650 million it achieved in 1996, although the 1998 net inflow of N$ 580 is still promising, and reflects the interest in the tax-exempted EPZs. But a turnaround in short term capital combined with the record current account surplus allowed for a rebuilding of foreign reserves. The composition of Namibia’s capital account implies that short term foreign obligations are on the rise. Although the numbers do not reveal whether these are dominated in currencies other than the Rand, it is a development that needs to be closely monitored by the authorities.
2. NAMIBIA’S ECONOMIC PROSPECTS

2.1 Namibia’s short term economic prospects are surrounded with an unusual uncertainty. As a resource-based small open developing economy, the country is always prone to external shocks, but the current global situation makes predictions even more perilous.

A. THE WORLD ECONOMY

2.2 After the financial shocks of mid-1997, much of East Asia is now in a full-fledged depression, which is for some countries even comparable with the Great Depression of the 1930s. And Japan has slipped into a recession, which is unlikely to be resolved any time soon, given the less than decisive action on its bad debt-ridden financial sector. While Europe is recovering from slow growth of the last few years, the US economy is slowing down, although gradually as long as stock prices hold up. This may lead to further reduction in 1998 and 1999 growth, which was already reduced from forecasts at the end of last year (Table 2.1).

2.3 Poor prospects in Asia and an increasing likelihood of a slowdown in the USA have contributed to volatility in emerging markets. Russia is facing a financial meltdown, and other emerging economies, including South Africa, experience the fallout in the form of weakening currencies, and steeply rising risk premiums in interest rates.

2.4 World trade volume grew by about 8 percent y/y in the first quarter of 1998 but preliminary data (Figure 2.1) show a sharp deceleration for April to about 4 percent and May to about 2.5 percent. The slowdown in April-May reflects a sharp contraction in US export growth, and slowing of exports originating in Asia reflecting the spreading weakness in regional activity and import demand. The outlook for world trade is for moderate growth in the next one or two quarters followed by a slight pick-up towards the end of 1998 and into 1999. We are still projecting world trade growth to average around 5 percent in 1998 and 5.5 percent in 1999. However, the risks to this forecast are

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Table 2.1: Global growth prospects

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Source: WDI/GDF.

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increasing for a variety of reasons: the Japanese recession is both deeper and longer than we envisioned, which would certainly complicate the prospects for import and export recovery in the IMF-3 countries; and, depending on confidence, capital flows to developing countries could be lower than we earlier predicted, forcing more developing countries outside Asia to retrench.

2.5 The trend toward slower export volumes is particularly worrisome now since the prices of primary commodities and some manufactures are also on the downswing, placing intense pressure on the balance of payments of some developing countries. The World Bank’s index of non-oil commodity prices fell 3.8 percent in June 1998, 21.5 percent below a year ago and fast approaching the lows reached in the recession years of 1991-93 (Figure 2.2). Average prices of primary commodities are now at 1990 levels and these declines have continued into 1999. Metals and minerals prices are now 65 percent of their 1990 levels and the fall in Asian demand coincides with significant expansion of supply (both realized and still to come), as in copper. This means rapid deterioration in trade and current account balances for countries with a large share of primary commodities in their export basket.

2.6 Gross private capital flows to developing countries rose 45 percent in June over May. This brought the total for the first half of 1998 to $82 billion, 27 percent below a year ago. The decline in half-yearly volume is due wholly to the fall in flows to East Asia.

2.7 Persistence of spreads at much higher levels than a year ago reflects uneasiness towards emerging markets. Developing countries outside of Asia can no longer expect to raise foreign capital on relatively favorable terms, as they did in March and April of this year. Yet, demand for private capital flows is clearly rising as current account deficits widen in a number of countries which export primary commodities. And, the intensification of competition from Asia in export markets for manufactured goods is probably only just beginning to be felt. An area of special risk is South-Asia, where in the wake of the nuclear tests, the declaration of sanctions, and disappointments on the economic policy front, monthly capital flows averaged less than $100 million a month in Q2 compared to $550 million in Q1 and $800 million in 1997.
B. The South African Economy

2.8 The Namibia economy is closely linked to that of South Africa, notably at its import side, but increasingly through exports of manufactured goods. As for Namibia, the recent external pressures and resulting fall in the Rand has left the macro outlook for the South African economy particularly uncertain.

2.9 The recent external pressures and resulting fall in the Rand have left the macro outlook for the South African economy particularly uncertain. Prior to May, the likely evolution of the economy seemed clear: in the absence of major progress on structural reforms in the run up to the May 1999 elections, economic recovery from the current business cycle downturn was likely to be slow, with GDP growth rising modestly from 1.7% in 1997 to around 2.0 percent by 1999. Labor absorption would remain minimal, unemployment would stay high, and the urgency of moving forward with the agenda of structural measures would increase.

2.10 But events over the last few months have clouded the outlook and raised uncertainty over the near-term performance of the South African economy. On the downside, the economy has been hit by large and unanticipated external "shocks", which have forced immediate macro adjustments on the economy (exchange rate depreciation, interest rate hike, contractionary impact on domestic demand, reduced foreign capital inflows, and the potential high cost of forward market intervention) whose impact will spread through the economy for some time. These events highlight the continuing vulnerability of South Africa to such external pressures and the short-run outlook will be largely determined by whether further bouts of external pressure occur, and how successfully the authorities respond to the aftershocks of recent events.

2.11 On the upside, recent adjustments could potentially yield medium-term benefits, once the immediate crisis impact has passed. In particular, the large nominal depreciation of the Rand could provided a welcome boost to South African exports, provided that gains from the more competitive exchange rate are not quickly eroded through offsetting wage or price movements. Recent empirical findings have confirmed that South African exporters do respond to real exchange rate movements, so that maintaining improved export incentives over the medium term could accelerate export growth and provide a much-needed external stimulus to the lackluster domestic economy.

2.12 The World Bank's macroeconomic scenario for South Africa presented in Table 2.2 describes one way that these opposing pressures might resolve. In this scenario, GDP grows at 0.1% in 1998, and growth is expected to rise only slowly, to 1% in 1999, 2% in 2000, and 3% from 2001 onwards. After the recent easing of fiscal targets for this year and next, fiscal policy remains broadly consistent with GEAR targets, despite election-year political pressures and a poor revenue outlook as growth slows, although continued weak provincial budget outcomes slow the pace of consolidated deficit reduction.

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2.13 South African inflation during 1998 is around 7%, and stays around this level for a few years. With inflationary pressures limited, the 1998 real exchange rate depreciation should translate into a durable medium-term improvement in competitiveness, and exports grow faster than GDP in 1998. With faster export growth, and import growth limited by slow domestic demand expansion, the current account deficit remains modest in 1998-99. The Reserve Bank takes advantage of the opportunity to reduce South Africa's external vulnerability by building up foreign exchange reserves to more adequate levels, with reserves expressed in terms of months of imports rising steadily.

Table 2.2: SOUTH AFRICA: SELECTED ECONOMIC INDICATORS, 1995-2002

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<tr>
<td>Gross domestic investment</td>
<td>18.9%</td>
<td>17.4%</td>
<td>15.9%</td>
<td>16.2%</td>
<td>17.0%</td>
<td>17.3%</td>
<td>17.3%</td>
<td>18.4%</td>
</tr>
<tr>
<td>Current account balance</td>
<td>-2.1%</td>
<td>-1.6%</td>
<td>-1.5%</td>
<td>-1.4%</td>
<td>-1.3%</td>
<td>-1.3%</td>
<td>-1.7%</td>
<td>-2.1%</td>
</tr>
<tr>
<td>OTHER</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inflation</td>
<td>8.6%</td>
<td>7.4%</td>
<td>8.6%</td>
<td>6.9%</td>
<td>7.0%</td>
<td>6.7%</td>
<td>6.9%</td>
<td>5.8%</td>
</tr>
<tr>
<td>Gross reserves (months of imports)</td>
<td>1.1</td>
<td>0.8</td>
<td>2.0</td>
<td>2.5</td>
<td>3.0</td>
<td>3.5</td>
<td>4.0</td>
<td>4.5</td>
</tr>
<tr>
<td>DOD/GDP</td>
<td>16.7%</td>
<td>18.7%</td>
<td>17.7%</td>
<td>22.0%</td>
<td>25.4%</td>
<td>26.8%</td>
<td>28.1%</td>
<td>29.6%</td>
</tr>
</tbody>
</table>

Source: IFS, South Africa Reserve Bank, Staff estimates.

C. SHORT TERM PROSPECTS FOR NAMIBIA

2.14 In light of developments thus far as reported above, it is expected that the Namibian economy will have grown by at most 1.5 percent in 1998. This growth is mainly due to strong performance in the first quarter of 1998; developments in the second and third quarter suggest that the economy is hardly growing at all at this point in time. Because most of the cut backs in diamond and copper have taken place in 1998, the outlook for 1999 GDP is slightly more positive. Nevertheless, most of the growth will have to come from increases in tourism and fisheries. Tourism is expected to post solid increases as the recent devaluation of the Namibian dollar will make trips to Namibia more competitive. In addition, the Namibian tourism industry is increasingly capable of attracting Western European tourists who in general spend more in Namibia than the tourists from neighboring countries, and will be more eager to travel to Namibia if the recent European growth rebound holds up.

2.15 Medium term growth prospects depends on a recovery in the South African economy and on an improvement in the investment climate in Namibia. Namibia has a positive national savings-investment balance which means that private savings can

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19 The projections are made with help of the NAMAC macroeconomic model, jointly developed by the National Planning Commission, the Bank of Namibia, The Central Statistical Bureau, and the Ministry of Finance. The projections include developments of policy variables in line with the Government's current plans.
currently not find enough profitable domestic investment opportunities. The projections assume that Government starts implementing the WASCOM committee recommendations as accepted by Cabinet. Government consumption and government spending are therefore expected to fall, which in turn will allow for higher private investment and a 3.6 percent growth rate in the year 2000.

2.16 The introduction of the VAT in financial year 1999-2000 will improve the government's tax collection. Increased sales tax revenues are expected to be used for a reduction in other taxes, notably corporate income tax, but only after the deficit has been brought back to sustainable levels. The government deficit is expected to remain within the targeted 3.7 percent under the assumption that the WASCOM recommendations are implemented. The government will have to take further steps to control its expenditures in the next millennium as its debt to GDP ratio is still on the rise, even with the projected decline of the deficit to 3.1 percent in FY 2000/01.

