ZIMBABWE ECONOMIC UPDATE

THE STATE IN THE ECONOMY

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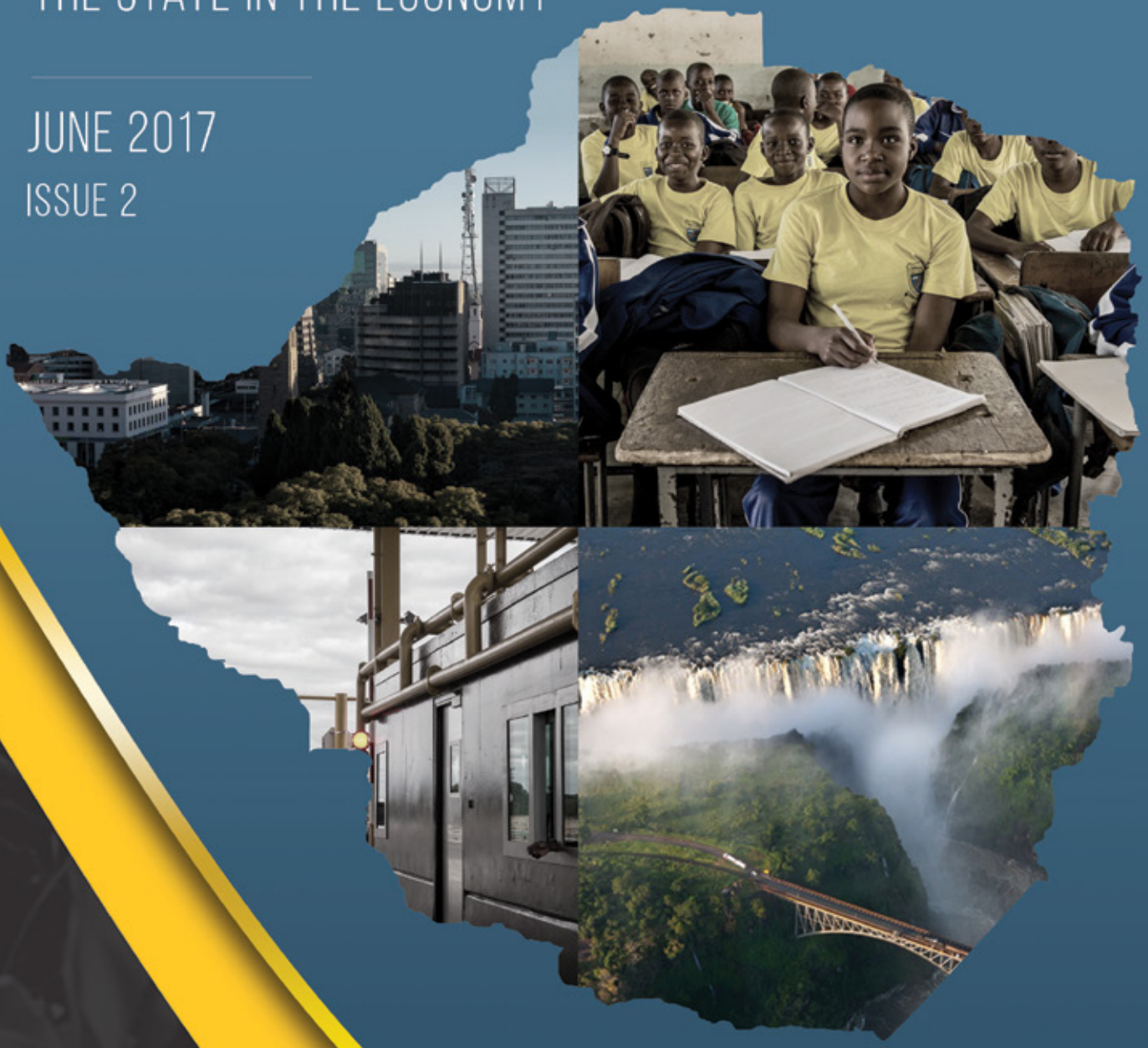

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ACRONYMS AND ABBREVIATIONS

ARDA	Agricultural and Rural Development Authority
GDP	Gross Domestic Product
GMB	Grain Marketing Board
LAs	Local Authorities
MoFED	Ministry of Finance and Economic Development
NSSA	National Social Security Authority
OPC	Office of the President and Cabinet
RBZ	Reserve Bank of Zimbabwe
SEPs	State-owned Enterprises and Parastatals
SOEs	State Owned Enterprises
ZAMCO	Zimbabwe Asset Management Company
ZESA	Zimbabwe Electricity Supply Authority
ZETDC	Zimbabwe Electricity Transmission and Distribution Company
ZIMSTAT	Zimbabwe National Statistics Agency
ZIMVAC	Zimbabwe Vulnerability Assessment Committee
ZINWA	Zimbabwe National Water Authority
ZPC	Zimbabwe Power Company

PREFACE

The Zimbabwe Economic Update (ZEU) offers a World Bank perspective on recent economic developments in Zimbabwe and also undertakes evidence-based analysis on key areas of the Zimbabwean economy. This second edition explores the Zimbabwean public sector: local authorities and state-owned enterprises and parastatals and has significantly benefited from authorities' input. Both in the preparation and review. The ZEU is intended to enhance ongoing policy debates to foster the country's goals to increase growth, reduce poverty and lessen inequality. I would therefore like to thank the Government of Zimbabwe for their considerable input into this publication.

Since the last ZEU, growth prospects have noticeably dimmed. Recent large public financing requirements have placed considerable pressure on the financial sector leading to liquidity shortages. Large areas of the economy have been affected, particularly, services and industry, although the ending of the drought has improved prospects of agriculture.

Clearly, urgent reform of the public sector is essential to bring overall public finances on a sustainable footing. However, its size and rigidity makes this a difficult task. The problem is compounded by a large public debt burden, which has substantially raised the cost of credit.

Tackling these twin issues requires a deep and extensive reform program. This could enable a rapid increase in capital and investment flows into the country. And rejuvenate the economy.

In this regard, I strongly support initial Government actions to bring finances under control. In particular, implementing measures to rationalize the public sector wage bill, and reduce public expenditure pressures. A key next step would be to consolidate the fiscal accounts and strengthen oversight of state-owned enterprises.

Sustaining this reform program will require broad multi-stakeholder consensus and steady political will. This is essential if we are to unlock Zimbabwe's long-term growth potential, alleviate poverty, and expand economic opportunities for the country's diverse and well-educated workforce.

I look forward to engaging on these issues with the Government of Zimbabwe, the private sector, civil society, and the country's other international development partners.

Paul Noumba Um

Country Director for Botswana, Lesotho, Namibia, South Africa, Swaziland, Zambia and Zimbabwe

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ACKNOWLEDGEMENTS

This edition of the Zimbabwe Economic Update (ZEU) was prepared by a World Bank team led by Johannes "Han" Herderschee (Senior Country Economist), with contributions from Jason Hayman (Consultant), Marko Kwaramba (Economist) and Nyasha Munditi (Consultant). The team benefited from the valuable support provided by Camille Nuamah (Country Manager), Sebastien Dessus (Lead Economist and Program Leader) and Ivailo Izvorski (Acting Practice Manager). Paul Noumba Um (Country Director) provided overall guidance. The team is grateful for the comments received from peer reviewers Cecile Valadier (Senior Economist), Smriti Seth (Economist), and Kjetil Hansen (Senior Public Sector Specialist). Finally, the team would like to express its gratitude to Bruno Bonansea (Cartographer), who designed the map on the cover, Sean Lothrop (Consultant) who edited the report, Cybil Maradza (Consultant), who formatted the draft and prepared it for publication, and Farai Sekeramayi-Noble (Program Assistant), who supervised the finalization of the report.

Chapters 2 and 3 of the ZEU summarize and elaborate on information first reported in Volumes 2 and 3 of the Zimbabwe Public Expenditure Review (PER) jointly prepared by the Government of Zimbabwe and World Bank staff. Mr. Z.R. Churu supervised the preparation of the PER series at the Ministry of Finance and Economic Development, while Senior Economists Johannes Herderschee and Leif Jensen led the World Bank team. Volume 2, "Local Government Service Delivery," was prepared by a team consisting of Mr. Tatenda Mandeya and Mr. Alpha Nhamo (both Ministry of Local Government, Public Works and National Housing), Janine Mans (Consultant), Ngoni Mudege (Senior Water and Sanitation Specialist), and Marko Kwaramba (Economist). Volume 3 "State Enterprises and Parastatals" was prepared by a team consisting of Samuel Phiri (Ministry of Finance and Economic Development), Marko Kwaramba (Economist), and Consultants Nikeisha Russell, Sonny Mabheju, Norman Mukwakwami, Tawana Nyabeze, and Peter Rundell. The PER was completed in October 2016, and its macroeconomic indicators were updated on March 6, 2017. All volumes of the PER are available at the World Bank website (www.worldbank.org). The information in the ZEU is current as of June 1, 2017.

EXECUTIVE SUMMARY

Zimbabwe faces complex fiscal and macroeconomic challenges, and well-designed policies will be vital to accelerate growth and poverty reduction. Government debt to the banking sector increased dramatically since 2015 and contributed to a protracted financial crisis that severely limited credit to the economy, negatively affecting the private sector. Meanwhile, the drought experienced during the 2015/16 agricultural season reduced agricultural output and exacerbated rural poverty. However, favorable rains received in 2016/17 are projected to boost growth of the agricultural sector in 2017 and per capita output is projected to increase this year.

The GDP growth rate fell from 1.4 percent in 2015 to just 0.7 percent in 2016, continuing negative per capita income growth. Severe credit constraints have caused a significant contraction in private demand. Per capita consumption fell by some 5 percent and the investment-to-GDP ratio shrunk from a level that was already well below the average for Sub-Saharan Africa. A fiscal expansion and an increase in net exports partially offset the contraction in private demand. While a drought caused a drop in agricultural production and hydroelectricity generation in 2016, mining grew strongly and output in the manufacturing, and services sectors increased modestly. Consequently, economic growth remained positive on balance.

Slowing growth has disproportionately affected poor households. Rural areas are home to 67 percent at least two-thirds of Zimbabwe's population, including 79 percent of the poor and 92 percent of the extremely poor. The agriculture sector remains the primary livelihood for many poor households, and a combination of poor weather and financial shocks in 2016 adversely impacted vulnerable households: the drought reduced the output of smallholder farms, while cash shortages delayed payments to agricultural workers. By 2016 the number of people experiencing food insecurity had increased to an estimated 2.8 million, or 17.5 percent of the country's total population. This is estimated to fall to 2.2 million or 13.8% of the total population as food security improves in 2017.

The central government shifted to an expansionary fiscal stance in 2016, resulting in the financial sector turmoil and crowding out credit to the private sector. Slowing growth reduced public revenue, while emergency food imports, the public distribution of agricultural inputs, payment of domestic arrears and a burgeoning public-sector wage bill increased expenditures. The decision in 2016 to increase agriculture-related spending despite the decline in revenue and the continued growth of the wage bill substantially widened the fiscal deficit. The government's fiscal position expanded by some 8 percentage points of GDP. The banking sector bore the brunt of the government's financing needs, which led to liquidity shortages in the economy.

Fiscal expansion in 2016 triggered a liquidity crunch and prompted banks to limit cash withdrawals.

Prior to 2016, the Zimbabwean central government maintained a prudent fiscal-policy stance, but other public institutions developed large financial imbalances. Zimbabwe's public sector accounts for roughly 50 percent of GDP, yet the central government's expenditures averaged about 25 percent of GDP during 2012-16. Statutory extra-budgetary funds, spending by local authorities (LAs), the operations of state-owned enterprises and parastatals (SEPs), user fees imposed by schools and medical facilities, and support from development partners account for over half of the Zimbabwean public sector and a quarter of the national economy.[1]

ZIMBABWE'S PUBLIC SECTOR ACCOUNTS FOR ROUGHLY **50%** OF ITS GDP

The fragmentation of the public sector poses considerable fiscal challenges, which are exacerbated by the limited oversight of many public institutions and parastatals. Oversight of extra-budgetary funds, LAs, and SEPs is largely limited to expenditure auditing. Delays in the publication of audited financial reports prevents timely fiscal assessments of the consolidated public sector. Chapters two and three of this Economic Update provide an indication of the scale of the government's fiscal challenges, particularly those involving LAs and SEPs. Given the important role SEPs play in Zimbabwe's economy, the government guarantees their debt, and the contingent liabilities generated by SEPs have increasingly strained the public finances. According to audited reports of State-owned Enterprises, as of end 2015 SEP debt guarantees accounted for US$ 2.1 billion of Zimbabwe's total public and publicly-guaranteed debt.

Zimbabwe's growing public debt burden and large, fragmented public sector continue to threaten fiscal sustainability. Zimbabwe's total public debt stock has grown rapidly, reaching 70 percent of GDP in 2016. External debt, most of which is in arrears, accounts for two-thirds of the debt stock. With limited access to international capital markets, Zimbabwe has increasingly turned to domestic debt financing, largely through the banking system. The domestic financial sector covered most of the widening fiscal deficit in 2016, and as banks depleted their US dollar reserves, many were unable to accommodate withdrawals. Cash shortages developed in early 2016, forcing banks to limit both cash withdrawals and import payments. Severe liquidity constraints also increased premiums for cash payments.

New bond notes introduced in November 2016 have eased liquidity shortages[1] but are unable to address the underlying macroeconomic imbalances.[2] The bond notes have increased the cash supply, boosting liquidity and attenuating deflationary pressures. However, further issues of bond notes will need to be carefully monitored to contain inflationary pressures.

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[1] This estimate is based on Central Government public finance data, audited reports of local authorities and state-owned enterprises, Zimstat Consumer Price Index and Balance of Payments data as Zimbabwe does not currently compile nor publish consolidated public sector accounts. It may over/under estimate the size of the consolidated public sector because of cross linkages between different parts of the state. For more detailed figures, see Zimbabwe Public Expenditure Review (2017), Government of Zimbabwe and World Bank. Donor funded projects as part of Official Development Assistance (ODA) are included in the public sector regardless of whether they are implemented by state bodies or through other mechanisms.
[2] As of May 10, 2017 the total value of bond notes in circulation reached US$140 million.

The liquidity crisis contributed to a narrowing of the current account deficit. While a decline in imports has narrowed the current-account deficit, Zimbabwe's external position remains precarious. A combination of tight credit conditions, the inability of Zimbabwean banks to honor international payments, and import restrictions caused imports to contract by about 14 percent. Meanwhile, exports increased by about 2.4 percent, and the current-account deficit contracted by 6 percentage points to 4.1 percent of GDP in 2016.