2.17 The current account balance is expected to show a solid improvement in 1998 as the 30 percent average depreciation of the South African Rand and hence, the Namibian Dollar will not have made itself felt completely in higher import prices from South Africa. At the same time, while commodity prices are down, diamond prices are holding up because of the CSO's cutback in supply. This will give Namibia a large terms of trade gain in 1998, which allows domestic savings to increase strongly. Namibia is a low-indebted country and its external indebtedness will show an improvement in 1998 because the private sector will have made a 30 million US$ bullet repayment on one of its loans. The foreign debt to GDP is projected to stay around 5 percent of GDP for the near future.
## Table 2.3: Namibia: Key Economic Indicators 1992-2000

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP per capita</td>
<td>3.1%</td>
<td>-5.0%</td>
<td>3.5%</td>
<td>0.3%</td>
<td>-0.3%</td>
<td>-1.3%</td>
<td>-1.6%</td>
<td>-0.5%</td>
<td>0.2%</td>
</tr>
<tr>
<td>Population</td>
<td>3.0%</td>
<td>3.2%</td>
<td>3.1%</td>
<td>3.1%</td>
<td>3.2%</td>
<td>3.1%</td>
<td>3.1%</td>
<td>3.1%</td>
<td>3.1%</td>
</tr>
<tr>
<td>GDP (at market prices)</td>
<td>6.3%</td>
<td>-2.0%</td>
<td>6.7%</td>
<td>3.4%</td>
<td>2.9%</td>
<td>1.8%</td>
<td>1.5%</td>
<td>2.6%</td>
<td>3.5%</td>
</tr>
<tr>
<td>Consumption per capita</td>
<td>-4.6%</td>
<td>-1.3%</td>
<td>0.0%</td>
<td>-1.2%</td>
<td>-1.4%</td>
<td>-7.8%</td>
<td>-0.2%</td>
<td>-1.1%</td>
<td>-1.0%</td>
</tr>
<tr>
<td>Exports of goods and services</td>
<td>5.8%</td>
<td>9.4%</td>
<td>-9.0%</td>
<td>6.8%</td>
<td>6.7%</td>
<td>2.6%</td>
<td>2.0%</td>
<td>2.4%</td>
<td>4.1%</td>
</tr>
<tr>
<td>Import of goods and services</td>
<td>4.4%</td>
<td>-0.8%</td>
<td>6.2%</td>
<td>-1.1%</td>
<td>8.7%</td>
<td>-8.7%</td>
<td>4.3%</td>
<td>2.8%</td>
<td>3.8%</td>
</tr>
<tr>
<td>Terms of Trade</td>
<td>-2.9%</td>
<td>-6.4%</td>
<td>18.0%</td>
<td>-11.9%</td>
<td>0.4%</td>
<td>-6.0%</td>
<td>12.4%</td>
<td>-5.1%</td>
<td>0.2%</td>
</tr>
<tr>
<td>Gross Domestic Investment</td>
<td>40.4%</td>
<td>-47.5%</td>
<td>130.4%</td>
<td>-11.7%</td>
<td>10.4%</td>
<td>-7.1%</td>
<td>2.3%</td>
<td>6.3%</td>
<td>5.8%</td>
</tr>
</tbody>
</table>

## National Accounts (% of GDP)

| Gross domestic investment | 21.2% | 16.1% | 23.1% | 20.7% | 22.5% | 19.8% | 19.3% | 19.9% | 20.4% |
| Public investment         | 6.4% | 6.4% | 6.0% | 5.9% | 5.4% | 5.0% | 4.7% | 4.9% | 5.4% |
| Gross national savings    | 24.1% | 20.9% | 27.5% | 25.3% | 25.6% | 25.7% | 29.7% | 25.2% | 25.5% |
| Private savings           | 23.0% | 18.8% | 24.8% | 23.3% | 26.4% | 24.5% | 29.0% | 24.7% | 23.6% |
| Gross domestic savings    | 12.1% | 9.6% | 16.9% | 12.8% | 13.5% | 14.2% | 19.1% | 16.0% | 16.8% |

## Balance of Payments (% of GDP)

| Exports of goods and services | 51.6% | 55.7% | 52.4% | 51.6% | 53.6% | 52.6% | 63.1% | 63.7% | 64.1% |
| Imports of goods and services | 60.7% | 62.3% | 58.6% | 59.5% | 62.6% | 58.2% | 63.3% | 67.6% | 67.7% |
| Current account before capital grants | 3.0% | 4.8% | 4.3% | 4.6% | 3.1% | 5.9% | 10.5% | 5.4% | 5.1% |
| Gross Reserves (mill. US$)    | 46.3 | 133.7 | 202.8 | 221.6 | 193.7 | 250.4 | 244.9 | 273.5 | 314.4 |
| Real effective exchange rate index | 99.0 | 99.2 | 99.4 | 100.0 | 92.4 | 95.4 | 99.0 | 99.0 | 99.0 |

## Government Finance (% of GDP)

| Total revenue and Grants | 34.2% | 33.0% | 32.5% | 32.6% | 33.2% | 36.5% | 34.8% | 34.1% | 33.6% |
| Tax revenue             | 8.7% | 8.3% | 8.0% | 9.2% | 9.6% | 10.1% | 9.3% | 8.8% | 8.9% |
| of which SACU revenues  | 4.7% | 4.9% | 4.2% | 3.3% | 3.5% | 3.1% | 3.6% | 3.6% | 3.6% |
| Non-tax revenues        | 0.9% | 0.6% | 0.3% | 0.4% | 0.4% | 0.3% | 0.2% | 0.2% | 0.2% |
| Grants (current and capital) | 3.0% | 4.8% | 4.3% | 4.6% | 3.1% | 5.9% | 10.5% | 5.4% | 5.1% |
| Gross Reserves as months of imports | 0.9 | 1.3 | 1.2 | 1.0 | 1.4 | 1.4 | 1.4 | 1.5 | 1.5 |

## Monetary Indicators (% of GDP)

| M2 | 28.4% | 33.5% | 34.5% | 38.6% | 44.1% | 43.0% | 41.6% | 41.7% | 41.7% |
| Domestic Credit (net) | 30.9% | 37.4% | 39.2% | 39.8% | 43.7% | 45.1% | 45.5% | 44.5% | 43.2% |

## Exposure Indicators

| External Debt (mill. US$) | 179.6 | 140.4 | 137.5 | 129.9 | 158.0 | 162.0 | 135.8 | 150.8 | 165.0 |
| External Debt/GDP | 7.2 | 5.5 | 4.5% | 3.9% | 4.8% | 4.8% | 4.8% | 5.1% | 5.3% |

Source: MOF, NPC, BoN, and staff estimates.
3. THE RELEVANCE OF A MEDIUM TERM EXPENDITURE FRAMEWORK FOR NAMIBIA

A. A MEDIUM TERM EXPENDITURE FRAMEWORK

3.1 The core of an MTEF is a decision making process to gauge what is affordable in aggregate over the medium term, and to reconcile this with spending policies and their costs over the same period. An MTEF consists of (i) a top-down estimate of aggregate resources available for public expenditure consistent with macro-economic stability (ii) bottom-up estimates of the cost of carrying out policies, both existing and new, and (iii) a framework which reconciles these costs with aggregate resources. It is called "medium term" because it provides data on a prospective basis, for the budget year and for following years (typically the next two years). The MTEF is a rolling process repeated every year.

3.2 Why is it needed? Government budgets are prepared according to an annual cycle, but in order to be formulated well, they must take account of events outside the annual cycle, in particular the macroeconomic realities, the expected revenues, and the longer term spending needs of existing and new programs and government’s spending policies. Thus, annual budgeting cannot be done properly in isolation but has to be linked to medium-term planning, or in other words, embedded in a medium-term framework. Examples of multi-annual considerations are:

- the future operating costs of capital expenditures.
- funding needs of entitlement programs where expenditure levels may change, even though policy remains the same.
- contingencies which may result in future spending requirements (for example enterprise loans guaranteed by government, where the government may have to fulfill the guarantee, if the enterprise defaults).

3.3 In addition, a medium term outlook is necessary because the time span of the annual budget is usually too short to fully adjust spending priorities. At the time the annual budget is formulated, most of the budget’s expenditures are already committed. For example, civil service salaries, retirement pensions, and debt service are mostly fixed. Other spending can be adjusted, but often only marginally. This means that any substantial adjustment of spending priorities will take place over a time span of several years. For instance, a government may wish to switch from blanket provision of welfare services to targeted provision designed for those most in need. The spending
implications of such a policy change stretch over several years, and only a medium term expenditure plan captures the full budgetary effects of the policy change.

3.4 The MTEF approach stresses that expenditure management is about appropriate policies in the medium term, rather than about cash management in the short term. Where the available cash is most potent influence on spending -- and it is in many African countries -- management in the normal meaning of the term becomes impossible, and program implementation becomes disrupted because of a shortfall in cash during the year. A key aim of an MTEF is to provide more predictable program funding and therefore better management, and better results from those programs.

3.5 Finally, the link between sectoral spending policies and budget allocations is often weak. Politicians make and announce policies, but the budget often fails to provide the resources necessary for the policies to be achieved. Or a government may announce increased expenditure on health and education, but may lack the monitoring and control tools to ensure that such expenditure in fact increases. An MTEF provides an estimate of the total resources available; a means of allocating this sum amongst competing sectoral policies; and a framework for ensuring that MTEF and budget allocations are consistent with spending policies over the medium term.

3.6 What are the aims of an MTEF? The objectives of an MTEF are:

- to improve macroeconomic balance by developing a consistent and realistic fiscal resource framework.
- to improve the allocation of resources to strategic priorities between and within sectors.
- to increase the predictability of both policy and funding so that ministries can plan ahead and programs can be sustained.
- to provide line agencies with a hard budget constraint and increased autonomy, increasing incentives for efficient and effective use of funds.

3.7 Implicit in the above are two further objectives:

- to improve the linkage between annual budgeting and medium term considerations such as investment plans, borrowing capacity, changing spending policies and priorities.
- to provide information relevant to political decision-makers on the cost implications of expenditure policies.

3.8 These are important objectives for a budget system. The ease of attaining them depends to a large extent on facilitating and constraining factors which vary from country to country.
Table 3.1: Components of an MTEF

<table>
<thead>
<tr>
<th>Core Processes</th>
<th>Supporting Processes</th>
<th>Purpose</th>
<th>Situation and Main Issues in Namibia</th>
</tr>
</thead>
<tbody>
<tr>
<td>Define the aggregate resources</td>
<td>Macroeconomic analysis, revenue</td>
<td>to provide a realistic estimate of the total</td>
<td>Macroeconomic forecasts in the NDP are shown to be unrealistic. The Policy Framework Paper (PFP) that triggers the annual budget formulation projects the macro-economic aggregates for three years, but fiscal targets are not set for the same time horizon.</td>
</tr>
<tr>
<td></td>
<td>forecasting and definition of</td>
<td>resources available in the medium term to allocate to spending programs.</td>
<td>-------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td></td>
<td>sustainable fiscal policy.</td>
<td></td>
<td>-------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Formulate and cost sectoral spending plans</td>
<td>Spending ministries formulate sectoral expenditure programs.</td>
<td>to show sectoral objectives, programs and activities and their costs.</td>
<td>The NDP shows objectives, programs and costs of sector policies. However, since spending ministries perceive planning and budgeting as procedural requirements instead of essential management processes, the reflection of the plan on actual implementation is quite weak.</td>
</tr>
<tr>
<td>Reconcile available resources with sectoral spending plans</td>
<td>Politicians and other decision makers reconcile top-down constraints with bottom-up spending demands.</td>
<td>to reach agreement on medium term expenditure programs.</td>
<td>Although the guidelines in the NDP seem to indicate an agreement on medium term expenditure programs, annual budgets fail to reflect this agreement. A rolling process may be needed for linking planning with budgeting.</td>
</tr>
<tr>
<td>Set medium term sectoral allocations</td>
<td>on the basis of relevant data,</td>
<td>to communicate to ministries a sectoral expenditure policy constrained by aggregate resources.</td>
<td>Although medium term sectoral allocations are communicated by the NDP, these guidelines do not serve as hard budget constraints. Cabinet’s involvement in planning and budget formulation is weak.</td>
</tr>
<tr>
<td></td>
<td>decision makers allocate the aggregate resources to sectors.</td>
<td></td>
<td>-------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Announce sectoral expenditure limits for year one of the MTEF</td>
<td>Formulation of annual budget</td>
<td>to ensure that the budgets prepared by ministries reflect agreed sectoral expenditure programs.</td>
<td>Annual budgets fail to reflect agreed sectoral expenditure limits of the plan. Furthermore, annual guidelines are not binding either. Hence there is no hard budget constraint. This situation is tolerated by the politicians.</td>
</tr>
<tr>
<td>Ensure that budget execution is in line with budget intentions</td>
<td>Accounting, reporting and expenditure controls are used during the execution of the annual budget.</td>
<td>to prevent excessive deviation from the annual budget and MTEF.</td>
<td>Overspending, additional budgets and virements are chronic and financial controls are weak. Overspending in recurrent expenditure is compensated with virements from development budget which destroys the credibility of the development budget as well.</td>
</tr>
<tr>
<td>Ensure that desired results are achieved</td>
<td>Incentives for civil servants to perform. Ex-post audit and evaluation;</td>
<td>To align civil servant’s and politician’s incentives with public goals.</td>
<td>Focus on performance is weak. Weak managerial accountability and evaluation capacity. Civil service reforms are not in place in spite of cabinet resolutions. Lack of a common vision among central agencies.</td>
</tr>
</tbody>
</table>
3.9 What does an MTEF consist of? An MTEF consists of a series of linked processes for:

- defining the aggregate resources available for public spending over the period of the MTEF.
- setting sectoral allocations within the limits of aggregate available resources, and communicating them to spending ministries.
- formulating and costing sectoral spending plans for the MTEF period.
- reconciling sectoral allocations with sectoral spending plans and setting expenditure priorities.
- setting sectoral ceilings early in the annual budget formulation process to provide a link between year one of the MTEF and the annual budget.
- ensuring that budget execution does not allow budget intentions to be distorted.

3.10 What does an MTEF require to work well? For an MTEF to work well its core processes have to work well and so do the external supporting systems identified in the previous section. This is partly a question of data gathering, analysis and reporting, and partly of people who can both supply and use the information, and institutional mechanisms for coordinating the efforts of participants. Coordination implies that the MTEF or the relevant supporting processes (or both) have to be adapted to the needs of the major participants: their decision making processes, annual cycles of work (in particular the requirements of the budget calendar), reporting responsibilities, and capacities. To be effective, it requires a strong interface with the political decision-making process.

3.11 Politicians often prefer informal means of securing funding for their pet projects. They may therefore see an MTEF as a threat, or at least as an inconvenience. To persuade them to channel their demands through an MTEF is therefore a major challenge. But the benefits outweigh the costs: if implemented well, an MTEF would give line ministries much more autonomy in managing resources within the sectoral budget constraint, and reestablish the line minister's authority over sectoral plans. The core ministries (the NPC and MOF) would be relieved of the task of detailed budgeting and close supervision of budget execution, and could focus on developing the macroeconomic and fiscal framework, and enforcement of sectoral spending ceilings rather than detailed expenditure control.

3.12 We now consider seven major requirements for MTEFs:

(1) Good macroeconomic framework: Good macroeconomic analysis and forecasts are needed, (of gross domestic product, public revenues and expenditures, prices etc.) as a basis for an MTEF. Even more important, the country must have sound macroeconomic management. Political and economic stability may make it easier to achieve this. Several OECD countries have adopted medium term expenditure planning. These countries find it more difficult to operate medium term expenditure planning systems, if their economic conditions were less stable.
(2) **Adaptable fiscal policy and instruments**: The MTEF approach is based on a strong link between macroeconomic policy and fiscal policy. The idea is an old one: that plans for future expenditure must be based on reasonable estimates of prospective resources. The new slant is that expenditure policy should also be sustainable, given the full implications of current policy decisions on future borrowing. Consequently, to operate an effective MTEF, a country needs a fiscal policy capable of funding aggregate public expenditure over the period of the MTEF without undesirable macroeconomic effects, and the ability to change fiscal policies, if sustainability requires it.

(3) **Budgetary discipline**: Behind the move to MTEFs is a conviction that the annual budget by itself is a poor mechanism for shifting resources from lower to higher priority uses. An annual budget tends to spread resources across the board via a series of incremental adjustments, rather than to shift resources in relation to major policy changes. Thus one year's budget is much like the last in terms of the proportionate shares of different programs. A major function of an MTEF is therefore to provide a better mechanism for aligning budgets with policies. But in many countries there are major differences between what is budgeted and what is in fact spent. If such "unintended" deviations are large during the budget year, the usefulness (and the effectiveness) of an MTEF is seriously in doubt. Thus, a functioning MTEF requires budget discipline.

(4) **Adequate information base**: An MTEF requires a solid information base: a satisfactory definition of public expenditure; complete and reliable information on expenditures over a period of time in a form that makes analytical sense; and a reliable means of forecasting revenues. This implies the need for a classification scheme permitting expenditure to be analyzed by sector and program and for accurate and timely accounting.

(5) **Institutional conformity and absence of bias**: An MTEF requires a supportive institutional base; that is to say one in which the various actors use the MTEF process rather than other means to take expenditure decisions. In particular, political decision makers must accept the MTEF as the means by which resources are allocated. It is also implied that participants do not wish to subvert the budget process via significant game playing. Exploiting budgetary rules in order to capture more resources is a well-documented strategy: spending year end surpluses to prevent their lapse; the camel’s nose whereby a small initial expenditure disguises an eventual large one; designating as low priorities the politically most favored programs, in the sure knowledge that they will not be cut, are examples. The dangers of game playing may be avoided by rewarding "good" budget behavior.

(6) **Appropriate parameters**: In order to design an MTEF, its parameters have to be set: the definition of aggregate expenditure to be used, the relationship between the sectoral breakdown and the organizational structure of government, the content of expenditure envelopes, the appropriate price basis for estimating future expenditures, the time period to be covered by the MTEF, the mechanism for its coordination with the annual budget process, its relationship with the development plan, investment budget and public investment program (if these exist); and the degree to which it is to be flexed for different scenarios.
(7) Transparency: Two types of transparency mechanisms, Fiscal Transparency and Policy Transparency, improve the accountability of actors engaged in the MTEF process. Fiscal transparency means being open to the public about the structure and functions of government, fiscal policy intentions, public sector accounts and fiscal projections. Policy transparency means being open to the public of what government intentions are in a particular policy area, which outcomes are to be achieved and the costs of achieving these outcomes. Transparency mechanisms, or public reporting requirements, strengthens accountability and increases the political risk associated with maintaining unsustainable policies. It can therefore enhance credibility, the benefits of which will be reflected in lower borrowing costs and stronger support by a well informed public.

3.13 The following box shows the proposed public reporting framework for Namibia around the budget cycle. Each report is the output of a process that leads to that report. Each process has an owner in order to specify clear accountabilities. In a way, the box represents a summary of the recommended processes that are detailed in following sections.

<table>
<thead>
<tr>
<th>Report</th>
<th>Responsible Entity</th>
<th>Time</th>
</tr>
</thead>
<tbody>
<tr>
<td>National Plan</td>
<td>Cabinet / NPC</td>
<td>-12</td>
</tr>
<tr>
<td>Economic and Fiscal Outlook</td>
<td>MOF / NPC / BoN</td>
<td>-6</td>
</tr>
<tr>
<td>Fiscal Strategy Report</td>
<td>Cabinet</td>
<td>-9</td>
</tr>
<tr>
<td>Economic and Fiscal Update</td>
<td>MOF / NPC / BoN</td>
<td>-6</td>
</tr>
<tr>
<td>Budget Policy Statement</td>
<td>Cabinet</td>
<td>-6</td>
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<tr>
<td>Corporate Plans</td>
<td>Sector Ministry</td>
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<tr>
<td>Estimates / Appropriation Proposal</td>
<td>Cabinet</td>
<td>-1</td>
</tr>
<tr>
<td>Budget Speech / Act</td>
<td>MOF</td>
<td>0</td>
</tr>
<tr>
<td>Economic and Fiscal Outlook</td>
<td>MOF / NPC / BoN</td>
<td>0</td>
</tr>
<tr>
<td>Economic and Fiscal Update</td>
<td>MOF / NPC / BoN</td>
<td>6</td>
</tr>
<tr>
<td>Midterm Review and Supplementary Budget</td>
<td>Cabinet</td>
<td>7</td>
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<tr>
<td>Whole of Government Financial Statements</td>
<td>Cabinet</td>
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<tr>
<td>Annual Reports</td>
<td>Sector Ministry</td>
<td>15</td>
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<tr>
<td>Auditor General’s Report</td>
<td>Auditor General</td>
<td>18</td>
</tr>
<tr>
<td>Midterm Review of NDP</td>
<td>Cabinet / NPC</td>
<td></td>
</tr>
</tbody>
</table>
Namibia’s Budget System and Reforms Toward an MTEF

Budget Preparation

3.14 Namibia’s current regulations on planning and budgeting provide an enabling environment for sound public expenditure management. Most of the rules of the game for an MTEF are already in place. The description of the planning process in the NDP, shows that all the basic rules and systems are already in place. This includes the methodology of the plan for specifying sector objectives, strategies and programs, the Cabinet resolution on progress reporting and monitoring, starting the budget process with a Policy Framework Paper, the sector ceilings that are issued early in the budget process, the requirements for medium term expenditure estimates in the budget manual, a new draft of the finance act, treasury instructions and financial management information systems.

3.15 On the other hand, there is a strong tendency for avoiding these rules. The weakness in the implementation of cabinet resolutions, budget guidelines and treasury instructions and chronic overspending are all obvious signs of this tendency. As long as existing rules and regulations are not enforced and what is on the paper is different than what actually gets done, further improvements in the rules and regulations will not improve the performance of the system. The same is true for the budget formulation; as long as budgets are remade during implementation, further changes and improvements in planning and budgeting formulation process will only increase the bureaucratic burden.

3.16 Setting the Policy Framework. Current budget preparation process starts with the preparation of the Policy Framework Paper (PFP) by the MOF, NPC and BoN. The PFP lays out the global economic trends and the outlook for the Namibian economy as well as the economic and budget policy objectives. The PFP indicates the expected growth rate and the inflation rate for the Namibian economy for the following three years but it fails short of explaining how they will impact the fiscal outlook within the same time horizon. Although PFP is sent to Cabinet for approval it remains to be primarily a report of the bureaucracy. The PFP is not published and it is an internal document for the government.

Recommendation 1: Identify Medium Term Resource Availability

3.17 To separate bureaucratic processes from political decision-making process and to identify bureaucratic and political accountabilities clearly, the PFP needs to be divided into three separate reports. The bureaucracy sets the stage with the economic and fiscal outlook report. The politicians make the tough choices and the tradeoffs with the following two reports: fiscal strategy report and budget policy paper. Publishing these reports will improve the transparency of the “Policy Framework” process and enable independent scrutiny of the underlying assumptions and forecasts.

3.18 The first part of the economic and fiscal outlook report, the economic outlook, explains the economic trends in the world and in the Namibian economy and lays out the
Namibia: review of recent economic performance

Macro economic projections for three year forward. The second part of the report, the fiscal outlook, explains how the economic outlook would impact the fiscal aggregates - expenditures, revenues, deficit and financial position (liabilities and financial assets) - within the same time horizon and with unchanged policy. This report has also an updating function, it includes the fiscal consequences of the decisions made by the Cabinet within the last six months and the outturn in expenditures, revenues, deficit and financial position. It incorporates also the analysis of expenditure trends in terms of economic classification: personnel, interest, transfers, other current and capital expenditures. This exercise should be repeated every six months and feed both the budget preparation and the mid-year fiscal review.