Policies favoring exporters have facilitated the current account adjustment. Exporters of selected manufactured goods and agricultural products (except tobacco) have been able to retain their export earnings in US dollars, which enables them to benefit from the depreciating value of the dollar-denominated deposits in Zimbabwean banks. This policy has successfully encouraged certain export sectors, but it reflects a tacit recognition that prices in Zimbabwe no longer reflect international US-dollar prices. While some firms have been able to increase exports to take advantage of this price differential, thus far this effect remains modest.

Outlook and Challenges

The GDP growth rate is expected to recover to 2.8 percent in 2017, though medium-term projections remain relatively modest. Favorable rains and a revitalized agriculture sector are expected to underpin GDP growth in 2017. However, the incomplete implementation of fiscal-adjustment policies and structural reforms, and the possibility that a rising money supply will boost inflation, are likely to dampen Zimbabwe's medium-term growth outlook.

The clearance of external arrears could expand the government's access to international capital, but only notably so if sound fiscal management and structural reforms successfully restore fiscal and external sustainability. In October 2016, Zimbabwe settled US$108 million in arrears to the IMF's Poverty Reduction and Growth Trust. The authorities are committed to expediting the clearance of arrears to other multilateral creditors, including the African Development Bank (US$610 million), the World Bank (US$1.2 billion), and the European Investment Bank (US$212 million). However, resorting to non-concessional lending to clear arrears in a context of tight liquidity conditions and depleted international reserves could add pressures to an already tight budgetary situation if not accompanied by fiscal, monetary and investment reforms.

Zimbabwe's long-term growth prospects are positive, but to restore fiscal and debt sustainability the government must adopt policies that reduce the country-risk premium in international capital markets. Despite the turbulence of recent years, Zimbabwe's economic fundamentals remain strong: the country has considerable human capital and a wealth of natural resources, and it continues to spend more on education as a percentage of GDP than any other country in Sub-Saharan Africa. A reduction in the country-risk premium would improve the government's access to affordable capital, enabling it to complete much-needed infrastructure investments and revive its major industries.

ESTIMATED ARREARS OWED TO SELECTED MULTILATERAL CREDITORS:

AFDB:
US$610 MILLION

WORLD BANK:
US$1.2 BILLION

EUROPEAN INVESTMENT BANK:
US$212 MILLION

CHAPTER 1

RECENT ECONOMIC DEVELOPMENTS[3]

1.1 Growth and Poverty

THE GDP GROWTH RATE

FELL TO

0.7%

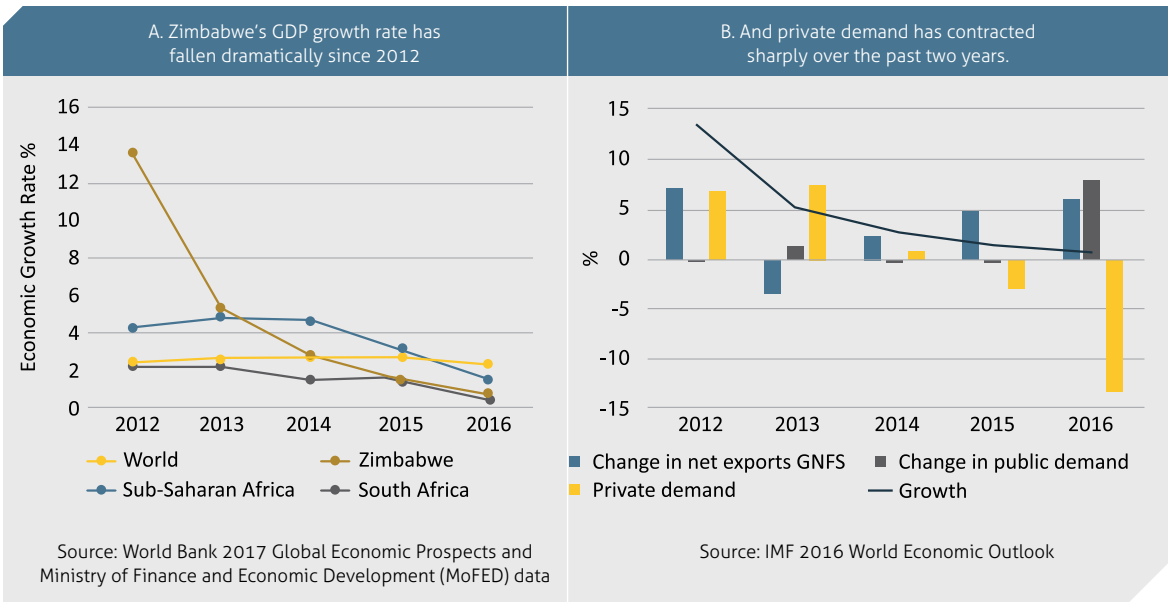
PERCENT IN 2016

Zimbabwe's economy grew by 0.7 percent in 2016 despite the combined effect of the El Nino drought and domestic financial turmoil. The drought reduced agricultural output and increased food prices towards the end of the year, despite the government's efforts to boost production and stabilize prices. The public provision of agricultural inputs, the creation of food-for-work programs, and the establishment of price supports for staple foods accentuated the government's expansionary fiscal-policy stance. Meanwhile, the government also increased spending on a cash basis to clear domestic arrears. The authorities financed much of the widening fiscal deficit by issuing Treasury bills purchased by commercial banks and a US$ 1 billion overdraft with the RBZ. As domestic borrowing reduced liquidity and crowded out credit to the private sector, demand fell, imports contracted sharply, and economic growth slowed (Figure 1). Good rains are projected to boost growth in 2017 but other sectors remain lackluster. To allow GDP growth to recover in 2017 and beyond, the authorities will need to improve public expenditure efficiency and ensure adequate liquidity in the financial sector.

Economic Growth by Sector

Growth slowed across almost all sectors in 2016. Manufacturing growth dropped modestly, hindering the expansion of the industrial sector, though renewed mining activity boosted output in the natural-resource sector. The drought reduced agricultural production and caused a sharp contraction in both the water sector and the hydropower-dependent electricity sector. Following a robust expansion from 2010-15, the service sector's growth rate fell just to 1.7 percent.

Figure 1: Growth Rates and Investment-to-GDP Ratios, Zimbabwe and Selected Comparators, 2012-16



[3] GDP data as revised by Zimstat in May 2017 are used in this report.

Agriculture

The drought caused the agricultural sector to contract for the second consecutive year. Agricultural output fell by 5 percent in 2015 and by another 3.6 percent in 2016. Major production declines were observed in the cotton (-71 percent) and maize (-31 percent). However, tobacco showed modest growth (1.8 percent) and production of beef went up substantially (13 percent) partly because of destocking.

AGRICULTURE **FELL BY 3.6%** IN 2016 AFTER **A 5% DECLINE** IN 2015

To mitigate the drought's impact on the agricultural sector, the government launched the "command agriculture program", expanded public food-for-work programs, distributed seed and fertilizer for the poor, and continued to use a price floor on key crops such as maize. The newly introduced command agriculture program provided farmers with inputs which are to be repaid by delivering grain to the Grain Marketing Board at the end of the growing season. These policies are projected to boost agricultural output in 2017. However, government intervention is both expensive and inefficient—especially the use of price support, as floor prices are set far higher than import competing prices.[4] Favorable rains during the 2016/17 agricultural season are expected to drive a robust recovery, and the agricultural sector is projected to make a sizeable contribution to GDP growth in 2017. Improving weather conditions will be complemented by the ongoing suspension of import duties on some fertilizer products through end-2017, and by the ongoing allocation of underutilized land managed by the parastatal ARDA and other government agencies to experienced farmers.

Mining

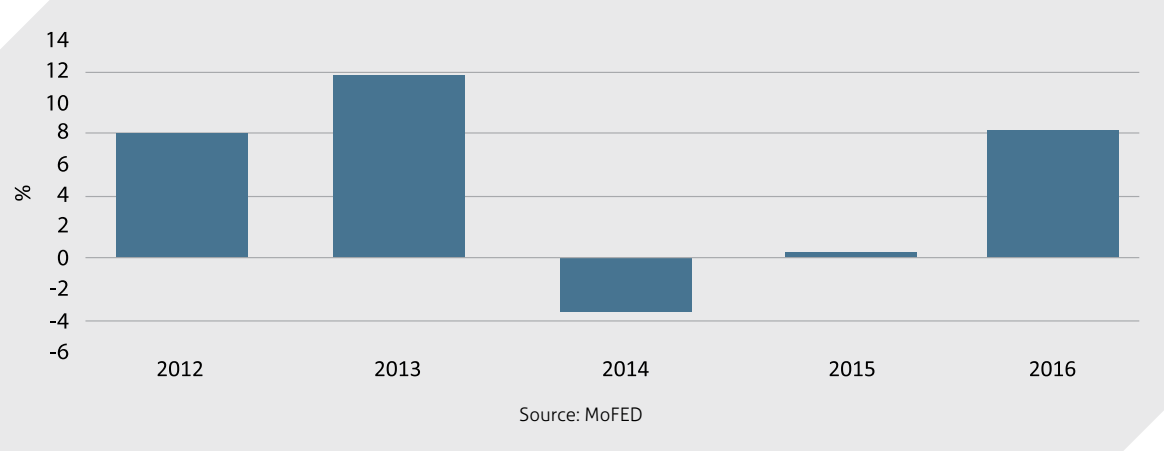
After contracting in 2015, the mining sector grew by 8.2 percent in 2016. Despite persistently low commodity prices and a difficult domestic economic environment, mining output increased markedly in 2016. Sectoral growth was driven by increases in platinum (19.4 percent) and gold (8.9 percent) production, which together accounted for about half of the mining sector's total output. Artisanal gold production increased rapidly, due in part to the government's decision to provide a US$20 million loan facility to unregistered artisanal miners and in part to the temporary reallocation of labor from the drought-stricken agricultural sector to the mining sector. However, diamond production fell by more than 25 percent, as the industry is currently transitioning from alluvial to hard-rock mining. Moreover, the Zimbabwe Consolidated Diamond Company was only able to operate two of the six concessions that it recently acquired, as its claim on the other four concessions was challenged in court. Nevertheless, the mining sector is expected to continue growing in 2017, mainly driven by gold

[4] For example, the intervention price for maize is US$390 per ton, more than 50 percent above the import price of US$250. The import price of maize may decline this year as other countries in Southern Africa also have an exceptionally good harvest.

and chrome production.

Despite its strong performance, the mining sector will face major challenges over the medium term. The cost of doing business in the sector remains high due to an outdated capital stock, a difficult business climate, and high royalty rates relative to other countries. Significant investment will be required to improve productivity, lower costs, and sustain sectoral growth rates. The government's commitment to the transparent, credible, and consistent application of its indigenization policy will remain crucial to attract and retain investment in the mining sector.

Figure 2: Growth of the Mining Sector, 2012-16 (%)



Manufacturing

The manufacturing sector's growth rate remained low at an estimated 0.3 percent in 2016. Growth remains low in spite of the fact that since mid-2016 the sector benefits from import restrictions on goods that compete with domestic production (Statutory Instrument 64, SI64). Following import protection capacity utilization increased as firms that serve the local market expanded production. However, the expansion of firms benefiting from import protection is limited by the size of the domestic market. On balance, the short-term benefit of SI64 was offset by continued closures of other firms. Exporting firms that could boost long-term growth lost competitiveness. Further, the sector continues to suffer from (i) escalating financing costs, (ii) a restrictive regulatory framework, and (iii) deteriorating infrastructure and an inadequate electricity supply. In this context, a combination of structural reforms and large-scale investment will be necessary for a sustained growth of manufacturing in 2017 and beyond.

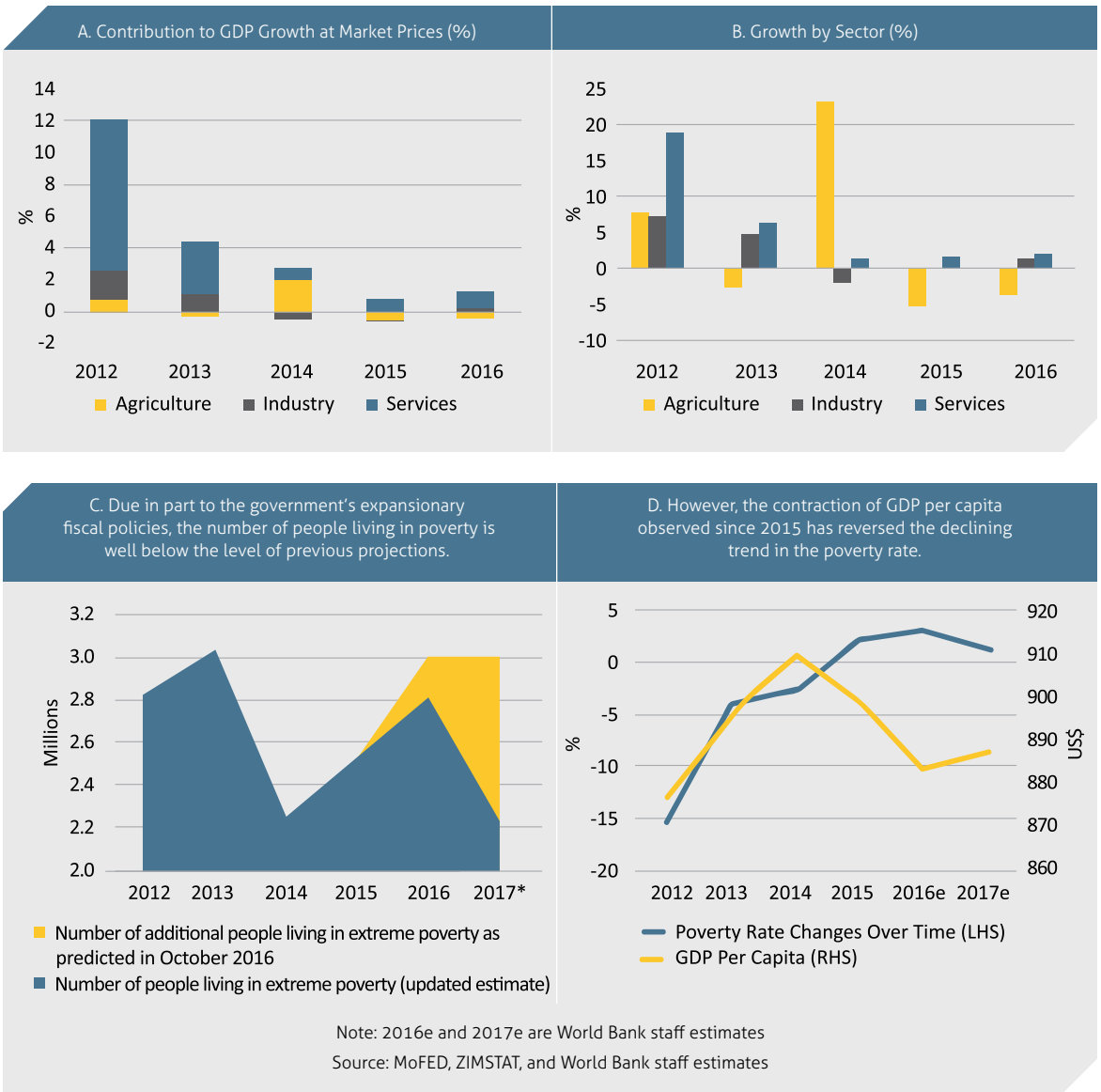
Services

While finance has been among Zimbabwe's best-performing sectors over the past five years, the recent liquidity crisis cut the overall growth rate of services to about 1.7 percent. Credit constraints also negatively impacted transport and communications and distribution, though rising tourist arrivals kept the growth rate for the hotels and restaurants sub-sector positive at 2.7 percent. Despite a turbulent economic environment, growth in the construction sector slipped only slightly to about 3.5 percent. However, public administrative services contracted by about 3 percent. The growth of the services sector will remain constrained in 2017 as liquidity shortages are projected to continue. Further, it may not be possible to meet the rapidly expanding demand for storage of agricultural products, possibly leading to deterioration in the value of stored products which would hold back growth.

Poverty

The drought and the liquidity crisis both exacerbated poverty. Contracting agricultural output disproportionately affected poor households, particularly in rural areas. The number of Zimbabweans in extreme poverty rose from 2.3 million in 2014 to 2.6 million in 2015 and reached an estimated 2.8 million in 2016 (Figure 3C). However, this increase was less than previously predicted, as government intervention alleviated the impact of the drought on the poor. In 2017, extreme poverty is projected to return to its 2014 level as the agricultural sector recovers.

Figure 3: Economic Growth and Poverty Rates, 2012-2016



Note: 2016e and 2017e are World Bank staff estimates

Source: MoFED, ZIMSTAT, and World Bank staff estimates

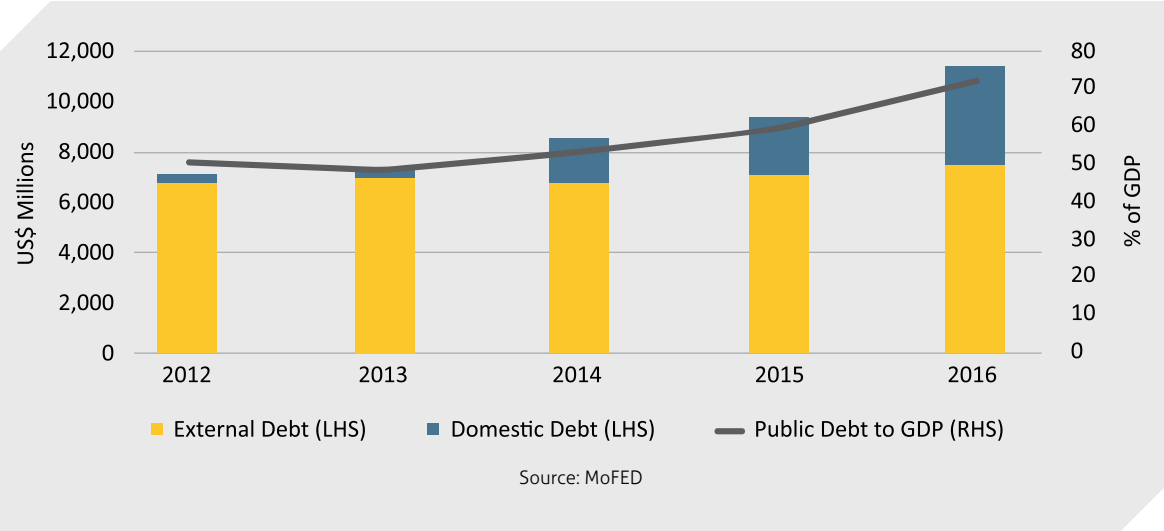
1.2 Fiscal Policy

After nearly a decade of fiscal prudence, the central government's shift to an expansionary fiscal stance in 2016 resulted in an economy-wide credit shortage and liquidity crisis. Revenue and expenditure dynamics both contributed to the deterioration of the government's fiscal position. As the economy weakened, public revenue fell by 6.3 percent—the first such drop since 2009. Meanwhile, the public-sector wage bill continued to rise, and drought-response policies drove a dramatic increase in total spending of around US$870 million, or 5.3 percent of GDP. In addition, the government started to issue Treasury bills to honor outstanding domestic arrears accrued by the Reserve Bank of Zimbabwe (RBZ) and several SEPs. The combined impact of falling revenues, rising expenditures and the repayment of arrears widened the fiscal deficit to around 10 percent of GDP in 2016. The government turned to the domestic banking sector to finance the widening fiscal deficit, resulting in an acute credit and liquidity shortage.

THE FISCAL DEFICIT **WIDENED** TO OVER **9%** OF GDP IN 2016

The public debt stock increased from US$9.4 billion (or 58 percent of GDP) in December 2015 to US$11.4 billion (or 70 percent of GDP) in 2016. In addition to the fiscal deficit, purchase of NPLs through the Zimbabwe Asset Management Company (ZAMCO) and the assumption of pre-2008 arrears in the fiscal accounts contributed to the increase in the debt stock (see below under financial sector issues). Domestic debt rose from US$2.3 billion to US$3.9 billion. Eighty percent of Zimbabwe's domestic debt is held by commercial banks. Most public debt is short-term weakening the debt profile.

Figure 4: Total Public Debt Stock



Source: MoFED

The liquidity shortage has also highlighted the medium-term fiscal-policy challenges stemming from Zimbabwe's large and complex public sector. Zimbabwe's sizeable public-sector workforce and generous wages and benefits relative to the private sector have generated substantial personnel costs that crowd out priority spending on operations, maintenance, and poverty-reduction programs.[5] The central government wage bill accounted for about 90 percent of public revenue and 66 percent of public spending in 2016.

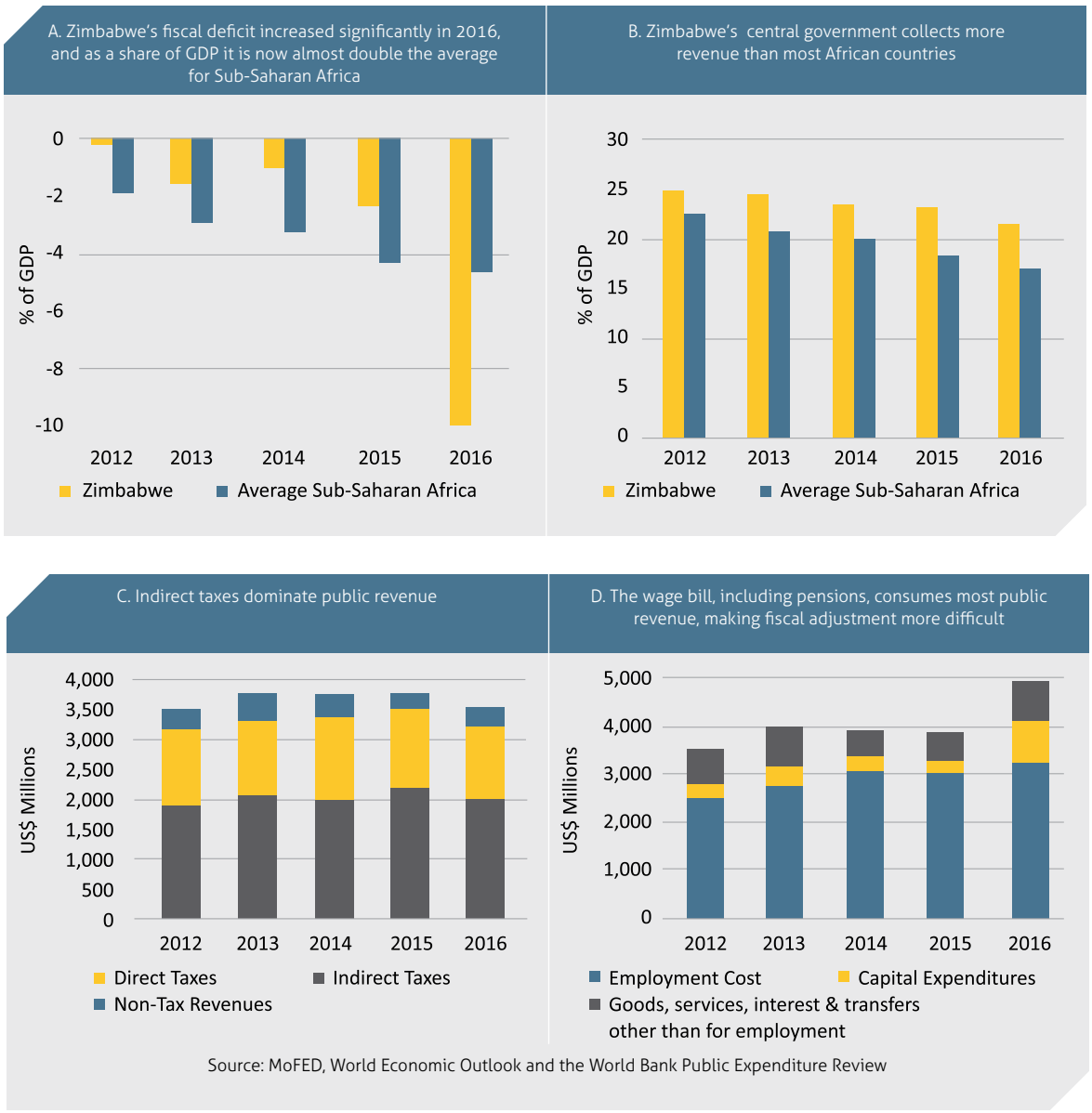
Rising personnel costs have also constrained the finances of LAs and SEPs, reducing their ability to deliver public goods and services. As their expanding wage bills have reduced the fiscal space for other current and capital spending, LAs have increasingly turned to user fees and other forms of extra-budgetary own-source revenue, further expanding the size and complexity of the public sector. Meanwhile, rising wage costs have deepened operating losses among SEPs, which already suffer from structural inefficiencies and a difficult economic environment.

The government will need to accelerate the implementation of structural reforms to restore fiscal sustainability while freeing resources for infrastructure investment and poverty-reduction programming. The government is currently designing measures to limit the growth of the wage bill and taking steps to improve the efficiency and accountability of SEPs. Accelerating growth and re-establishing sustainable fiscal dynamics will require integrating these efforts into a comprehensive reform program, which includes refocusing public spending on priority capital investment projects and social programs, improving the business environment through the transparent and consistent implementation of modern investment policies, and addressing the country's debt burden and governance challenges.

The central government wage bill is equivalent to 90% of public revenue and 66% of public spending.

[5] Government of Zimbabwe and World Bank (2017), Public Expenditure Review.

Figure 5: Key Fiscal Indicators, 2012-16



Source: MoFED, World Economic Outlook and the World Bank Public Expenditure Review

1.3 Monetary and Financial Sector Policy

In the wake of the liquidity shortage, credit to the private sector remains severely limited. In 2016, the government borrowed the equivalent of roughly 11 percent of GDP to finance the fiscal deficit and to pay for other commitments such as arrears. It raised the majority of this financing by an overdraft with the RBZ and by issuing Treasury bills to the private sector. Most of the Treasury bills were eventually bought by commercial banks at discounted rates. While this boosted the profitability of banks in the short term, the scale of the borrowing resulted in liquidity shortages across the financial sector. In response, banks placed daily restrictions on cash withdrawals, while the RBZ issued bond notes since November 28, 2016 and promoted the use of mobile payments ("plastic money").[6] Nevertheless, net outflows of US dollars have continued.

The financial sector remains vulnerable to both systemic weaknesses and policy risks. Bank assets continue to perform poorly, which coupled with balance-of-payments issues, operational inefficiencies and severe liquidity

[6] Bond notes are issued by the RBZ and legal tender in Zimbabwe at par with the US dollar and serve as a five percent export incentive.

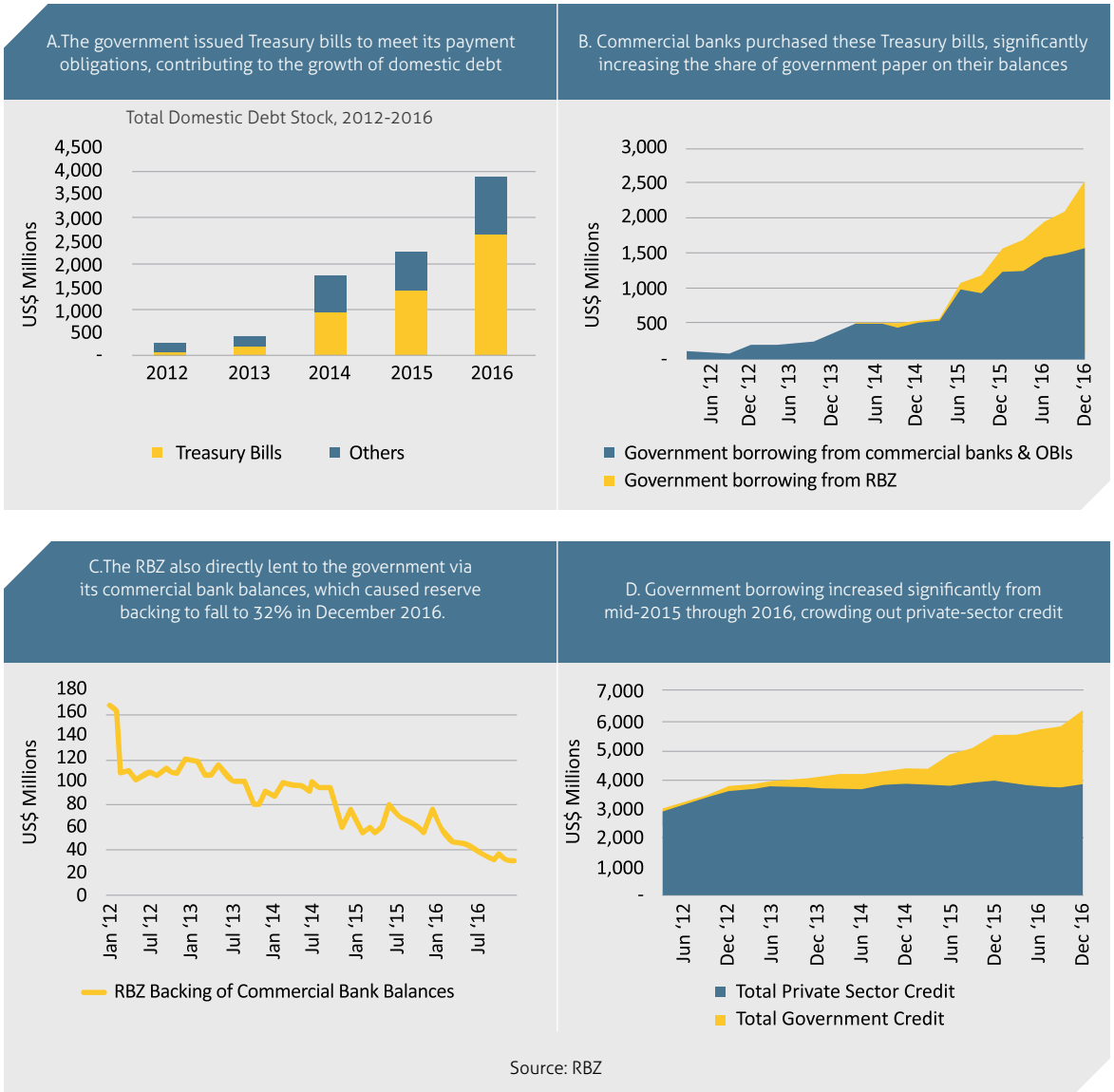
restrictions have significantly reduced profitability of the financial sector. Moreover, the sector remains vulnerable to further economic shocks, despite authorities' efforts to purchase NPLs through the Zimbabwe Asset Management Company (ZAMCO) until March 2017. Although capital adequacy levels have recovered to reasonable levels, assets are not sufficiently diversified with the financial sector particularly exposed to the public sector.