3.19 The MOF, NPC and BoN continue preparing this report and submit it to the Cabinet. A modeling exercise has already been conducted with the participation of officials from these organizations and the World Bank experts. The responsible agencies can provide alternative scenarios and option to politicians by using this model. The scenarios will help them to understand the repercussions of their decisions on the economy.

3.20 Setting the economic and fiscal targets and determining the policy priorities is the job of the Cabinet. The third report, the fiscal strategy, is prepared by the Cabinet and sets out government’s fiscal targets for three year forward. The fourth report, the budget policy paper, should indicate what the government’s inter-sectoral priorities are and establishes the base for the guidelines. The logic behind committing the cabinet to a fiscal strategy prior to establishing inter-sectoral priorities is putting the availability before needs, i.e. identifying the constraint before the decision-making on spending.

3.21 If the Cabinet and MOF have difficulty in enforcing the budget ceilings, then an alternative method would be to get the Parliament vote on budget ceilings. This arrangement will divide the parliamentary discussion into two parts: first, the Parliament will review the Economic and Fiscal Outlook and the Budget Policy paper and vote for the total expenditure, revenue and deficit as well as sector ceilings for the Ministries. This discussion takes place six months before the fiscal year and can be streamlined with the discussion on supplementary budget of the current year. The second part of the discussion will concentrate on the allocation of funds to programs within the sector and takes place a month before the fiscal year.

Recommendation 2: Publish a Statement of Fiscal Risks

3.22 This statement is presented within the budget policy paper, providing information on all material fiscal risks surrounding the estimates of revenue and expenditure contained in the central government budget. Risks can be either positive or negative, i.e., there may be an increase or a decrease in revenue, in comparison with the projections. Where possible, risks should be quantified. The statement contains information on risks broken down into following categories:

- variations in key forecasting assumptions.
- uncertainty about the size of specific expenditure commitments.
- contingent liabilities.
other items that have not been included in the budget policy statement because of the extent of uncertainty about their timing, magnitude or eventuality.

**Recommendation 3: Involve the Prime Minister early in the Budget Process**

3.23 The Cabinet Subcommittee that deals with fiscal issues is currently chaired by the Minister of Finance. Since this subcommittee is responsible of preparing the proposals of policy priorities and inter-sectoral tradeoffs for the full cabinet, it would be more effective if it is chaired by the Prime Minister and the Minister of Finance resumes the deputy chairman role. This arrangement is expected to increase the Cabinet’s ownership of the budget and to discipline its decision-making.

3.24 **Allocating Resources to Government’s Strategic Priorities.** The NDP lays out government’s medium term priorities and the PFP lays out government’s annual priorities. A quick review of the NDP and annual budgets show that public resources are indeed allocated to sectors that are listed as government’s priority. The inter-sectoral distribution of total resources in 1998-1999 budget in percentage terms is quite similar to the guidelines shown in the plan. On the other hand the mid term review of the plan reveals that most of the targets set out in the plan are not attained. This outcome indicates a weakness in the translation of the resources used to the results achieved. A careful review of the planning and budgeting processes shows a number of reasons for this outcome:

(i) The budget formulation process is not used to review the performance of ministries and to address identified problems to enhance efficiency of resource allocation. Instead it became an instrument for allocating the increments across the board. Furthermore additional budgets, virements and overspending during budget implementation undermines the credibility of the budget formulation process.

(ii) The overall resource availability is not properly defined in the medium term. Guidelines act as baseline figures instead of ceilings.

(iii) The targets set out in the plan are generally related to development programs. On the other hand implementation of stated policies require an effective combination of activities financed by operational expenditure as well as development expenditure. Activities financed by operational expenditures do not have clear service delivery targets.

(iv) The link between what government spends and what it gets in return is missing. In other words, inputs are not linked to outputs.

(v) Since outputs are not identified, the link between outputs and outcomes can not be identified either. Hence, effectiveness
indicators and intermediate outcomes are missing. This indicates an ambiguity on how the outcomes will be achieved.

(vi) The vote/appropriation structure is solely organization based. Main divisions of votes are also organization-based. This does not reflect a service/program structure.

(vii) Although the legal framework grants large amounts of flexibility to ministries (accounting officers) to move expenditures within votes and even between votes, accountability on the use of these resources is weak.

(viii) There are no standards for allocating the resources within sectors/votes.

(ix) Actual expenditures show that development expenditures were sacrificed for operational expenditure during budget formulation process as well as during budget implementation via virements.

(x) The development costs were underestimated.

Recommendation 4: Introduce Corporate Planning at the Ministries

3.25 The mid-term review of the NDP explains clearly that the sector ministries perceive the planning process as a government-wide procedural requirement instead of a management tool. Their ownership of the plan is low. It might be beneficial to separate planning into two complementary processes. The first process lays out the government wide policies which runs across sectors, as in the Part 1 and 2 of the current plan and it is repeated every five years. The five-year cycle of the government wide plan should be consistent with the election cycle in order to allow the incoming government to state its policies and to reflect the government program to the plan.

3.26 The second process, the preparation of sector plans as in the part 3 of the current plan, is owned by sector ministries. At the beginning of every year sector ministries prepare and publish a corporate plan along with their budget request, explaining their objectives, outcome targets and strategies and laying out performance measures for each program area. Corporate plans include three year cost estimates of current policies. At the end of the year they prepare and publish an annual report along with their final accounts and financial statements, explaining the achievements towards targets and the reasons of deviation. This arrangement is expected to increase the ownership of sector ministries and to enhance performance accountability. It would also integrate progress reporting and evaluation into the budget cycle. The summary of the activities that go into corporate planning process is shown in Box 3. 1. The midterm review of the government wide plan continues to serve as an evaluation process.
Recommendation 5: Re-Introduce Three year Cost Estimates of Current Policies

3.27 Both the budget guidelines and treasury instructions require medium term estimates of existing programs. The medium term estimates are already in place for the development expenditures. The system needs to be extended to cover all spending, current and development, direct and indirect (quasi-fiscal operations, tax expenditures, treasury guarantees). The estimates should base on existing policies to allow recognition of their cost. As long as policies stay the same, their costs in real terms are expected to stay the same as well. Forward estimates should be owned by the MOF and first out year of expenditure estimate should become the basis for budget negotiations for the following year. The MOF reflects the changes in parameter values (inflation, exchange rate, salary increases etc.) on forward estimates. This arrangement is expected to focus the budget negotiations on the discussion of policy changes instead of financing of current policies and allow a better integration between policy-making and budgeting processes.

Recommendation 6: Report Tax Expenditures and include them in the Cost Estimates of Policies

3.28 Tax expenditures include exemptions from the tax base, allowances deducted from gross income, tax credits deducted from tax liability, tax rate deductions and tax deferrals. They are often identical in their effects to explicit expenditure programs. For instance, the Government’s EPZ strategy is largely based on an array of tax exemptions and reductions. The mid-term review of the NDP mentions about reviewing tax breaks, tax exemptions and tax incentives and replacing them cash subsidies where possible. Since there are generally a part of sector policies, they should be classified as expenditures and be included in the cost of policies.

Recommendation 7: Report Quasi-Fiscal Activities conducted by Parastatals and include them in Cost Estimates

3.29 Parastatals carry out QFA in the form of providing non-commercial services, usually through charging less than cost-recovery prices for specific services. These non-commercial activities may be financed by cross subsidization between different groups of consumers and/or by incurring losses that are financed from the budget or by borrowing. This confuses the fiscal and commercial responsibilities of government and makes it difficult to ensure that managers are fully accountable for their performance. In principle, where such activities are desirable, they are best financed by explicit budget transfers, for example, through a clear contract for the non-commercial output by the parastatal. Since there are generally a part of sector policies, they should be classified as expenditures and be included in the cost of policies.

Recommendation 8: Increase Cabinet’s involvement in the budget formulation process

3.30 The cabinet should allocate adequate time to review the corporate plans and annual reports of sector ministries early in the budget process. The review of annual reports should take place prior to budget policy statement where the cabinet announces its policy priorities. The budget policy statement feeds the corporate plans which are
reviewed by the cabinet prior to the submission of estimates to the Parliament. The NPC and the MOF could assist the cabinet in its reviews. The summary of the activities that go into cabinet review process is shown in Box 3.2.

**Recommendation 9: Change Government's Expectations from the Budget Process**

Government's commitment to use the budget formulation process to select the outputs it wants to fund to achieve planned outcomes" will open the way to tie the resources to outputs and outputs to outcomes. Without such a commitment improving performance will be improbable. If resource allocation is not tied to outputs, sector ministries will have no incentives to identify what they produce and to become efficient.

<table>
<thead>
<tr>
<th>Box 3.2: Preparation of Budget Policy Statement By Cabinet</th>
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<tbody>
<tr>
<td><strong>Submit annual reports</strong></td>
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<tr>
<td><strong>Review government wide strategic plan</strong></td>
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<td><strong>Review annual reports</strong></td>
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<td>Review actual outcomes (effectiveness indicators-intermediate outcomes)</td>
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<td>Review planned outcomes</td>
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<td>Review explanations for deviation</td>
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<tr>
<td>Review corrective measures and business strategies</td>
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<td>Review costs and cost estimates</td>
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<td>Review evaluation reports</td>
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<tr>
<td><strong>Review fiscal strategy report</strong></td>
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<tr>
<td><strong>Assign sector outcome targets</strong></td>
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<td><strong>Assign sectoral expense targets</strong></td>
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<tr>
<td>direct expenses</td>
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<td>cash</td>
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<tr>
<td>capital charges</td>
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<td>indirect expenses</td>
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<td>quasi-fiscal expenditures</td>
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<td>treasury guarantees</td>
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<tr>
<td>tax expenditures</td>
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<tr>
<td><strong>Review fiscal risks</strong></td>
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<tr>
<td><strong>Prepare and publish budget policy statement</strong></td>
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<tr>
<td><strong>Prepare guidelines for submitting portfolio budget statements</strong></td>
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<tr>
<td><strong>Prepare sector plans</strong></td>
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<td><strong>Review sector plans and portfolio budget statements</strong></td>
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<td><strong>Sector Ministry</strong></td>
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<td><strong>MOF / Treasury</strong></td>
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<td><strong>Sector Ministry</strong></td>
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<td><strong>Cabinet</strong></td>
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3.3.1 Within this framework, corporate planning will continue to serve as the process of relating government’s policies with sector objectives, outcome targets and sector strategies whereas the strategies will be expanded to identify the outputs needed to achieve outcome targets and to include service delivery strategies.
Box 3.3: Planning for Outcomes and Outputs by Sector Ministries

**define portfolio mission and vision**

**specify outcomes**
- review government’s policy objectives and priorities
- relate community needs with outcomes
- specify outcome in terms of an impact on the community
- identify how the portfolio contributes to public welfare
- identify target groups
- set a timeframe for achieving the outcome
- set the indicators to be monitored
  - set the long-term attributes of the outcome
  - identify immediate and direct consequences of outputs on the outcome

**set outcome hierarchies**
- link outcomes, intermediate outcomes and outputs
- define effectiveness indicators
- specify outputs
- separate the impact of direct outputs, administered items and third party outputs on outcomes