DEFLATION EASED FROM AN AVERAGE OF **-2.4%** IN 2015 TO **-1.6%** IN 2016

The domestic -interbank payment system continues to function, but Treasury bills are heavily discounted relative to cash. Depositors are unable to fully access cash deposits. Bank lending is limited, and lending interest rates are high, while deposit interest rates are too low to compensate for the risks involved. As a result, credit to the private sector remains scarce, and reduced lending rates are only generally available to a limited number of customers with exceptionally strong credit ratings (Figure 6D).

Year-on-year inflation turned positive in February 2017. Consumer prices began to increase in October 2016, driven by rising food prices and the appreciation of the South African rand against the US dollar. A well-functioning electronic payment system has increased liquidity, which was further bolstered by the introduction of bond notes in November 2016. As of May 10, 2017, the total value of bond notes in circulation was US$140 million.

Figure 6: Financial Sector Indicators, 2012-2016



Source: RBZ

1.4 The Balance of Payments

The liquidity shortages negatively affected the balance of payments. In 2016, Zimbabwe experienced net outflows of portfolio investment and other long-term capital, excluding foreign direct investment. This represented a dramatic reversal from the previous year, when Zimbabwe recorded a US$650 million inflow. By end-2016, gross international reserves had fallen to US$310 million, or just over 2 weeks of import cover—an inadequate buffer against a contraction in net capital inflows equal to 5 percentage points of GDP. As investor confidence shrank and capital inflows declined (Figure 7A) the current account adjusted (Figure 7D).

LIQUIDITY SHORTAGES SUPPRESSED IMPORTS WHICH FELL BY **13.6%** IN 2016

A decline in imports strengthened the current account balance, while exports increased modestly. The liquidity shortages eroded the purchasing power of importers, and goods imports fell by 13.6 percent between 2015 and 2016. Credit constraints have also prevented importers from making regular payments, causing an increase in the stock of private external arrears. Meanwhile, goods exports grew by 2.4 percent in 2016, driven by rising output in the mining sector. Data for the first quarter of 2017 suggest that this trend is continuing, though not as dramatically as in 2016.

Figure 7: Balance of Payments

Source: IMF 2017 World Economic Outlook and RBZ

KEY CHALLENGES INCLUDE:

1. REDUCING THE FISCAL DEFICIT
2. ATTRACTING INVESTMENT ON COMPETITIVE TERMS
3. MANAGING INFLATIONARY PRESSURES
4. RESTORING FINANCIAL SECTOR SOUNDNESS

Outlook and Challenges

While the GDP growth rate is expected to recover to 2.8 percent in 2017, several important challenges threaten Zimbabwe's medium-term outlook. As rainfall patterns return to normal, a revitalized agricultural sector is expected to underpin GDP growth in 2017. However, the 2016 fiscal deficit has largely exhausted the government's access to financing and limited the resources available for the 2017 budget and subsequent budgets. Domestic financial markets are too small to absorb the Government of Zimbabwe US$1 billion overdraft with the RBZ. Replacing this overdraft with Treasury bills and a domestic bond would further constrain the supply of credit to the private sector. Conversely, adding to the overdraft to finance the 2017 budget will increase the money supply and intensify inflationary pressures, which to date have been largely contained by administrative measures. Going forward, inflationary pressures and tighter controls are projected to limit growth. Although structural reforms, including improvements in the business climate, remain vital to Zimbabwe's economic development, in the short run they are not likely to fully offset the cost of foreign-exchange rationing. Critical fiscal adjustments and effective monetary policies will be required to reduce inflation.

Economic reforms and clearance of external arrears could lower Zimbabwe's risk premium and expand its access to international capital. Fiscal adjustment would reduce the government's reliance on monetary financing of the deficit and strengthen the financial sector. Similarly, structural reforms could help unlock Zimbabwe's agricultural and mining potential. Combining these reforms with the settlement of external payment arrears would amplify their impact. In October 2016, Zimbabwe settled US$108 million in arrears to the IMF's Poverty Reduction and Growth Trust, but the country remains in arears to the African Development Bank (US$610 million), the World Bank (US$1.2 billion), and the European Investment Bank (US$212 million). The government's Lima Proposal envisaged settling these arrears, then rescheduling Paris Club bilateral debt while launching a reform effort supported by an IMF financing program. Executing this plan would greatly strengthen Zimbabwe's fiscal position and improve its debt profile.

Zimbabwe's long-term growth prospects are strong. Zimbabwe possesses substantial human and natural resources, and it continues to spend more on education as a share of GDP than any other country in Sub-Saharan Africa. Continued growth in agriculture and mining could boost other sectors through

backward and forward linkages. Moreover, investors could leverage Zimbabwe's well-educated workforce to expand non-traditional service exports. Though Zimbabwe's infrastructure has deteriorated in recent years, a lower risk premium on international credit could facilitate access to capital and help to revive major industries.

While a good harvest is projected to boost GDP in 2017, sustaining robust long-term growth will require addressing underlying fiscal and financial-sector imbalances. A projected 20 percent rebound in agricultural output is expected to push the GDP growth rate to 2.8 percent in 2017. The recovery of agriculture will have positive spillover effects on other sectors, such as transportation, agro-processing, and manufacturing. Growth in 2017 is expected to be positive in per capita income terms, and positively impact on poor households. However, the recovery will have a much more modest effect on the fiscal sector, with public revenues growing only slightly. Meanwhile, it will take strong political commitment to reduce expenditures in the medium-term. Consequently, the resulting fiscal deficit will have to be primarily financed by the domestic financial sector. The resulting US dollar liquidity shortages will slow growth in the manufacturing and services sectors.

Given Zimbabwe's ongoing fiscal challenges, liquidity shortages are expected to continue for the foreseeable future, and exports are projected to grow modestly. Despite the anticipated liquidity shortages, the domestic electronic payment system is projected to continue to function effectively, allowing consumers and investors to access their bank deposits. However, inflows of cash deposits into the banking system are unlikely to recover swiftly after a period in which withdrawals were subject to quantitative restrictions. Export earnings will increase banking-system resources, but cash reserves will remain insufficient to meet demand for cash withdrawals. RBZ guidelines will direct export earnings to priority imports.

ADMINISTRATIVE MEASURES MAY BE CIRCUMVENTED BY A PARALLEL MARKET

The current account deficit is projected to narrow further. A difficult investment climate and the administrative allocation of export earnings have discouraged investment and reduced capital inflows. Portfolio investment and long-term capital inflows are unlikely to recover in absence of a major policy change. In this context, the current-account deficit is projected to narrow, as exports and current transfers will largely finance imports of goods and non-factor services. If the government continues to adopt complex administrative measures to manage foreign-exchange earnings, market-based pricing systems will also likely evolve, and importers who are ineligible for an administrative allocation may resort to these price-based systems in the parallel market.

The government is likely to continue to partially finance the fiscal deficit through financial sector intermediation. Financing the budget through bonds and Treasury bills would continue to crowd out lending to the private sector, while monetary financing through the RBZ overdraft will further undermine private sector confidence and may eventually boost inflation. Over the near term, inflation is projected to remain contained, boosting fiscal revenues. While expenditures will remain elevated, revenue growth will shrink the deficit and limit domestic financing of the budget.

Sector Projections

AGRICULTURE & MINING SHOULD **GROW** BUT REMAIN **VULNERABLE:** MANUFACTURING & SERVICES REQUIRE MACRO ADJUSTMENTS

The agricultural sector is projected to return to its long-term growth trend after 2017. Good rainfall in 2017 is expected to produce an unusually robust maize harvest, but after 2017 agricultural output will continue to fluctuate around its long-term average growth rate. Moreover, the 2017 harvest is threatened by late rains in May, which caused flooding, as well as limited warehouse capacity and the risk of "army worm" infiltration. Sustained agricultural growth will require investment in irrigation infrastructure, improved inputs, and more effective management. The authorities have liberalized some fertilizer inputs, and the Zimbabwe Asset Management Company has reallocated some land from commercial farmers who defaulted on their loans to contract farmers, whose management skills may boost output.

The mining sector is expected to continue growing, but it will remain vulnerable to macroeconomic conditions. Gold production, which accounts for half of the mining sector's foreign-exchange earnings, is expected to increase by 10 percent, and global gold prices are projected to remain broadly stable.[7] However gold producers are not legally regarded as exporters and cannot hold nostro (foreign exchange-denominated) accounts, which leaves them particularly exposed to liquidity constrains. Platinum and nickel production are expected to remain stable, as are projected prices. Chrome and diamonds are expected to drive growth in the mining sector following the removal of an export ban on unprocessed chrome and the anticipated resolution of lawsuits that are keeping some diamond mines closed.

The manufacturing sector requires investment and access to imports. Manufacturers have been protected from international competition since mid-2016 by administrative measures, but a sustained recovery will require investment and predictable access to capital- and intermediate-goods imports. In the absence of renewed capital inflows, investment in the manufacturing sector is projected to remain insufficient to trigger a recovery. Administrative management of liquidity shortages and the prioritization of certain imports further inhibits the recovery of the sector.

The services sector is unlikely to resume its role as the engine of economic growth. The sector comprises a broad range of activities, some of which are projected to grow rapidly while other remain exposed. The new airport in Victoria Falls should continue to have a positive impact on growth and tourism, but it is too isolated to trigger a broader recovery in the services sector, which remains constrained by liquidity shortages and controls on import payments. In 2018, new regulations to revalue securities at their market price will expose the fragility of the banking sector.

Risks and Opportunities

The authorities are aware of the risk that the fiscal deficit poses to banking-sector liquidity. The Minister of Finance and Economic Development highlighted this issue in Parliament on April 6, 2017. However, in the absence of consolidated fiscal accounts and an integrated debt-management system, government financing requirements may continue to rise (Box 1).

The use of administrative measures to manage fiscal and external imbalances could have unintended consequences. Administrative controls on import payments have helped narrow the current account deficit. These controls are designed to ensure that Zimbabwe's limited foreign-exchange earnings finance priority imports, but a lack of transparency could undermine public confidence

[7] World Bank Group. 2017. *Commodity Markets Outlook,* April. World Bank, Washington, DC.

in this policy.

The authorities have an opportunity to combine macroeconomic management reform with measures to enhance the business climate. In September 2015, the authorities began preparing legislation targeting key aspects of the business climate. These draft laws, several of which have already been submitted to Parliament, will:

1. Codify the President's announcement of Zimbabwe's Indigenization policies made on April 11, 2016, providing greater predictability to foreign investors;
2. Implement measures that allow for an efficient allocation and use of the most productive farmland in Zimbabwe including creation of an electronic registry of titles to land and other real property;
3. Improve transparency in and access to public tenders by local companies;
4. Establish a registry of movable assets that could be used as financial collateral;
5. Streamline processes for declaring insolvency and liquidating assets;
6. Modernize the judicial framework for settling commercial disputes;
7. Improve the business climate by easing the regulatory burden associated with founding and administering firms and by strengthening protections for minority investors.
8. Strengthen corporate governance and performance accountabilities in SEPs.

Table 1: Selected Macroeconomic Indicators, Estimated and Projected, 2014-2019

	2014	2015	2016	2017f	2018f	2019f
Real GDP Growth, at constant market prices	2.8	1.4	0.7	2.8	0.9	0.2
Private Consumption	-4.9	7.8	-16.2	7.4	-1.3	-0.2
Government Consumption	19.6	2.7	11.5	-2.3	-3.9	-1.8
Gross Fixed Capital Investment	8.4	4.7	21.2	-9.0	-2.8	-0.6
Exports of Goods and Services	-3.1	-5.5	2.3	2.2	2.1	3.3
Imports of Goods and Services	-8.4	13.7	-13.4	-0.1	-13.0	-4.1
Real GDP Growth by sector	2.8	1.5	0.7	2.6	0.9	0.2
Agriculture	25	-4.7	-3.7	20.0	3.0	2.5
Industry	-1.4	0.0	0.8	1.1	1.4	1.2
Services	1.3	3.9	1.7	-0.5	0.1	-0.9
Inflation (private consumption deflator)	-0.2	-2.4	-1.6	3.2	9.6	8.8
Current-Account Balance (% of GDP)	-16.9	-10.6	-4.7	-4.1	-1.0	-0.4
Fiscal Balance on cash basis (% of GDP)	-1.0	-2.3	-10.0	-7.0	-4.9	-4.7
Debt (% of GDP)	51.6	55.6	70.2	73.3	72.2	71
Primary Balance on cash basis (% of GDP)	-0.7	-1.7	-9.2	-5.9	-3.5	-2.8

Note: These projections assume no change in Zimbabwe's risk premium and access to capital inflows.

Source: MoFED

Box 1: A Consolidated Public Sector?

The public sector in Zimbabwe is estimated to account for roughly 50 percent of GDP (see footnote 1 on page viii). This size of the public sector is very unusual in fast growing economies, as it generally crowds out private enterprises. The exceptions to this are several of the Nordic countries where the public sectors are highly efficient, and rarely fragmented.

Central government revenues and expenditures only account for around half of the public sector and are used mainly to pay wages of a large civil service. Zimbabwe's wage bill as a share of government revenues is more than double the average shares in SADC, sub-Saharan Africa, and low income countries. The remaining half of public spending is divided across a range of entities, including statutory extra-budgetary funds such as Zimbabwe National Road Authority, local authorities, state-owned enterprises and parastatals (SEPs), other extra-budgetary funds such as user fees at schools and medical facilities, and donor-funded projects.

The Government, the Parliament and the public in general have had incomplete and piecemeal information with which to manage and hold accountable the public sector. Central government has published monthly and quarterly consolidated financial statements regularly since 2011 and audit reports have been submitted on time to Parliament since 2015. However, accounts of extra-budgetary funds, local authorities and SEPs have not been published in a timely manner. In many cases these have not been easily accessible even within government by different oversight entities.

The fragmentation of resources makes it difficult to coordinate spending and policy implementation, and to ensure clear accountabilities. The combination of 27 line ministries, 107 SEPs, 95 local government units raises the likelihood of duplication or inconsistencies, if not coordinated through an effective spending accountability framework. Overlapping programs with their own structures/staff may be duplicating fixed administrative costs across government which limits their actual coverage and impact on the ground. Fragmentation also makes it difficult to ensure that resources are well-targeted, and may in fact exacerbate rather than address inequalities.

Efforts are underway to consolidate information toward better accountability:

- Since 2015, Government collates spending estimates from different sources, including donor-financed projects, in the Estimates Book of Expenditure ("Bluebook") for information, but these are not yet consolidated into public sector accounts against which actual spending could be monitored.
- The authorities are expanding coverage of the Integrated Financial Management Information System (IFMIS), which currently operates in all ministries and provincial capitals, to local authorities.
- The Government is strengthening the link between the Human Resources Management Information System and the IFMIS to better monitor spending on the wage bill.
- The State Enterprises Restructuring Agency has collected all the audited accounts for SEPs for the past five years and established a new website to make these accessible to the public.
- The 2010 Audit Act expanded powers of Auditor General to local authorities, SEPs and foreign missions. In 2016, audit reports were submitted and considered by Parliament for 47 local authorities, 20 foreign missions, 80 miscellaneous funds and 84 SEPs.
- The Public Accounts and other Committees in Parliament have received extensive training and capacity building to better review accounts and audits of public spending and Parliament has established a new Parliamentary Budget Office.

CHAPTER 2

LOCAL AUTHORITIES

2.1 Introduction

Local authorities (LAs) deliver many vital public services in Zimbabwe, but they face serious financial imbalances and capacity constraints. This chapter examines the role of LAs in the Zimbabwean public sector, with a focus on urban councils. The analysis reveals key financial challenges that weaken the ability of LAs to provide quality public services while undermining the fiscal stability of the government as a whole.

LOCAL AUTHORITIES REVENUES HAVE **STRUGGLED** TO KEEP PACE WITH SERVICE DELIVERY NEEDS AND EXPENDITURE GROWTH

LA revenues are not commensurate with their administrative responsibilities. LAs are responsible for a wide range of policy areas, including housing and land management, local road networks, public lighting, solid waste disposal, and public water and sanitation systems. LAs are financed by a combination of central government transfers, various user fees, and proceeds from the sale of local assets such as real estate. However, LA revenues are often insufficient to

meet their financial obligations, leading to mounting subnational debt burdens and widening gaps in service delivery.

LA revenues are neither reliable nor sustainable. While the 2013 Constitution mandates that the central government to share revenues with LAs, this provision has not yet been implemented. LAs rely on user fees to cover the cost of public service delivery, but these fees are approved by the central government or sectoral regulators. Inadequate revenue potential is exacerbated by the limited capacity of many LAs to collect revenues efficiently or manage their finances effectively. Persistent financial imbalances have led many LAs to turn to one-off income sources, such as sales of public land, and to unsustainable debt accumulation.

Personnel costs consume the largest share of LA budgets, leaving little room for capital investment or spending on operations and maintenance. Since 2011, employment costs have represented, on average, over 40 percent of total LA spending. During 2011-14, LA revenues fell while employment costs increased. Administrative, financial, and management costs represent nearly a quarter of all LA spending, and these costs are increasing relative to spending on service delivery. An analysis of water supply, sewerage, and solid waste disposal expenditures by eight LAs found low levels of spending on operations and maintenance, leading to a decline in service delivery over time.

THE **MAJORITY** OF
LOCAL AUTHORITIES RAISE
MOST OF THEIR REVENUES
INTERNALLY

Going forward, LAs will need to strengthen their financial management capacity. LAs must establish systems to better manage spending, control deficits and debt levels, improve revenue collection, maintain hard wage-bill ceilings, and ensure that adequate resources are available for priority nonwage expenditures. Meanwhile, the central government must fully implement the Constitutional provision mandating revenue-sharing with LAs.

2.1.1 Legal and Institutional Context

The Urban Councils Act and the Rural District Councils Act govern the establishment of LAs in urban and rural areas. The Ministry of Local Government, Public Works, and National Housing oversees urban councils, while the Ministry of Rural Development and Preservation of National Cultural Heritage oversees rural communities. These two ministries provide the legislative and policy framework within which LAs operate. The Ministry of Finance and Economic Development plays an important role in financing capital investments implemented by LAs. The Local Government Board established under the Urban Councils Act approves appointments and dismissals of senior local council members, and the Minister is empowered to dissolve local councils and to dismiss councilors and mayors. LAs also work with a range of civil-society organizations, including professional networks, community groups, and resident associations.

The 2013 Constitution greatly expanded both the powers and responsibilities of LAs. The Constitution authorized LAs to raise own-source revenues, subject to the approval of the Minister of Local Government, and established a framework for intergovernmental transfers. The Urban Councils Act allows urban councils, with the consent of the Ministries of Local Government and Finance, to issue stocks, bonds, bills, and other debt and equity instruments.

2.2 LA Revenues and Expenditures

2.2.1 Revenues

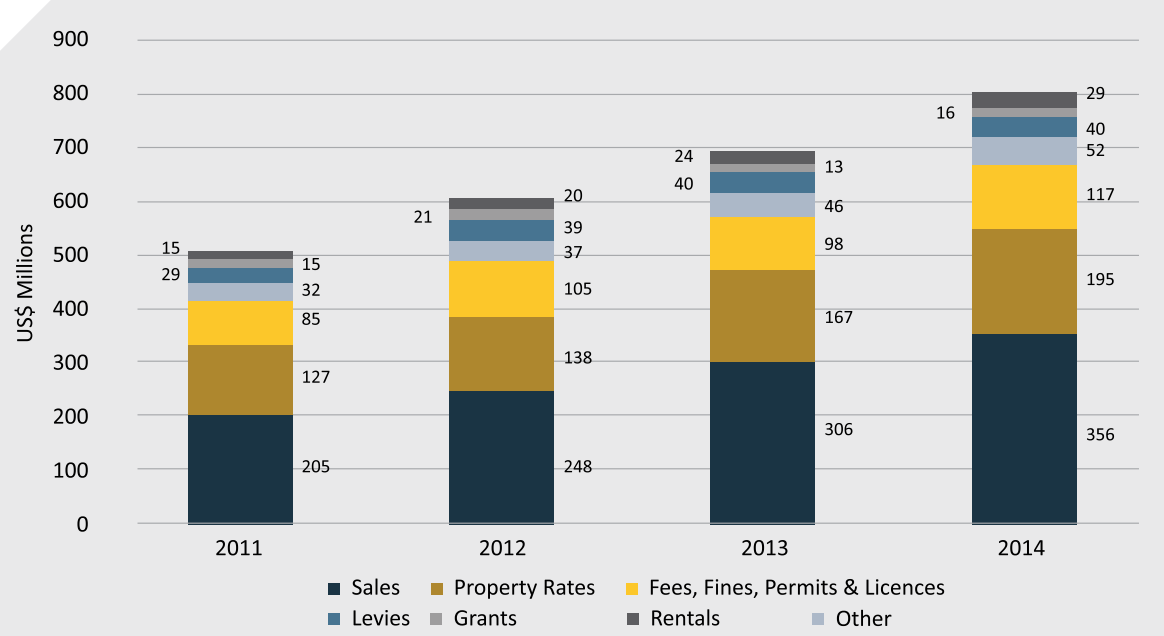
LA REVENUES **ROSE** BY
60%
BETWEEN 2011 AND 2014

LAs receive some transfers from the central government, but user fees for local services finance a large and growing share of local expenditures. While the Constitution states that at least 5 percent of national revenues should be allocated to LAs, actual intergovernmental transfers do not always reach this level. Most LAs now raise the majority of their own revenues internally through various fees, levies, fines, permit and license charges, as well as property taxes, and asset sales. LAs impose fees for services such as parking, sewerage, solid waste disposal, and commercial/industrial and domestic water services. LAs also charge user fees at local hospitals, clinics, schools, libraries, and other community facilities. Some LAs raise funds through income-generating activities, and some have access to loans and grants from external donors.

THE MAJORITY
OF THIS INCREASE CAME FROM
ESTATE SALES
WHICH GREW BY **75%**

LA revenues rose from US$570 million (5.2 percent of GDP) in 2011 to just over $800 million (6.4 percent of GDP) in 2014. Much of this increase came from residential and industrial real-estate sales which grew by 75 percent, as land prices have risen sharply in recent years. Rising land prices have also boosted property-tax revenue. In addition, revenue from fees, fines, and charges for permits and licenses rose by 37 percent between 2011 and 2014 (Figure 8).

Figure 8: Trends in LA Revenue by Source, 2011-2014 (US$ millions)



Source: Local Authorities and Auditor General

However, the growth of some revenue sources did not meet expectations. Tightening fiscal constraints at the central level limited the flow of intergovernmental grants and investment transfers. The limited flow of grants intensified pressure on LAs to increase their own-source revenue capacity, but challenging economic circumstances and constraints on fees and rates limited their ability to do so. There is no system in place to execute the Constitutionally-mandated transfer of revenues from the central government to LAs. The government has not yet defined the formula or mechanism for revenue-sharing. In addition, most income-generating projects run by LAs (such as farming activities and entertainment halls) failed to cover their operating expenses, and these projects were often poorly managed and/or economically unviable.

Most income-generating projects run by LAs failed to cover their operating expenses.

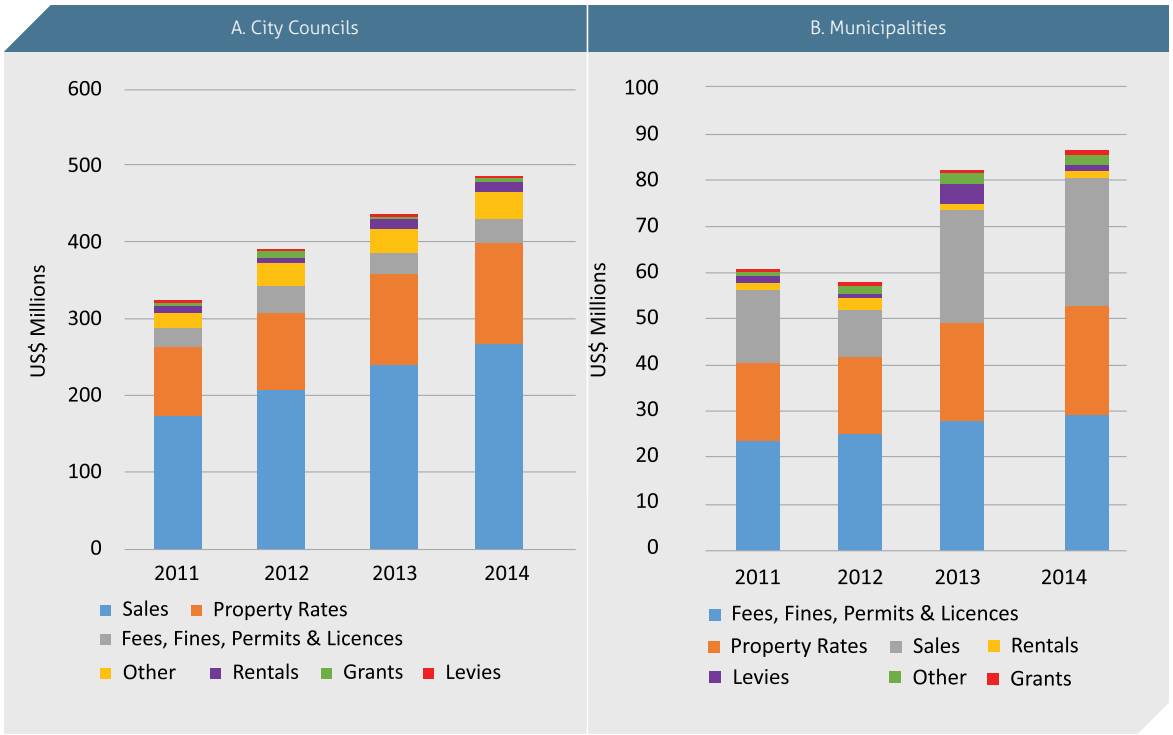
In 2009, the authority to license vehicles on behalf of the Ministry of Transport and Infrastructure Development — and to collect the associated fees—was transferred from LAs to Post Office and Savings Bank. Prior to the transfer the LAs received 10 percent of the license fees as payment for their services. In addition, Ministry disbursed a portion of its licensing revenue to LAs based on local traffic levels and road classes and condition. The loss of the 10 percent license fees was not compensated after the transfer of the collection of the fees.

A debt write-off in 2013 was followed by a rapid increase in payment arrears for local services, as residents appear to be delaying payment in the hope of another write-off. In 2013, the Ministry of Local Government issued a directive requiring LAs to write off arrears owed by residential taxpayers. Residential tax revenue has since continued to underperform.