**identify outputs in relation with delivery organizations**
- departmental agencies
  - departmental outputs
  - contracted out services
- administered items (subsidies, benefits and grants)
- third party outputs

**define output attributes**
- quantity, quality, and cost

**set measures and indicators for output attributes**
- quantity and quality
- cost
  - specify all outputs produced by the agency
  - identify all costs incurred for the financial period in which the output is being costed
  - identify all direct costs
  - decide on the cost allocation methods to be applied
  - identify all indirect costs
  - decide on the cost drivers to be applied
  - apportion the indirect costs
  - add the direct and indirect costs to arrive the full cost of producing the output

**group outputs**
- for appropriation, for portfolio management and for agency management

**allocate costs to outcomes**
- assign agency output costs
- assign administered costs: transfers, quasi-fiscals, treasury guarantees, tax expenditures
- assign cost of third party outputs

**prepare and submit corporate plan**

**planning for performance monitoring, assessment and evaluation**
- set mechanisms to review the relation between community needs and actual outcomes: appropriateness
- set mechanisms to review the relation between planned and actual outcome: effectiveness
- set mechanisms to review the relation between inputs and outputs: efficiency
- set the formats of reporting performance information and their standards
Recommendation 10: Identify Outputs

3.32 Identification of what government produces, the outputs, in terms of quantity and quality and relating inputs to these outputs are essential for measuring efficiency and improving performance in the public sector. Since the outputs of policy making are difficult to specify, a pragmatic approach would be to separate policy implementation/service delivery functions from policy-making functions and to focus on specifying the outputs of service delivery functions. As the government specifies the outputs, the accounting system needs to be revised towards an accrual base. The accrual framework will enable the determination of full cost of outputs, i.e. the capital cost (depreciation of assets) and the pension liabilities of personnel as well the cash costs. The summary of the activities that go into identification of outputs and relating them to outcomes is shown in Box 3.3.

Recommendation 11: Outsourcing and Performance Contracts

3.33 Prior to considering the outsourcing options, a fundamental review needs to be conducted by each ministry to determine essential and nonessential work. In particular work that can not be related to a particular output should be considered as nonessential. Abolishing nonessential work will provide quick efficiency gains and release resources for essential work. As outputs are identified, sector ministries start choosing the organizational type of agency that would provide the output. Depending on the characteristics of the output, an agency could be a department within the public service, a local government (decentralization), a parastatal or a private company.

3.34 After identifying outputs and the type of organization best suited to deliver those outputs, ministry prepares a purchase agreement with the agency specifying the quality, quantity and cost of the service to be provided. This agreement is accompanied by a performance contract between the accounting officer of the ministry and the chief executive officer of the agency for achievement of a certain level of performance. These contracts are expected to improve service delivery and to increase managerial accountability. Experimentation with these type contracts can start immediately with the existing parastatals and their managers.

3.35 The efficiency gains expected from outsourcing and agency creation will depend on the contract management and regulation capacity of sector ministries. Without building this capacity, outsourcing may result to the balkanization of the public sector and increase risks. Excellent work has been done in this area by the Efficiency and Charter Unit of the Prime Minister’s Office. This work needs to be owned and supported by other central agencies like Public Service Commission, NPC, MOF and the Treasury.

Recommendation 12: Change the Appropriation / Vote Structure

3.36 Once outputs are identified, appropriations / votes can be based on outputs or on output classes. That requires the consent of the Parliament and Auditor General. In general, this step has low priority: many countries have moved to an output-based public expenditure management system without moving away from the classic line item budget.
Budget Implementation

3.37 **Cash Flow Planning.** Before the start of each month, MOF asks other ministries how much cash they need in the following month and issues Treasury warrants accordingly. MOF tried to receive quarterly cash need projections from ministries, but ministries failed to submit them. The current method is a reactive one and does not allow the MOF to manage cash effectively.

**Recommendation 13: Issue six-month cash flow projections**

3.38 At the beginning of the fiscal year, the MOF could issue a six-month cash release projections for each ministry and send it to ministries for consideration. The circular could state that no response by a ministry would mean that the ministry is comfortable with that plan and monthly warrants would be released accordingly. For the ministries that respond to cash release projections their warrants will be adjusted accordingly. Failure to respond could also be interpreted as an indicator of weakness in the ministry’s work-program and these ministries need to be monitored closely for overspending. After the mid-year expenditure review and additional appropriations, the exercise could be repeated for the remaining fiscal year. This will be a proactive procedure.

3.39 The MOF has enough information to implement this procedure. The statistics of previous years monthly revenues and expenditures are available, enabling determination of the seasonal patterns of cash inflow. Combined with the data on future debt service from the debt management unit and salary and employment data from the Prime Minister’s office, a simple cash release projection for six months can be established. The missing information would be about procurement of goods and services which would be captured from ministries’ responses. In the case of no response, previous year’s information can be used as a simple rule of thumb. Over time, when the commitment monitoring and reporting improves, the cash flow projections can be used to better plan timing and amount of treasury bills, thus saving interest costs for government.

3.40 **Commitment Monitoring and Control.** Treasury instructions chapter DG explains in detail how to keep the commitment registers. Paragraph 102 states that “the commitment register is kept to be able at any time to determine the funds available under each division of a vote and to be able to approach the Treasury in good time for the application of virement.” In spite of this regulation, overspending is frequent. This can be interpreted as either the commitment registers are not kept or as a weakness in the internal controls systems of sector ministries in separating the authorities between expenditure request, approval and payment.

**Recommendation 14: Integrate commitment controls with the Funds control system**

3.41 An additional provision can be issued to regulate the pre-commitment process where an appropriation reservation should be required prior to entering contracts. Once a contract is signed, it should be registered as a commitment with the expected date of that commitment becoming a liability, so that treasury warrants can be adjusted accordingly. Commitment registers need to be integrated with the funds control system, so that the
system can check whether appropriation is available before a commitment is made. Currently funds control system checks the availability of appropriation right before issuing the check. That is too late, failure to issue the check is considered as arrears. In the future as the procurement module of the Integrated Financial Management system is developed, this module could provide the necessary information to the Funds control system for effective commitment controls.

3.42 **Mid-term budget review and supplementary budget.** In July Treasury sends a letter to ministries asking whether they have any additional budget requests. The deadline for requesting additional budget from the Parliament is November. Between August and October Treasury reviews the actual financial results for the midyear, compares them to budget forecasts, reviews the fiscal consequences of the cabinet decisions since the budget, estimates the resource availability, prepares negotiates with ministries for additional expenditures and prepares the supplementary budget requests. The process is slightly different from the original budget formulation process, it does not begin with ceilings, so every ministry asks as much as they can.

3.43 This process has an inherent bias for escalating expenditures. First, additional budget is expected by the ministries, it is not conditional on rare circumstances. Second, it starts four months after the original budget, too early. Third, it begins with a letter asking the ministries for additional demands, which ministry would say no to more money? It undermines the credibility of the original budget formulation process significantly.

** Recommendation 15: Start the mid-term-review with identifying spending constraints**

3.44 As recommended above the Economic and Fiscal Outlook (EFO) report should be prepared twice a year; the first report triggers the formulation of the annual budget formulation, whereas the second report triggers the midyear review. In EFO, the macro economic forecasts are updated, the actual financial results for the midyear are compared with the fiscal targets and the fiscal consequences of recent cabinet decisions are calculated. Then the cabinet can decide whether the expenditures needed to be cut or increased. The idea is the same as proposed before, put the constraints in front of the decisions.

3.45 Consider the current year as an example: the budget is prepared with a 4.3% GNP growth assumption and the budget as it is voted results to a deficit of 3.8% of GNP. In midyear, revised growth estimates show a 1-1.5% growth in GNP instead of 4.3% which will result in lower revenues than expected causing a deficit around 5% if the expenditures were to stay the same. On the other hand, cabinet decisions since the budget already increased the expenditure bill that in return increases the deficit further. What do you do? Do you send a letter to ministries asking for additional expenditures or asking for savings from their spending?

3.46 **Financial Reporting.** Currently the financial reporting consists of the revenue and expenditure estimates submitted to the Parliament at the beginning of the financial year and appropriations accounts that are submitted to the office of Auditor General six months after the end of fiscal year. The Auditor General’s report to the Parliament
includes the final accounts of expenditures and revenue, the statement of Government's
debt, the statement of treasury guarantees, the statement of debt to the government,
investments and shares. These are comprehensive and detailed statements which are
rarely seen in developing countries. On the other hand these statements are not submitted
to the Parliament with Government's budget request. Although the budget begins with an
estimate of financial position at the end of fiscal year, this statement is more of a
statement of operating balance than financial position.

**Recommendation 16: Publish a Statement of Financial Position with the Budget that
shows government's debt and financial assets**

3.47 The budget document should include of the estimate of financial position (debt
and financial assets) at the end of the fiscal year. The Economic and Fiscal Outlook
reports should update the information on government's financial position every six
months. Publishing the composition of central government debt and financial asset
holdings will yield a measure of net debt. With these figures the government can better
assess its ability to finance its activities and honor its debt obligations. It is most
important to monitor the changes in the level and composition of public debt and
financial assets, since these are the basis for accepted approaches to assessing the
sustainability of fiscal policy.

3.48 Debt should be broken down by remaining maturity, and classified as short (less
than 12 months), medium and long term. Reporting of financial assets should cover all
such assets as cash and cash equivalents, other monetary assets such as gold and
investments and loans and advances. In addition investments might be broken down into
direct marketable securities, equity investments in private companies, portfolio
investments in private companies and investment in international institutions. Foreign
exchange reserves held by the Bank of Namibia should not be reported as part of central
government statement of financial assets.

**Recommendation 17: Publish a Statement of Contingent Liabilities with the Budget**

3.49 Contingent liabilities reflect existing commitments, the ultimate fiscal
consequences of which are dependent on future events that may or may not materialize.
Examples include loan guarantees, exchange rate guarantees, deposit insurance and
indemnities. Transparency requires that such contingent liabilities should be shown to
give a full picture of fiscal activities and policies. If no reporting is required for such
liabilities, there may be an incentive to substitute a guarantee for budget measures and the
relative merits of budgetary and other instruments are unlikely to be properly evaluated.
It is therefore recommended that a statement of the outstanding stock of contingent
liabilities is published with the annual budget and is updated in the Economic and Fiscal
Outlook reports. The statement should include a brief indication of the nature of each
contingent liability to enable at least some assessment of its potential fiscal significance.
It is also recommended to receive authorization from the Parliament with the
appropriation act for a certain limit on guarantees in order to put a ceiling on the blank
provision in the Finance Act.
Recommendation 18: Publish a Statement of Tax Expenditures with the Budget

3.50 Tax expenditures do not require formal annual approval by the Parliament and, once introduced, are typically not subject to the same degree of scrutiny as actual expenditures. These practices can lead to an undesirable proliferation of tax expenditures, lack of review of effects and continued appropriateness, serious deficiencies in the tax base and lack of transparency over their financial costs and distributional effects. Tax expenditures often favor well-organized interest groups. It is therefore recommended that a statement be published with the annual budget of all tax expenditures, together with a brief explanation of the nature of each program, to enable at least some assessment of their justification and fiscal significance.

Table 3.2: Summary of Recommendations

<table>
<thead>
<tr>
<th>Recommendation</th>
<th>Responsible Agency</th>
<th>Supporting Agency</th>
<th>Possible Date of Introduction</th>
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<tbody>
<tr>
<td><strong>Budget Formulation</strong></td>
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<tr>
<td>Identify Medium Term Resource Availability</td>
<td>Cabinet</td>
<td>Treasury, NPC, BoN</td>
<td>1999</td>
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<tr>
<td>Publish a Statement of Fiscal Risks</td>
<td>Cabinet</td>
<td>Treasury, NPC, BoN</td>
<td>1999</td>
</tr>
<tr>
<td>Introduce Corporate Planning at the Ministries</td>
<td>Sector Ministry</td>
<td>NPC</td>
<td>2001</td>
</tr>
<tr>
<td>Report Tax Expenditures and include them in Cost Estimates of Sectors</td>
<td>Sector Ministry</td>
<td>Revenue</td>
<td>2001</td>
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<tr>
<td>Report Quasi-Fiscal Activities conducted by Parastatals and include them in Cost Estimates of Sectors</td>
<td>Sector Ministry</td>
<td>Treasury, NPC</td>
<td>2001</td>
</tr>
<tr>
<td>Increase Cabinet's involvement in budget formulation process</td>
<td>Cabinet</td>
<td>1999</td>
<td></td>
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<tr>
<td>Change Government's Expectations from the Budget Process</td>
<td>Cabinet</td>
<td>2001</td>
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<tr>
<td>Identify Outputs Outsourcing and Performance Contracts</td>
<td>Sector Ministry</td>
<td>NPC, ECU</td>
<td>2001</td>
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<tr>
<td>Change the Appropriation / Vote Structure</td>
<td>Sector Ministry</td>
<td>NPC, Efficiency and Charter Unit (ECU)</td>
<td>2000</td>
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<tr>
<td><strong>Budget Implementation</strong></td>
<td>Treasury</td>
<td>Sector Ministry</td>
<td>1999</td>
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<tr>
<td>Issue six-month cash flow projections</td>
<td>Sector Ministry</td>
<td>Treasury</td>
<td>1999</td>
</tr>
<tr>
<td>Integrate commitment controls with the Funds control system</td>
<td>Treasury, NPC, BoN</td>
<td>1998</td>
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<td>Start the midterm-review with identifying constraints</td>
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<td><strong>Financial Reporting</strong></td>
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</tr>
<tr>
<td>Publish a Statement of Tax Expenditures with the Budget</td>
<td>Revenue</td>
<td>2000</td>
<td></td>
</tr>
<tr>
<td>Improve system based audit capabilities of the Auditor General</td>
<td>Auditor General</td>
<td>1999</td>
<td></td>
</tr>
</tbody>
</table>
3.51 **Audit.** The Auditor General publishes excellent reports reviewing the overall situation of government finances, the ledger, the financial position of the government and the details of each vote. His analysis is based on regularity audit.

**Recommendation 19: Improve system based audit capabilities of the Auditor General**

3.52 In his audit report of 1995-1996 fiscal year, the Auditor General finds that 18 out of 28 ministries and offices overspent at the vote level and 27 ministries and offices (except his office) overspent at the subdivision level. He calls this situation alarming. The Auditor General could go a step further, analyze the deficiencies of the ministries’ financial management systems and provide recommendations for improvements in their systems. Moreover, all ministries conduct some portion of their financial management operations on computers and that portion will increase even more. This situation requires the Auditor General to build capacity in auditing the computer based systems.

**B. CASE STUDIES: MTEFs IN SELECTED AFRICAN COUNTRIES**

**South Africa**

3.53 The Budget Speech for 1998 announced the adoption of a medium term expenditure framework. It is described as “the operational plan by which we give substance to our reconstruction and development efforts.” Its goals are:

- to strengthen political decision-making in the budget process; to enable the Cabinet to make the link between the budget allocations and the services which are intended to be delivered.
- to strengthen co-operative governance and decision-making.
- to make the Rand go further; to deliver better services.
- to create a medium term environment for public sector planning.
- to relate what we spend to what we buy.
- to achieve greater transparency and openness in making budget policy.

3.54 Strong, public, political commitment to MTEF is an excellent basis for its successful adoption. The National Budget Review provides details of the MTEF process. It is a three-year rolling process (the budget year plus two further years) in which expenditure is expressed at estimated current prices. It applies to both national and provincial government and reflects Government’s social and economic priorities and the country’s reconstruction and development commitments.

3.55 The benefits of an MTEF are:

(i) allocation of resources to priority services.
(ii) more efficient planning and management.
(iii) a framework within which policy proposals can be assessed.
(iv) more transparency in government.
Namibia: review of recent economic performance

(v) a reduction in rollovers (expenditure commitments from previous years).

(vi) a clear demonstration of how fiscal targets will be met.

3.56 South Africa's approach to the MTEF is comprehensive. The model, which is in course of implementation, contains all the necessary components for successful adoption, (a macroeconomic framework, a fiscal policy, medium term expenditure forecasts for three years, an annual budget process linked to the MTEF, and draft sectoral programs). The components are linked to one another and there is strong political support for the entire process. South Africa's MTEF is at an early stage of development. Nevertheless, already much has been achieved. The following tables from the National Budget Review illustrate in aggregate terms the macroeconomic link and the breakdown by sector.

Table 3.3: Consolidated National and Provincial Spending 1995/96 to 2000/01 (in billion Rand)

<table>
<thead>
<tr>
<th>Outcome</th>
<th>Preliminary</th>
<th>MTEF Projection</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total spending</td>
<td>154.4</td>
<td>182.7</td>
</tr>
<tr>
<td>as % of GDP</td>
<td>31.1%</td>
<td>32.9%</td>
</tr>
<tr>
<td>% growth</td>
<td>18.3%</td>
<td>7.5%</td>
</tr>
<tr>
<td>less debt service costs</td>
<td>31.3</td>
<td>34.3</td>
</tr>
<tr>
<td>Total non-interest spending</td>
<td>123.1</td>
<td>148.4</td>
</tr>
<tr>
<td>as % of GDP</td>
<td>24.8%</td>
<td>26.7%</td>
</tr>
<tr>
<td>% growth</td>
<td>20.5%</td>
<td>5.6%</td>
</tr>
<tr>
<td>GDP inflation rate</td>
<td>8.2%</td>
<td>8.5%</td>
</tr>
<tr>
<td>GDP (R billion)</td>
<td>497.3</td>
<td>556.0</td>
</tr>
</tbody>
</table>


3.57 Also, significant work has been done on sectoral programs. Sectoral teams were established in August 1997. They were assigned to six expenditure areas: education, health, welfare, criminal justice and personnel management. Their aims have been to analyze budget submissions so that understanding of the service implications of the proposed budgets is improved; to develop simple spending models linking expenditure, unit costs and outputs; to produce a menu of policy choices linking budget allocations to service delivery; to make recommendations on the structure of the votes in question; and in the cases of education, health and welfare to reach agreement on the amount and structure of unconditional grants.

3.58 Besides the obvious links needed for any MTEF, the South African version has additional links designed to increase its relevance and chances of success. First, it is located within a larger program for budget reform which focuses on fiscal decentralization, translation of policy goals into service delivery, increased efficiency and transparency, and promoting partnership between the public and private sectors. Second, budget reform is seen as dependent on improvements in financial management which
receives specific incremental funding under the MTEF program. Third the extent to which cost and conditions of public sector employment are seen as significant issues within the MTEF program. The program specifically addresses personnel management, public service regulations, budgeting for personnel costs and decentralization of personnel decision-making. This establishes a strong link between expenditure management and personnel issues, which is quite rare in programs for public sector reform.

Table 3.4: Consolidated National and Provincial Expenditure: Functional Breakdown 1995/96 to 2000/01 (in billion Rand)

<table>
<thead>
<tr>
<th>Protection services:</th>
<th>Average growth for MTEF</th>
</tr>
</thead>
<tbody>
<tr>
<td>Defense</td>
<td>11.6</td>
</tr>
<tr>
<td>Justice</td>
<td>1.6</td>
</tr>
<tr>
<td>Police</td>
<td>9.3</td>
</tr>
<tr>
<td>Prisons</td>
<td>2.7</td>
</tr>
<tr>
<td>Social services:</td>
<td>73.9</td>
</tr>
<tr>
<td>Education</td>
<td>34.6</td>
</tr>
<tr>
<td>Health</td>
<td>16.1</td>
</tr>
<tr>
<td>Social security and welfare</td>
<td>15.2</td>
</tr>
<tr>
<td>Housing</td>
<td>3.0</td>
</tr>
<tr>
<td>Other</td>
<td>5.1</td>
</tr>
<tr>
<td>Economic services:</td>
<td>17.5</td>
</tr>
<tr>
<td>Water schemes, related services</td>
<td>1.4</td>
</tr>
<tr>
<td>Fuel and energy</td>
<td>0.2</td>
</tr>
<tr>
<td>Transport, communication</td>
<td>7.3</td>
</tr>
<tr>
<td>Agriculture, forestry, fishing</td>
<td>3.5</td>
</tr>
<tr>
<td>Mining</td>
<td>0.2</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>0.8</td>
</tr>
<tr>
<td>Regional development</td>
<td>0.9</td>
</tr>
<tr>
<td>Other</td>
<td>3.3</td>
</tr>
<tr>
<td>General Admin., other</td>
<td>10.8</td>
</tr>
<tr>
<td>Interest</td>
<td>29.5</td>
</tr>
<tr>
<td>Reserve</td>
<td>1.3</td>
</tr>
<tr>
<td>Total Budget Expenditure</td>
<td>158.1</td>
</tr>
</tbody>
</table>

Source: IFS, South Africa Reserve Bank, staff estimates.

3.59 The MTEF approach deserves to succeed in South Africa because it has been well-conceived and planned and because it addresses the right questions. Its chances of success are enhanced by strong government commitment and a realistic approach to the magnitude of the task which is seen as requiring several years. Whether it can provide the right answers is as yet unknown. Certainly, innovations rarely match the rhetoric...
used at their introduction. Consequently some redrawing of the boundaries of expectation may occur. Nevertheless, MTEF in South Africa has a good chance of achieving its central aims if it is pursued with energy and determination.

Malawi

3.60 In 1994 the World Bank and Government of Malawi collaborated in the Malawi Budget Management Review. As an outcome, in 1995 GOM decided to adopt an MTEF as suggested by the World Bank.

3.61 The intention was to carry out the MTEF within a macroeconomic framework with three alternative scenarios (high, medium, low), the central case being the existing scenario. Resources were to be split between capital and recurrent expenditure, and within recurrent expenditure between wage-related and other recurrent expenditure (ORE). Recurrent expenditure was to be allocated to economic sectors using the three scenarios. Sector expenditure allocations would create the conditions for ministries to plan for 3-5 years ahead with reasonable assurance of availability of resources; to assess the need for repair and maintenance expenditure to maintain existing capital stock; to address the imbalance between wages and ORE; and to confront choices and constraints to support rational resource allocation decisions.

3.62 Beginning in 1995, this approach was applied to the four largest spending ministries (education, health, agriculture and public works) and to the police. The exercise was extended to 12 ministries in 1997-98 and will apply to all ministries in the following year. At the center, the approach involves the development of a macroeconomic framework, the derivation of aggregate and sectoral ceilings and reprioritization of expenditure. The intention is that in due course there will be one budget for both recurrent and development expenditures, and that the MTEF will be prepared in constant prices for the budget year plus three further years.