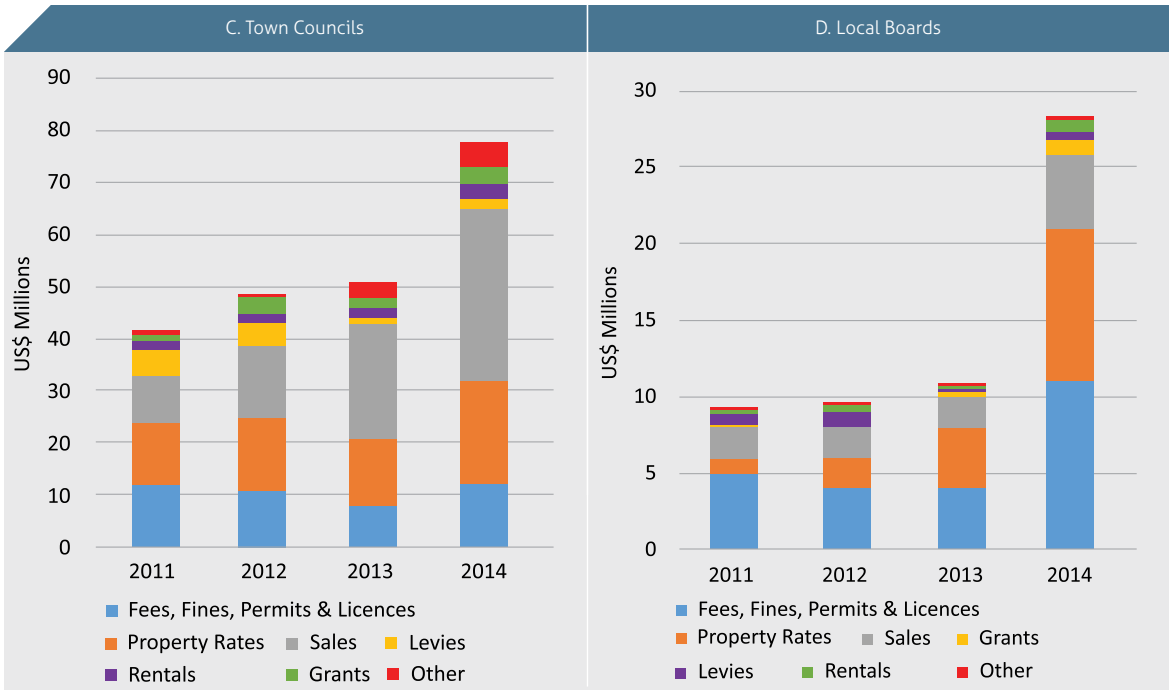
Some LAs are also bound by restrictions on user fees. For instance, certain LAs are required to charge customers rates for water services that are only marginally higher than what Zimbabwe National Water Authority (ZINWA) charges the LAs for water supply. The inability of LAs to cover the cost of local services is particularly acute in low-income areas. To improve collection efficiency and reduce waste, about a third of Zimbabwe's urban LAs are now piloting the use of prepaid water meters.

Ultimately, resource mobilization performance depends on LA's revenue structures and the strength of their local economies.[8] For example, city and town councils often depend primarily on revenue from asset sales, followed by property taxes, while municipal councils and local boards tend to rely on fees, fines, permits and licenses, with property taxes again playing a secondary role (Figure 9).

Figure 9: Disaggregated Local Government Revenues (US$ millions)



[8] Urban councils classified according to status, structure, power, authority and resources. City Councils are the largest, followed by Town Councils, Municipal Councils, and finally Local Boards.



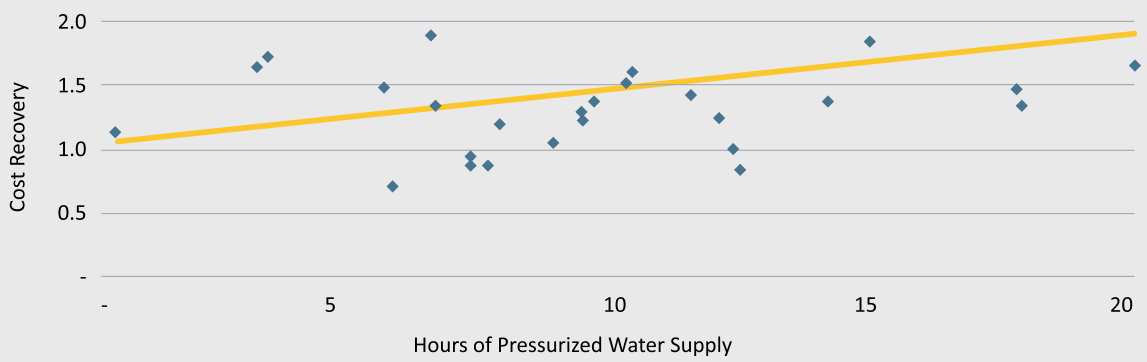
Source: Local Authorities and Auditor General

HIGHER COST RECOVERY WOULD SUPPORT EXPANDED **COVERAGE** OF WASTE COLLECTION, SEWERAGE AND WATER SERVICES

Given the varied financial performance and management capacities across LAs, there is inadequate legislative guidance to promote both equity and efficiency in own-source revenue collection at the local level.[9] The Ministry of Local Government has the authority to approve tariffs and has adopted a broad mandate to ensure local revenue generation is adequate. However, in practice the focus tends to be on achieving cost recovery for water and sewerage tariffs applied to urban consumers. Data from a recent Service Level Benchmarking Survey suggest that greater cost recovery would enable LAs to provide better waste collection, sewerage, and water-service coverage (Figure 10).

[9] These include water utilities, solid-waste disposal services, residential and commercial sewerage, and other services provided by LAs under the Urban Councils Act and the Rural District Councils Act.

Figure 10: Cost Recovery among Water Utilities and Water-Service Coverage, All Urban Local Authorities, 2012-2015 Average

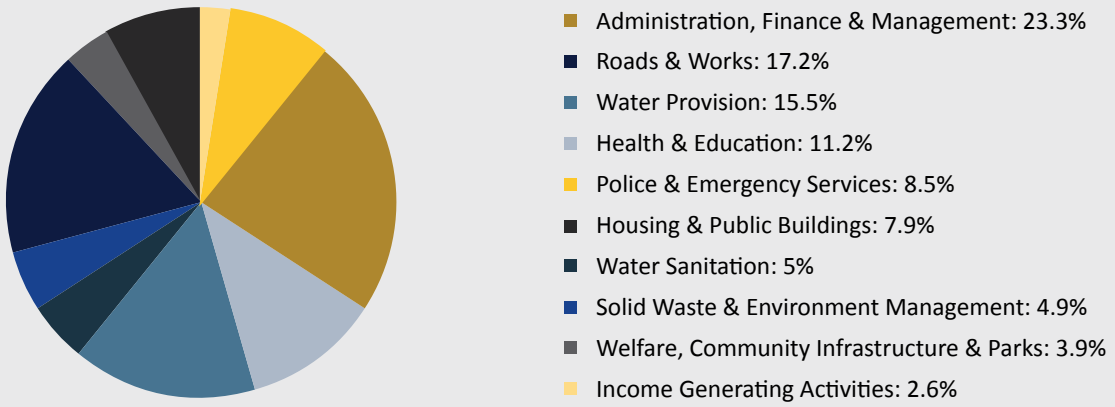


Source: Service Level Benchmarking Surveys, 2012-2015

2.2.2 Local Government Spending

Since 2013, LAs have assumed responsibility for an expanding range of public services. Administrative, finance, and management costs represent the largest share of LA expenditures (Figure 11). Roads and related public works make up the second largest share, though these costs have fallen in recent years due to the changes in vehicle-licensing authority described above. Other large LA spending categories include water utilities and education and health services. Transfers from the central government are unevenly distributed across expenditure areas. For example, intergovernmental transfers fund mainly the health and education wage bill, while user fees tend to cover administrative costs, maintenance, and capital investment.

Figure 11: Aggregate Budget of Selected Local Authorities by Expenditure Area, 2011-15 Total



Source: Local Authorities and Auditor General

FROM 2011 TO 2014
LOCAL AUTHORITIES' EXPENDITURES GREW BY 132%

From 2011 to 2014, rapidly rising personnel costs, administrative and interest expenses caused LA expenditures to grow by 132 percent, from US$556 million to US$1.3 billion. Rising personnel costs have crowded out capital investment and nonwage recurrent expenditures, including spending on repairs and maintenance. Personnel costs dominate local government expenditures, accounting for an average of over 40 percent of LA spending since 2011 (Figure 12), although the Ministry of Local Government has set a target ratio of 30:70 for personnel to non-personnel spending. From 2011 to 2014, just 7 percent of LA expenditures was devoted to repairs and maintenance, including spending on council roads and transportation-related services.[10]

Figure 12: Revenue and Expenditure Trends among Local Authorities, 2011-14 (US$ millions)

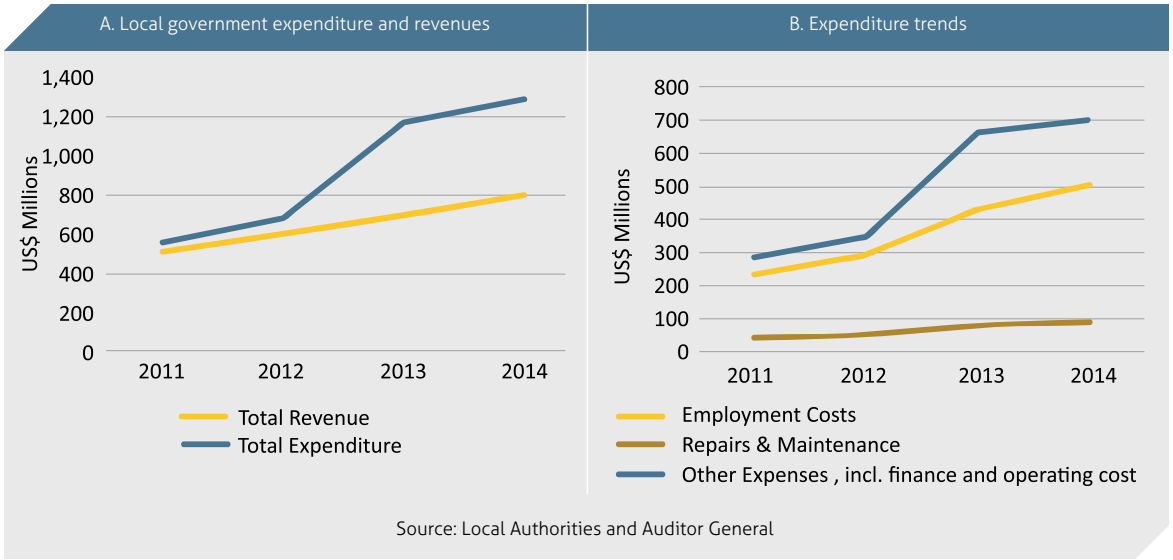
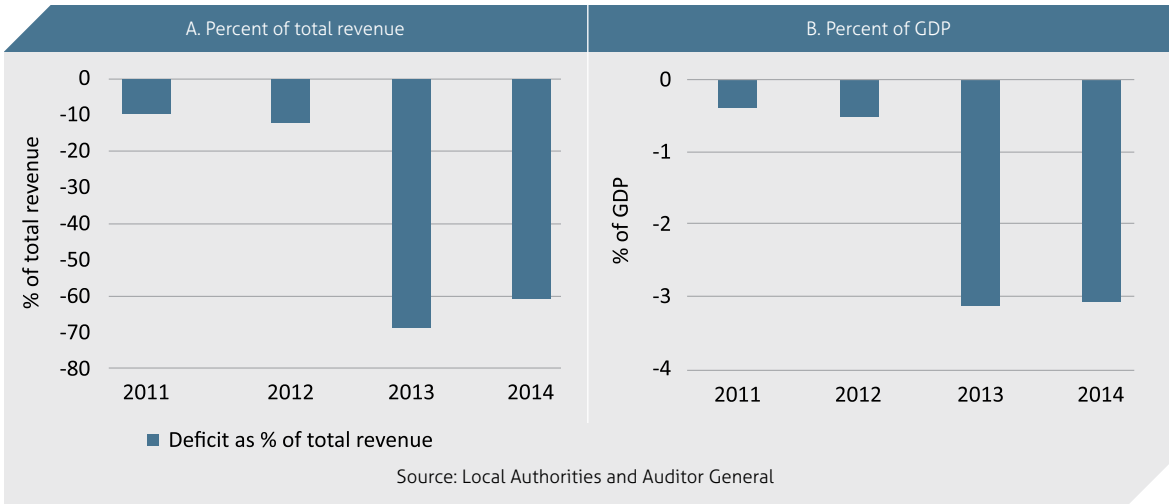


Figure 13: Local Authorities' Aggregate Fiscal Deficit



[10] LAs with capital expenditures below the recommended level include Bulawayo, Chegutu, Epworth, Gweru, Harare, Lupane, Marondera, Plumtree and Rusape. Together, these areas are home to over half of Zimbabwe's urban population.

Persistent deficits are a threat to service delivery. Among selected LAs, spending on service delivery—including health and education, roads and public works, social welfare, and community infrastructure—declined between 2012 and 2015 (Table 2). The largest expenditure category is administrative, financial, and management costs. The growth of this category is narrowing the resource envelope for all other forms of spending.

Table 2: Expenditures by Category, Selected Local Authorities, 2012-14 (%)

	Actual				
	2012	2013	2014	2015	Ave
Administrative, Finance, and Management	21%	18%	29%	26%	23%
Health and Education	13%	10%	12%	11%	11%
Water Supply	12%	15%	19%	16%	15%
Water Sanitation	4%	7%	3%	5%	5%
Solid Waste and Environ. Management	5%	6%	4%	4%	5%
Roads and Works	24%	18%	11%	16%	17%
Welfare, Community Infra., and Parks	5%	3%	4%	3%	4%
Housing and Public Buildings	4%	13%	6%	6%	8%
Income Generating Activities	3%	2%	2%	3%	3%
Police and Emergency Services	9%	7%	10%	9%	8%
TOTAL	**100%**	**100%**	**100%**	**100%**	**100%**

Source: Ministry of Local Government

2.3 Fiscal Challenges

Expenditure growth among LAs has outpaced revenue growth, and small intergovernmental transfers have exacerbated fiscal imbalances at the local level. Central government debt to LAs reached US$36 million in March 2016. Moreover, the central government's control over changes in fees and tariff rates constrains the ability of LAs to respond to financial shortfalls.

In addition to financial constraints, LAs face a range of other factors that limit their ability to fulfill their mandates. These include: (i) an ongoing urbanization process that has strained the country's ageing urban infrastructure;[11] (ii) the 2008 cholera epidemic exposed the inadequate state of local water and sanitation infrastructure; and (iii) hyperinflation and dollarization, which contributed to the decline of intergovernmental transfers and loans for local investment. An annual benchmarking survey found that just under half of participating urban LAs could provide at least 15 hours of water service per day.