3.63 The major achievement to date has been in the field of sectoral programs. Here a strategic review of the whole of government helped to define ministries’ objectives and functions, besides indicating opportunities for modification, reduction and elimination of activities (duplication of function, transfer to the private sector, contracting out, cost recovery). Initially the emphasis was on the recurrent budget. As a result the quality of budget requests has improved and managers have been involved actively in budgeting, some for the first time. Some problems remain with regard to defining activity costs and bringing together both capital and recurrent costs.

3.64 In practice, several difficulties have emerged. Government had not developed its own macroeconomic framework and had been using that of the IMF at the time that the MTEF was introduced. A working group to create a macroeconomic model for the economy has only recently been set up. As a result, the macroeconomic framework has not provided an adequate basis for fiscal planning. Consequently the process for communicating expenditure ceilings to ministries was also imperfect. Government, the IMF and the World Bank agreed the policy framework paper on which ministry ceilings were based. But late announcement of the ceilings for the 1997-98 budget cycle severed the essential link between the MTEF and the annual budget. Besides, the announced
ceilings were far below expectations, giving rise to frustration in ministries and confusion about the nature of the MTEF process. On top of this, the failure to obtain overt and sustained political commitment to the MTEF process, even at the basic level of parliamentary participation, means that its influence remains superficial.

3.65 The reported difficulties are being played out against a fundamentally discouraging background for the introduction of an MTEF. Malawi is one of the poorest countries in the world. The World Bank noted in 1996 that it had slipped into its worst economic crisis in a decade, including the collapse of its fiscal system. A year earlier the Malawi Budget Management Review noted "...the budget is not working well. Line ministries have little confidence in the capacity of the budget to provide realistic budgets. This has weakened expenditure control...the links between the recurrent budget and the development budget have progressively weakened. Government finances have become seriously over-extended. The Government has found it difficult to maintain competitive wages for technical and professional cadres, project implementation is delayed by unreliable funding of counterpart costs and departments lack funds to maintain public sector investments when completed. Donors have increasingly sought to compensate for the weakness of the domestic budget through projects and by other means".

3.66 Given this background, and the fact that inadequate skill levels throughout the public service in budgeting and financial management are seen as a serious barrier to the cost effective implementation of the government’s development priorities, the decision to attempt an MTEF seems heroic. A less ambitious budget reform policy might have been more appropriate. For instance, given the serious fiscal problems faced by Malawi, a realistic objective might have been a macro framework and an MTEF-type approach to budgeting for the budget year only, rather than an MTEF primarily addressing sector expenditure programs but without an adequate macro context, and requiring four year forecasts expressed in constant terms. A less ambitious technical approach targeting aggregate fiscal discipline (as in Uganda), might also have activated greater political support by addressing issues of greater political relevance. In particular, claiming that MTEF would provide greater funding predictability, in a fundamentally unpredictable resource environment, resulted in inevitable contradictions.

3.67 Also, the budget reform policy might have targeted the improvement of basic systems on a time line in which a full MTEF would have been placed as a more distant objective. Inadequate basic systems pose a serious obstacle to the realization of the MTEF concept: separation of decisions and information regarding recurrent and development expenditure; the presence of significant unrecorded and uncontrolled donor flows; the weak control of within-year expenditure; and the absence of up to date, accurate and relevant accounting information. Substantial improvement of these processes will require both resources and time.

3.68 In conclusion, the MTEF continues to be relevant as a concept for Malawi. It may yet be realized in practice, if it can be properly adapted to the country’s capacities and priorities. In particular the lack of a macroeconomic framework and explicit fiscal policies derived from the framework, deprive the MTEF of its starting point: a definition of the aggregate resources available to fund expenditure over the medium term. Thus the annual ceilings announced to ministries as part of the annual budget cycle have proved to
be largely irrelevant. To achieve relevance, the MTEF process requires better fiscal underpinning, sustained and explicit political support and stronger means of enforcing budget discipline.

**Uganda**

3.69 Since 1992, budget strategy has been guided by an exercise known as the annual budget framework. This is an adaptation to Ugandan conditions of the MTEF approach. Its objectives are the same as those cited in the main text. Before the change, the budgeting horizon was very close: the end of the budget year. This had two major results: budget allocations were made routinely by civil servants rather than by decision makers, and only a weak link was established between the budget and the nation’s strategic priorities. The budget framework clarifies strategic choices and is adapted to the needs of Cabinet decision making. Annually, the budget framework paper (BFP) abstracts from the enormous volume of detail contained in annual budgets to focus on a strategic view of government’s policies and the resources available to pursue them.

3.70 The BFP was introduced in 1992 to address a serious fiscal crisis. Its early emphasis was therefore on macroeconomic factors. In the next two years it was expanded to cover allocative issues including planning for civil service changes (cost, numbers and remuneration). The BFP for 1995/96 contained comprehensive three year projections by sector and by ministry, and priority expenditure areas were identified. This provided the first occasion for Cabinet to consider ministries’ expenditure plans over an extended time horizon, engendering intense interest and debate. However in 1996/97 a large revenue shortfall coincided with the de-merger of the Ministries of Finance and Economic Planning. The consequent uncertainty meant that the full three year BFP was not prepared, and the budget exercise concentrated on issues within the budget year.

3.71 There are several major constraints preventing the achievement of a more successful budget framework. First, the within-year budget process lacks discipline in the sense that spending ministries do not respect hard budget constraints. He analyses budget and actual data by ministry over a three year period and concludes that a fairly stable pattern of winners and losers emerges, with the “losers” representing sectors which are identified among Government’s apparent “priorities”. Second, the budget framework is vulnerable to abrupt revenue shortfalls. In this context he notes that domestic revenue instability in sub-Saharan Africa is roughly three times as high as in other developed countries. Third, in the case of Uganda, donor dependence may have been an additional cause of resource instability. Fourth, Uganda’s financial markets lack depth and this implies that demand has to be managed by fiscal rather than monetary means. Again, the result is a more volatile environment for planning public expenditures.

3.72 Following steps are now needed to achieve a more realistic budget framework in Uganda. First, care is needed to ensure that the BFP does indeed reflect national priorities. Second, broader ownership is needed to ensure a more disciplined budget implementation. Third, broader ownership implies the need for greater involvement of line ministries and Parliament. The BFP should be distributed to Parliament in good time, that Parliament monitor the BFP against actual budget implementation and that the
BFP be published. Finally the BFP is a way of achieving better coordination between donors.

3.73 The BFP has achieved the following: it has contributed strongly (along with better cash flow management) to macroeconomic stability by promoting aggregate fiscal discipline; it has introduced a medium term focus in cabinet’s budget decisions; and has provided a framework in which key policy changes can be more effectively evaluated. At the same time it has encountered problems: it has been a weak allocative device because of significant variation between budgeted and actual expenditure; and the sector analysis underpinning the BFP has lacked clear objectives, links between resources and results, integration of recurrent and development expenditure and adequate coverage of donor funded expenditure.

3.74 Despite reverses, BFP may still have a future in Uganda. High on the list of preconditions for a successful future are the changes listed above, including better mechanisms for ensuring consistency between budgeted and actual expenditure which he sees as critical to the future of BFP. Thus realistic budgets, effective expenditure controls, good reporting systems and strong political oversight are key to future development of the MTEF in Uganda.

C. SUMMARY AND CONCLUSIONS

3.75 At the request of the Finance Minister, the September 1998 economic mission assessed the feasibility of a Medium Term Expenditure Framework for Namibia. This chapter reports on this assessment, and provides guidance on how such a system could be implemented. Whether such a system should be implemented depends to a large extent on the willingness of politicians to have their policy decisions constraint by resource availability in the medium term, and to be accountable for the results of spending decisions. Adopting a new budget framework requires the consent of the cabinet and their commitment to the new rules of the game. Therefore, the Minister of Finance alone cannot carry budgetary reforms; they are the responsibility of the cabinet as a whole, led by the Prime Minister’s role. Without the leadership of the Prime Minister a new framework that takes the cabinet as its centerpiece could not be implemented. The mission was unable to assess the political will for such a system, and this chapter should therefore be seen as a technical guide to an MTEF rather than a policy recommendation to the Namibian Government.

3.76 Unlike many other developing countries, Namibia has the basic system for sound public expenditure management in place. This system includes: the National Development Plan, including specific sector objectives, strategies and programs; Cabinet resolution on progress reporting and monitoring; a Policy Framework Paper as the start of the budget process; sector spending ceilings early in the budget formulation process; requirement for medium term expenditure estimates in the budget manual; the State finance act; treasury instructions regulating financial management; and a basic financial management information systems. This system could form the basis for reforms to improve the performance of public expenditure management.
On the other hand, there is also a strong tendency in Namibia to avoid the rules embedded in the existing system. The weak implementation of cabinet resolutions, budget guidelines and treasury instructions, and chronic overspending by line ministries and the President’s office reflect this tendency. The Auditor General reports, after revealing that 18 out of 27 ministries/offices overspent in 1996, that:

"...This appalling lack of financial discipline is of serious concern. Unauthorized expenditure of this magnitude has serious implications for cash flow management in the Government. It is also tantamount to contempt of the National Assembly’s powers to control and authorize the use of the taxpayers money for approved activities up to specified limits."

This situation indicates that the decision-makers perceive present planning and budget formulation processes as procedural requirements rather than essential decision-making processes within which they shape credible medium term commitments. The result: decisions made by using formal rules lose their credibility and enforceability. The cost is high; if avoidance of formal institutions continue, the legitimacy of the state will lessen in the eyes of the people.

In countries with coalition, minority, divided or short tenured governments, the political situation hampers politicians to engage in medium term commitments. But Namibia is unconstrained by such political conditions: the governing party has a significant majority in the Parliament now and will have in the foreseeable future. Hence, politically, the government is able to engage all other actors in establishing credible commitments.

A key issue is getting the governing party to use formal mechanisms of the state—including the budget process -- to make its political decisions. In other words, getting the cabinet to use the "planning and budget formulation processes of the state" to facilitate the "policy and decision-making processes of the party" so that the leadership of the party could "establish medium-term commitments" among them.

A neighboring country facing similar political conditions -- South Africa -- realized the need for redesigning its planning and budget formulation processes to facilitate the decision-making throughout government. They adopted a Medium Term Expenditure Framework. The Budget Speech for 1998 described the medium term expenditure framework as "the operational plan by which we give substance to our reconstruction and development efforts."

A Medium Term Expenditure Framework requires the Cabinet to make two sets of decisions prior to triggering the annual budget process. First, a decision on medium term fiscal targets, and second, a decision on spending priorities and sector spending limits. Central agencies support the setting of aggregate fiscal target by publishing a fiscal and economic outlook report, and sector ministries support the setting of cabinet’s priorities with their corporate plans. Fiscal targets are published in a fiscal policy statement and cabinet’s sectoral priorities and allocations are published in a budget policy statement. The key is setting the fiscal targets and realizing the constraints collectively.
before discussing the spending priorities and allocations. Transparency of the processes is ensured by publishing the reports mentioned above.

3.83 In Namibia’s budget process, the Cabinet does not make the decisions on fiscal ceilings and sectoral allocations. The current process allows for such decisions, but since it is owned by the Ministry of Finance (MOF) instead of the Cabinet, it does not facilitate cabinet discussions. The responsible Cabinet committee is led by the Minister of Finance. The Ministry of Finance provides information to that committee and handles relations with the sector ministries. Information goes to Cabinet for approval, not for decisions. The result is that the budget process is perceived as a MOF-internal process, hence as a procedural requirement for the Cabinet rather than an opportunity for policy making.

3.84 The key contribution an MTEF can have for Namibia is a budgeting framework which sets the cabinet at the center, with the planning and budgeting processes supporting the cabinet’s policy making. This chapter first described a generalized “good practice” version of that framework – the MTEF. Next it discussed how an MTEF could be adopted and integrated with Namibia’s current planning and budgeting processes in Namibia. Finally, it showed how refinements in various functional areas could be made so that they could meet the requirements of the new framework.
ANNEX A: A NOTE ON NAMIBIA’S GROWTH DETERMINANTS

Introduction

1. Namibia’s growth experience since independence fell short of expectations. The country’s first national plan (NDP1) projected an annual growth rate of GDP per capita of 3 percent for the period 1995-2000, but the average Namibian is no better off than in 1995. Why was growth so low? This annex tries to find an explanation by applying the findings of endogenous growth theory to Namibia. The endogenous growth literature explains growth not only by accumulation of the inputs in the production process but also by the quality of the inputs and the policies of the country in which accumulation takes place. The next section will briefly introduce the endogenous growth literature and its empirical findings. Section 3 uses the insights of the endogenous growth literature to explain the Namibian growth experience. That section will discuss the policy areas through which Namibia can improve its growth prospects and will compare its performance in those areas with that of other low and middle income countries to which Namibia belongs as well as a group of fast growers. As investment remains critical for growth, the last section will briefly look at what determines private investment in the endogenous growth literature.

2. Neoclassical theory of economic growth explains growth with the accumulation of inputs in the production process. In the standard model, those inputs are labor and capital. Capital and labor show decreasing returns, implying that in the long run output growth equals population growth plus some exogenously determined technological progress factor. In the long run there can be no increase in per capita income without technological progress. An important conclusion is that the growth rates should converge among countries. Empirical evidence, however, shows a different story: richer countries seem to grow faster than poorer countries and output growth is often larger than the growth of the production inputs of capital and labor. The difference between output growth and the growth of capital and labor is called total factor productivity growth (TFP growth).

3. Growth can be interpreted as the contribution to growth by technological progress. This factor is different across countries and seems to be larger in developed countries than in developing countries. In the mid-1980s, research on economic growth had a strong revival, starting with the work of Romer (1986) and Lucas (1988). The motivation for this renewed research was the notion that the determinants of long run growth are the crucial issue of development. The central question is why TFP growth differs across countries, what ultimately determines TFP growth, and how these factors...
influence the accumulation of capital and labor. Thus the endogenous growth literature does not only pay attention to the accumulation of inputs, but also to the quality of these inputs and to factors that influence the accumulation of the inputs among which the policy environment of a country. In particular it investigates how spillovers of knowledge across producers and the external effects of human capital help avoid diminishing returns to the accumulation of capital and labor.

4. In addition to the theoretical research, a vast amount of empirical literature studying TFP growth differences across countries has also emerged. The most widely used and quoted empirical studies are those by Barro (1991) and Levine and Renelt (1992). They identify the following five variables as contributing to the explanation of growth: 1. The initial level of income; 2. The stock of knowledge and the quality of labor as measured school attainment; 3. The accumulation of capital as measured by the investment ratio; 4. The distortion of the investment climate and opportunities caused by government crowding out as measured by government consumption to GDP ratio; and 5. The disadvantage of high population growth as it implies that a larger amount of time is spent in raising children than in other productive activities. The cross country regressions of Barro, and Levine and Renelt resulted in the following two growth equations:

**Barro’s growth equation:**

\[
\text{per capita growth} = 3.02 - 0.75 \times \text{LOG(Y)} + 2.5 \times \text{PRIM} + 3.05 \times \text{SEC} - 11.9 \times \text{GOV}
\]

**Levine and Renelt’s growth equation:**

\[
\text{per capita growth} = 0.83 - 0.00035 \times Y + 3.17 \times \text{SEC} + 17.5 \times \text{INV} - 0.38 \times \text{POP}
\]

where \(Y\) is the level of initial per capita income at international prices, PRIM is gross primary school enrollment rate, SEC is the gross secondary school enrollment rate, GOV is the ratio of government consumption to GDP, INV is the share of investment in GDP and POP is the population growth rate.

**Namibia’s experience and fundamentals**

5. This section evaluates Namibia’s growth performance since independence by examining the underlying fundamentals as discussed above. The note will compare the levels of inputs into the Barro and Levine and Renelt equations for Namibia with the levels of these same indicators for the low and middle-income group of countries and a group of “fast growers” as identified in Levine and Renelt (1992). It will identify for which indicators Namibia deviates most significantly from these reference groups; it will calculate the relevant elasticities and calculate for those indicators the amount by which Namibia should change its levels as to increase its growth prospects by one percent.

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20 See Barro and Sala-i-martin for a comprehensive overview of the literature.

21 Note that the growth rates predicted by these regression equations should be viewed as long-term average. Based on the neoclassical growth theory, one should expect that the initial growth rates would be higher than these averages and then decrease over time as the GDP per capita levels converge to OECD levels.
6. Namibia’s growth experience has been a bumpy one since independence (see Figure 1.2) GDP per capita increased initially after independence, but it has been on a steady decline since 1994. The same is true for the TFP per capita growth (see the trend line in Figure 1.2). To explain the decrease in TFP growth we will turn to the above-introduced indicators. Table I.1 compares Namibia with its relevant income group, low and middle-income countries and with the category of “fast growers”. Namibia outperforms its comparators in the low and middle-income group with respect to primary and secondary school enrollment. However, a note of caution needs to be added to this observation. For example, transition economies, which have a comparable level of GDP per capita, have secondary school enrollment rates of 84 percent and hence are able to better host productive activities that require a high level of human capital. The outstanding differences between Namibia, the low and middle-income countries and the fast growers are with respect to investment and government consumption.

7. During the period 1990-97, investment was on average almost 5 percentage points lower than its counterparts in the low and middle-income group of countries and on average close to 3 percent below the group of fast growers. Namibia could have had .9 and .5 percent higher per capita GDP growth respectively if it would have been able to attain the investment levels of its reference groups (see Table I.3). Lower population growth would have contributed to higher per capita growth as well.

8. Consumption in Namibia is extremely high compared to its reference groups. It is 18 percentage points to GDP higher than the low and middle income country group and 16 percentage points above the fast growers group of countries. A level of government consumption to GDP of 15 percent can potentially increase GDP per capita per annum growth by approximately 2 percentage points (see Table I.3).

9. Note that the elasticity for investment, government consumption and primary school enrollment ratio are bigger than one. It is most beneficial for Namibia’s growth prospects if the government would lower its consumption levels and would be able to create the right incentives for increases in investment. Table I.2 gives ceteris paribus

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Table I.1: Comparison of Growth determinants

<table>
<thead>
<tr>
<th></th>
<th>Namibia</th>
<th>Low and Middle Income</th>
<th>Fast-Growers**</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP per capita growth</td>
<td>-2.3%</td>
<td>1.4%</td>
<td>-0.1%</td>
</tr>
<tr>
<td>Primary school enrollment</td>
<td>1.29*</td>
<td>1.33</td>
<td>1.33</td>
</tr>
<tr>
<td>Secondary school enrollment</td>
<td>0.44*</td>
<td>0.57</td>
<td>0.62</td>
</tr>
<tr>
<td>GDI-GDP ratio</td>
<td>16.0%</td>
<td>20.3%</td>
<td>21.2%</td>
</tr>
<tr>
<td>Government Consumption-GDP ratio</td>
<td>24.3%</td>
<td>32.0%</td>
<td>32.0%</td>
</tr>
<tr>
<td>Population Growth</td>
<td>3.1%</td>
<td>3.1%</td>
<td>3.1%</td>
</tr>
</tbody>
</table>

* 1990 observation.

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22 The elasticity for primary school enrollment is indeed bigger than one. However, further increasing the gross enrollment from a current level of 1.33 seems unrealistic and is unlikely to generate the calculated return. Namibia’s high gross enrollment reflects to some extent the backlog in education, and to some extent the low efficiency of the education system, which leads to high duplication.
the necessary levels of each indicator that corresponds with an increase of the per capita growth level with 1 percent. For instance, if investment to GDP were 25 percent rather than the current 20 percent, Namibia’s per capita growth rate would have been 1 percent rather than the 0 percent at present.

10. It is clear by evaluating Table I. 2 that the realistic instruments to attain higher growth are secondary school enrollment, investment and government consumption. Increasing secondary school enrollment ratios are high on the government’s agenda, but will take a considerable amount of time. Hence, this leaves fiscal policy in the form of some combination of increasing investment and lowering government consumption expenditures as the most likely alternative in the short run.

Table I. 2: Identifying Policy Priorities

<table>
<thead>
<tr>
<th>Levels required for 1% additional growth</th>
<th>Levine &amp; Renelt</th>
</tr>
</thead>
<tbody>
<tr>
<td>Primary school enrollment</td>
<td>1.73</td>
</tr>
<tr>
<td>Secondary school enrollment</td>
<td>0.95</td>
</tr>
<tr>
<td>GDI-GDP ratio</td>
<td>..</td>
</tr>
<tr>
<td>Government Consumption-GDP ratio 16.4%</td>
<td>..</td>
</tr>
<tr>
<td>Population Growth</td>
<td>0.08%</td>
</tr>
</tbody>
</table>


11. Increasing investment by increasing government investment in a country that has quite an adequate level of physical infrastructure will most likely crowd out private investment even with an abundance of savings in the private sector. Namibia is one of the few countries in Africa and in the development world as a whole with a positive current account balance and henceforth, negative foreign savings. This implies that there is a surplus on the (national) savings - investment balance. This surplus is invested abroad as it apparently can not find profitable investment opportunities in Namibia (see Figure 1.2).

12. It is clear from Figure 1. 2 that the marginal efficiency of capital as measured by a five year moving ICOR has deteriorated significantly over the past five years. An empirical cross-country study on the determinants of private investment by Easterly and Rebelo (1993) identifies similar indicators as the growth equations of Barro (1991) and Levine & Renelt (1992).
Easterly and Rebelo equation:

\[
\text{Ratio of private investment to GDP} = 0.083 - 0.00842Y + 0.083\cdot PRI - 0.737\cdot TAXES,
\]

where \( Y \) is GDP per capita, \( PRI \) is the primary school enrollment ratio and \( TAXES \) is the ratio of domestic taxes to domestic absorption. The variable \( TAXES \) is a measure for the tax distortion caused by tax policies. The policy variable that the government can influence, is the indicator: domestic taxes over domestic absorption. The 1997 value of this indicator is 17.8 percent while the mean of the sample in Easterly and Rebelo (1993) is 7.4 percent. Namibia comes out at the high end with respect to distorting the investment climate and investment opportunities as measured by the fiscal policy indicator of domestic taxes as a ratio to domestic absorption. Lowering this indicator to the regression sample’s mean could potentially increase private investment by 7 percentage points.

Conclusion

13. Namibia’s fundamentals as identified by the endogenous growth literature can be used to explain the recent dismal growth performance. Critical indicators such as the ratio of investment to GDP, Government consumption to GDP and domestic taxes to domestic absorption have values that do not foster growth. The growth prospects for Namibia would greatly improve if the government of Namibia would be able to bring its fiscal indicators, in this case government consumption to GDP and domestic taxes to domestic absorption more in line with international averages.
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