THE AVERAGE DEBT OF LOCAL AUTHORITIES **INCREASED BY 21.2%** FROM 2014 TO 2015

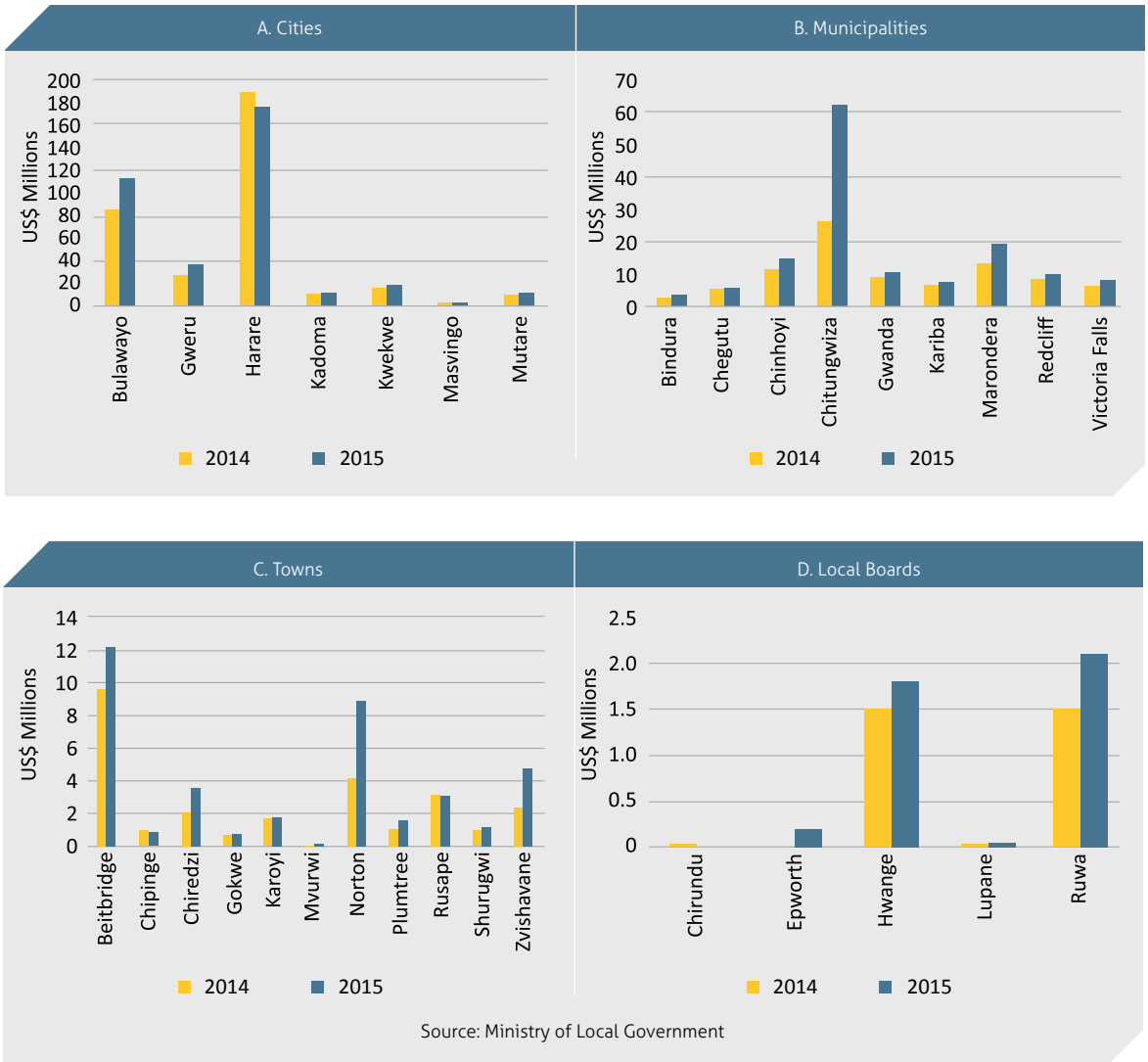
LAs face three major challenges, the first of which will be to improve service provision despite inadequate funding for either capital investment or recurrent expenditures. Local officials must frequently divert capital budgets to cover recurrent expenditures, especially wages. Consequently, much of the local

[11] In the wake of the cholera epidemic, the central government, LAs, and donors implemented emergency investments in water and sanitation infrastructure. However, these investments were insufficient to meet the needs of the population.

infrastructure stock is outdated and poorly maintained. Many LAs also lack the institutional capacity to deliver quality services across multiple sectors.

The second challenge will be to manage a rising debt stock. LAs have accumulated large debts in recent years, as the aggregate LA fiscal deficit rose from 9.3 percent of total revenue in 2011 to 60.7 percent in 2014. City councils, and, to a lesser extent, municipalities, have run especially large deficits. The average LA debt stock increased by 21.2 percent between 2014 and 2015. The total LA debt burden reached an estimated US$555 million in 2015, or about 105 percent of total LA revenue (Figure 13).[12] LAs have financed their deficits primarily by taking out expensive loans from the financial sector, opening overdraft facilities, or in many cases running salary and payment arrears (Figure 14). The rising debt burden has contributed to rising finance costs (Table 2) that drain resources away from service delivery.

Figure 14: Debts Across Local Authorities

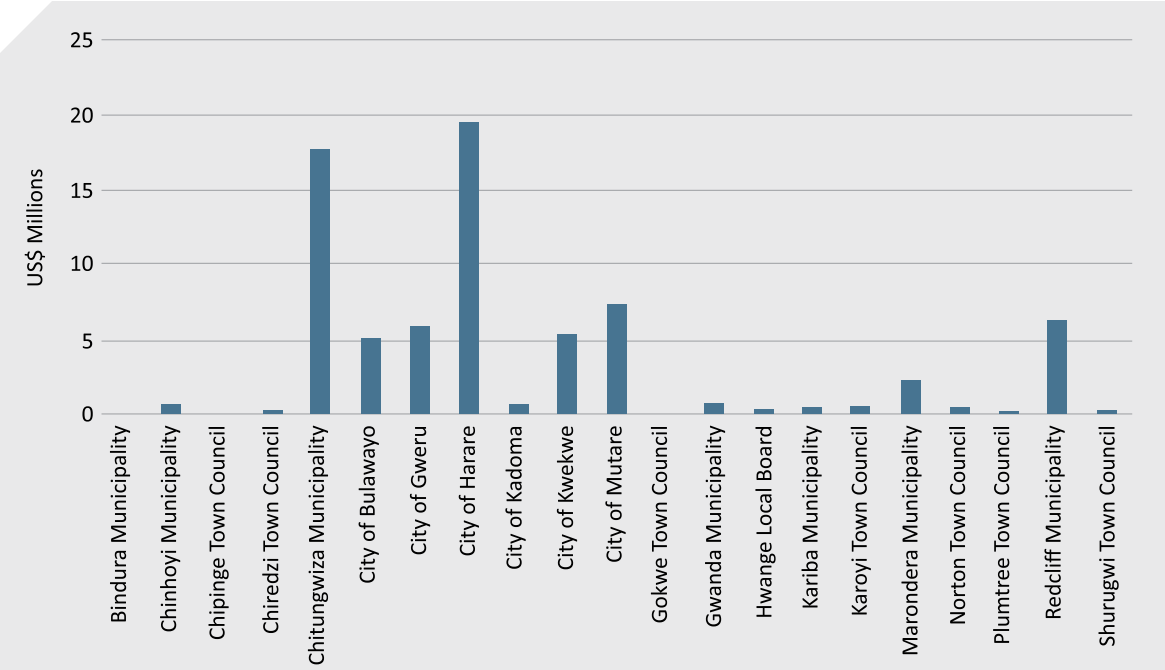


Source: Ministry of Local Government

[12] In the wake of the cholera epidemic, the central government, LAs, and donors implemented emergency investments in water and sanitation infrastructure. However, these investments were insufficient to meet the needs of the population.

The third challenge will be to cope with the end of exhaustible revenue streams. Many LAs have supplemented their revenues by selling off public assets. While this has helped cover financial gaps in the short run, it is inherently unsustainable. In some cases, the sale of public assets has negatively affected the ability of LAs to deliver services.

Figure 15: Salary Arrears, 2015 (US$ millions)



Source: Ministry of Local Government

2.4 Policy Options

Though the performance of LAs has improved since 2011, progress has been slow. Efforts to improve the quality and quantity of services provided at the local level are hindered by: large and growing fiscal deficits among LAs; a steady increase in demand for local services without a commensurate increase in resources; the low operational efficiency of most LAs; and weak governance systems among some LAs

POLICY OPTIONS TO ADDRESS THESE CHALLENGES INCLUDE:

MINISTRY OF LOCAL GOVERNMENT OBJECTIVES:

- LIMIT PERSONNEL COSTS TO NO MORE THAN 30% OF TOTAL SPENDING
- REDUCE SUBNATIONAL DEBT LEVELS
- IMPROVE LOCAL PFM SYSTEMS
- STRENGTHEN REVENUE CAPACITY

1 Reform the Intergovernmental Transfer System

Revenue disparities among LAs reflect local economic differences, which are compounded by the inconsistent application of revenue rules. The authorities could improve distributional equity by aligning intergovernmental transfers with local needs and revenue capabilities, particularly in areas with a large share of poor households.

2 Rationalize Personnel Costs

The Ministry of Local Government's target for personnel spending (30 percent of total spending) would be more useful if it were integrated into a broader effort to improve public administration at the local level. As part of this effort, LAs should establish systems to monitor recruitment, wages, benefits, and personnel performance.

3 Control Subnational Debt Accumulation

LAs must tighten control over their fiscal deficits to maintain debt sustainability and mitigate financial risks. To curtail excessive borrowing, the Ministry of Local Government should consider implementing a "traffic-light system" similar to that used in Colombia, which regulates the ability of LAs to assume debt based on transparent, objective evaluation criteria.

4 Improve Financial Management

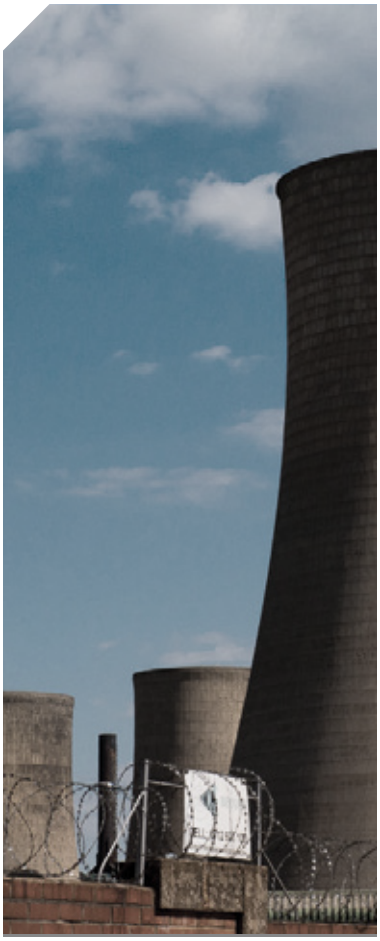
Building the financial management capacity of LA staff could enhance expenditure efficiency. A combination of staff training and institutional reform could enable LAs to better manage resources and deploy them more effectively while maintaining a sustainable financial stance.

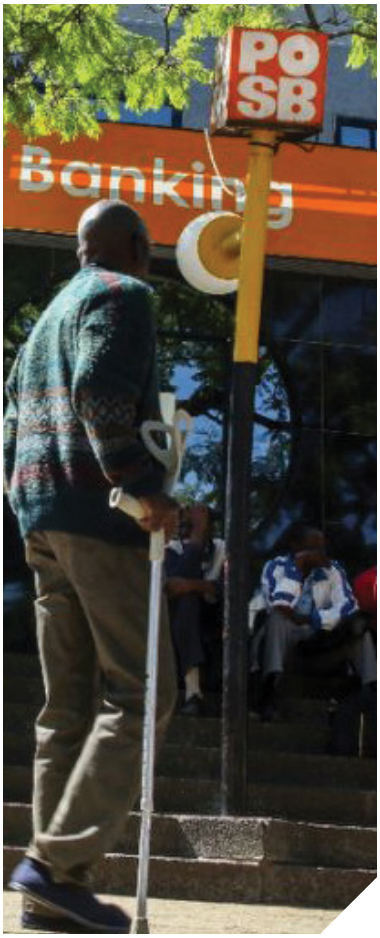
5 Strengthen the property tax policies and enforcement

Property taxes represent one-fifth of all LA revenue. However, many LAs lack functional property-registration systems, while others lack complete and up-to-date property valuations. Efforts to strengthen property registration and valuation mechanisms could increase LA revenue.

CHAPTER 3

STATE-OWNED ENTERPRISES





3.1 Introduction

State-owned enterprises and parastatals (SEPs) play an important role in the Zimbabwean economy, but their poor financial and operational performance has limited their impact. In 1980, Zimbabwe had just 20 SEPs. Despite privatization efforts undertaken since the 1990s, that number has since risen to 107. Zimbabwean SEPs drive investment and job creation in key sectors, provide vital public services, and implement public policies. The analysis presented in this section focuses on 38 of the 43 commercial state enterprises that operate on a cost-recovery or for-profit basis, most of which are active in the energy, transportation, communications, and agricultural sectors.[13]

107 SEPs
OF WHICH **43** ARE
WHOLLY COMMERCIAL

[13] See Annex 1 for a list of the 38 commercial SEPs examined in this section.

Most Zimbabwean SEPs operate at a loss and require public subsidies to remain solvent—and some have accumulated significant tax arrears. Of the 38 SEPs examined here, only five do not require public support. Expensive or unavailable financing, low rates of revenue collection, and operational inefficiencies have prevented some SEPs from covering their long-run marginal costs. Moreover, the recent deterioration of the macroeconomic environment, combined with weak SEP governance and oversight, has further undermined their performance.

SEPs are a major source of fiscal risks. The sector is a net drain on public finances. Taxes and dividends paid by commercial SEPs have declined, SEP tax liabilities have grown, transfers from the government to SEPs have increased and the central government has accumulated some payment arrears to SEPs that deliver public services. The absence of effective oversight has also allowed SEPs to accumulate liabilities through extensive financial linkages and complex cross-debts, which intensify systemic fiscal risks.

Although various institutions are responsible for SEP governance and oversight, accountability and monitoring have been weak. SEPs have traditionally reported to individual ministries in their respective sectors, while agencies with broader mandates, such as the State Enterprises Restructuring Agency, the Ministry of Finance and Economic Development (MoFED) and even the Office of the President and Cabinet have not received adequate information to provide broader oversight.

The government has prepared a new draft law on SEP corporate governance and is taking steps to strengthen enforcement of reporting requirements. Improving corporate governance, operations management, financial transparency, and subsidy targeting among SEPs, while also containing personnel costs, would limit the fiscal risks posed by SEPs, and enhance their contribution to the economy as a whole.

3.2 The Role of SEPs in the Zimbabwean Economy

SEPs REPRESENT ABOUT

15.3%

OF ZIMBAWBE'S GDP AND...

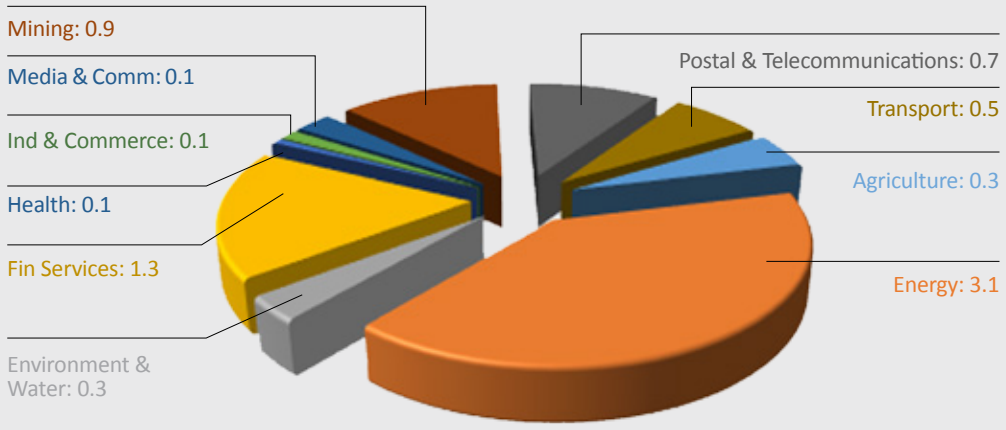
18%

OF PUBLIC SECTOR EMPLOYMENT

SEPs make a significant contribution to economic activity in Zimbabwe, but their relative economic importance has declined in recent years. Just 43 of Zimbabwe's 107 SEPs are wholly commercial enterprises. Commercial SEPs are concentrated in the energy, transportation, communications, and agricultural sectors, where they both provide essential public services and implement government policies. Most noncommercial SEPs are regulators, research organizations, and tertiary education institutions. Some SEPs combine regulatory and commercial functions, which can create conflicts of interest and undermine performance incentives. SEPs contribute to public revenue through taxes and dividends, but the net flows today are negative.

SEPs represent about 14 percent of Zimbabwe's GDP, with commercial SOEs contributing about 7.5 percent. SEPs' combined share in GDP fell from an estimated 16.4 percent in 2009 to 12 percent in 2014, while the contribution of solely commercial SEPs slid from 8.3 percent to 6.9 percent. SEPs in the energy sector were the largest contributor to GDP at just over 3 percent, followed by SEPs in the services and financial sectors, each of which represent just over 1 percent (Figure 16).

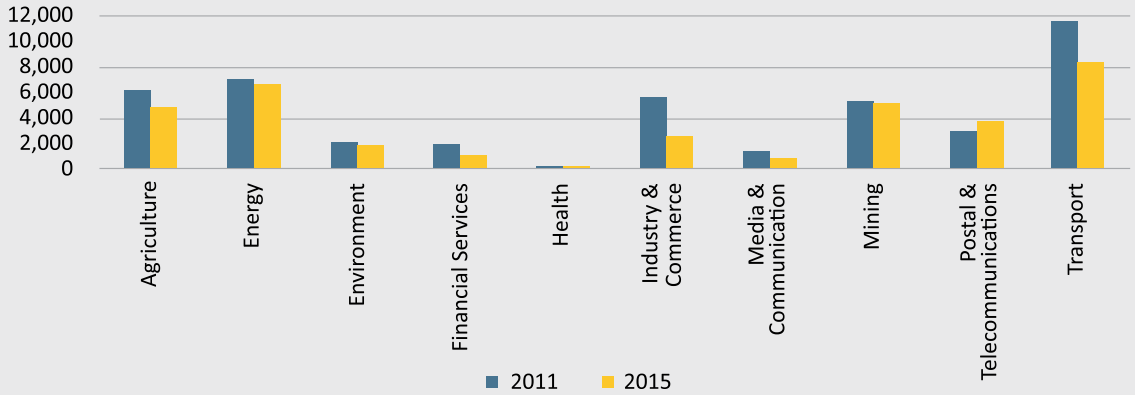
Figure 16: SEPs' Contribution to GDP by Sector, 2012-2014 Average (%)



Source: Audited Financial Statements: Data compiled by World Bank Staff

SEPs accounted for 5 percent of formal employment and 18 percent of public sector employment during 2011-14, but these shares have also fallen over time. Zimbabwe's SEPs employed an estimated 36,171 people in 2015, down 18 percent from a peak of about 44,000 in 2011. The transportation sector remains the largest employer, followed by the energy sector (Figure17). SEPs in the energy and mining sectors maintained employment, even as total SEP employment has declined.

Figure 17: SEP Employment by Sector



Source: Audited Financial Statements: Data compiled by World Bank Staff

Many SEPs assist the central government in implementing social policies, particularly those involved in the electricity, water, and agricultural sectors. These policies include increasing service access and lowering costs for poor households, stabilizing markets for small producers, and encouraging private investment in certain sectors. The Grain Marketing Board (GMB) maintains a strategic grain reserve, stabilizes grain prices, and finances the provision of inputs to farmers. The Zimbabwe Electricity Supply Authority (ZESA) and the Zimbabwe National Water Authority (ZINWA) provide access to affordable electricity, water supply and sanitation. How these social policies are financed and targeted has an

important impact on the long-term sustainability of the services that SEPs provide. For example, while ZESA and ZINWA receive public funds to expand coverage to affordable electricity and water services, these transfers plus their own-source revenues are not sufficient to cover their total costs, and both operate at a loss.

Box 2: SOE Performance in the Electricity Sector

ZESA dominates Zimbabwe's electricity sector. Despite a recent increase in private-sector participation, ZESA still controls most of the country's electricity generation and transmission capacity through its subsidiaries, the Zimbabwe Electricity and Transmission and Distribution Company (ZETDC) and Zimbabwe Power Company (ZPC).

However, ZESA has been operating at a loss since 2012. ZESA has faced corporate governance challenges, including the lack of a board of directors and a performance agreement for its major subsidiary, the Zimbabwe Power Company, while a significant increase in personnel costs has crowded out spending in other areas.

ZESA's customers do not make timely payments for services, and they pay below-cost rates. The government's 2013 decision to write off more than US$80 million in consumer arrears to ZESA further weakened its financial position, and by September 2016, consumer arrears had risen to US$987 million. Sectors with unpaid electricity bills included mining (US$52 million), manufacturing (US$210 million), and other commercial activities (US$436 million). In addition, domestic consumers owed US$294 million, and farmers owed US$84 million. Moreover, Zimbabwe's electricity tariffs remain below both ZESA's long-run marginal cost levels and the regional average.[14] Due to below-cost tariffs, ZESA incurred US$517 million in losses between 2009 and 2016.

3.3 SEP Financial Performance

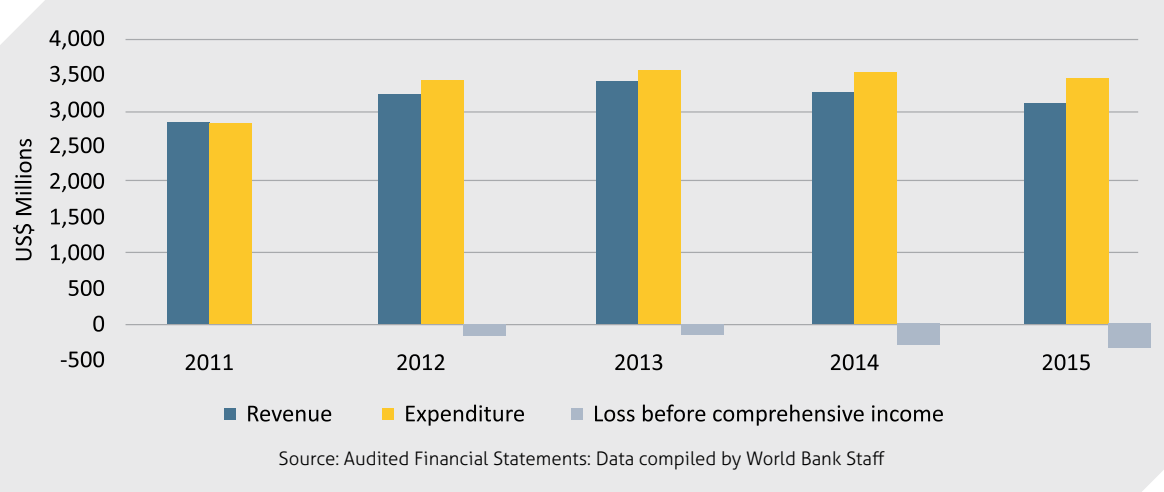
Among most SEPs, gross expenditures have grown much faster than revenues, undermining their financial viability, with the notable exception of the energy sector. The 2013 Constitution requires SEPs to "conduct their operations so as to maintain commercial viability." However, a difficult macroeconomic environment has depressed SEP revenues, while financing is constrained and rising interest rate cost have increased borrowing costs. Customer arrears are mounting, including arrears from the central and local governments and from other SEPs.

The aggregate revenue of Zimbabwean SEPs averaged US$3.2 billion (or 22 percent of GDP) during 2011-15. Aggregate revenue peaked in 2013 and declined thereafter. SEPs in the energy sector generate half of total SEP revenue and have followed the same pattern. By contrast, revenues among SEPs in the finance and communications sectors grew steadily from 2011 to 2015, reflecting the strong overall performance of the Zimbabwean services sector.

The Constitution requires SEPs to "conduct their operations so as to maintain commercial viability."

[14] Tariffs are set at US$0.0986 per KWh, considerably below the regional average of US$0.14 per KWh.

Figure 18: Aggregate SEP Financial Balances, 2011-15

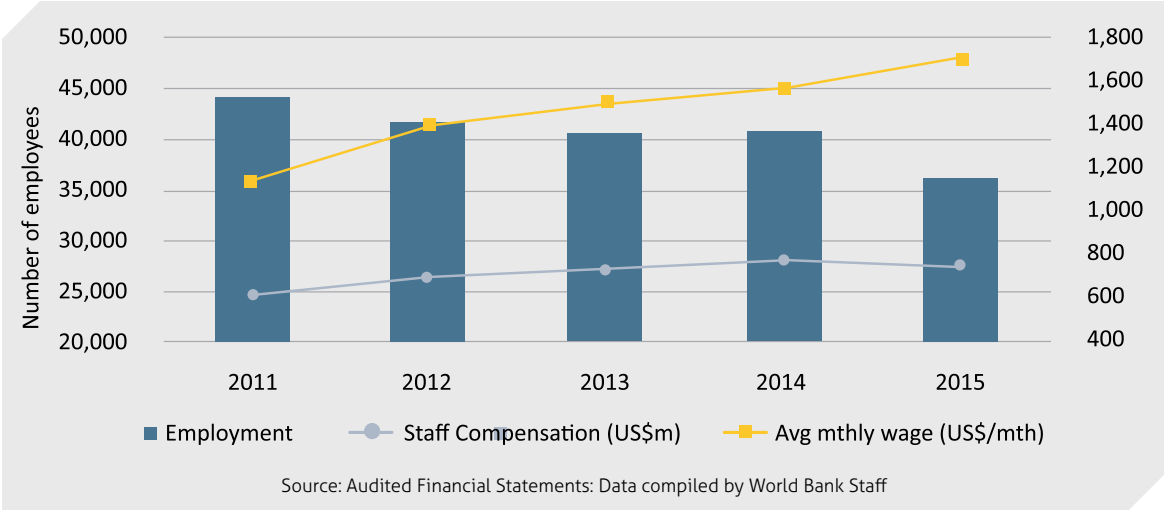


Tariff policies and collection rates have an important impact on the financial balances of SEPs. In some cases, below-cost tariffs are intended to support consumption among poor households, while in other cases financial losses are due to operational inefficiencies. The 2013 cancellation of consumer payment arrears to ZINWA and ZESA's subsidiary, the Zimbabwe Electricity Transmission and Distribution Company (ZETDC), benefited both rich and poor households, and it significantly reduced willingness to pay among customers. ZINWA's stock of customer arrears grew by 20 percent between 2011 to 2015, and ZETDC's increased by 51 percent. Meanwhile, the communications SEP TelOne, which focused on strengthening collection, reduced its customer arrears by 17 percent.

SEP EXPENDITURES **ROSE** BY ABOUT **5.9%** PER YEAR DURING 2011 TO 2014 WHILE REVENUES GREW BY **2.9%**

Total SEP expenditures rose by about 5.9 percent per year during 2011-14, while annual revenues grew by just 2.9 percent. Aggregate annual expenditures averaged US$3.5 billion during 2011-15. Personnel costs, which account for about one-fifth of SEP spending, increased by an average 5.5 percent per year even as SEP employment declined. Debt-service costs also increased by 6.1 percent.

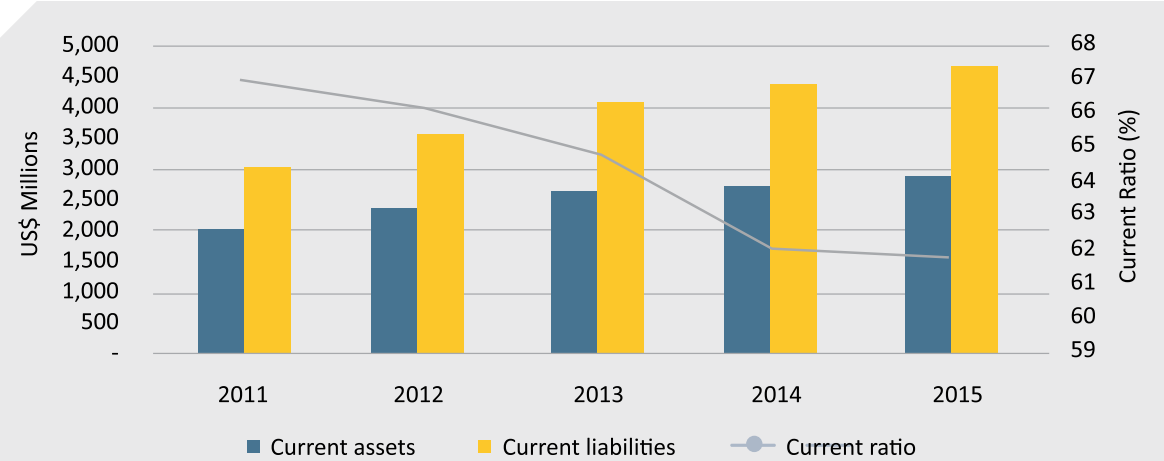
Figure 19: SEP Employment and Compensation



SEP LOSSES HAVE **PRACTICALLY DOUBLED** EACH YEAR DURING 2011 - 2014 REACHING **2.1%** OF GDP

These trends severely weakened the finances of commercial SEPs, as aggregate net losses (before comprehensive income) nearly doubled each year during 2011-2014. Overall, commercial SEPs moved from close to the break-even point in 2011 to reporting combined losses of just under US$340 million (or 2.1 percent of GDP) in 2015. Some sectors, such as agriculture and water, consistently register losses, while others, such as mining, have seen their profitability decline in recent years. Only the financial services and health sector SEPs have traditionally generated profits. In addition, the aggregate working capital position of SEPs is precarious. Twenty-five of the 38 reviewed commercial SEPs have become illiquid, with current liabilities exceeding current assets, and seven are insolvent. Finally, the state's return on SEP assets has deteriorated from -0.2 percent in 2011 to -2.3 percent in 2015.

Figure 20: Current Assets and Liabilities



Source: Audited Financial Statements: Data compiled by World Bank Staff

3.4 Fiscal Contributions and Risks from SEPs

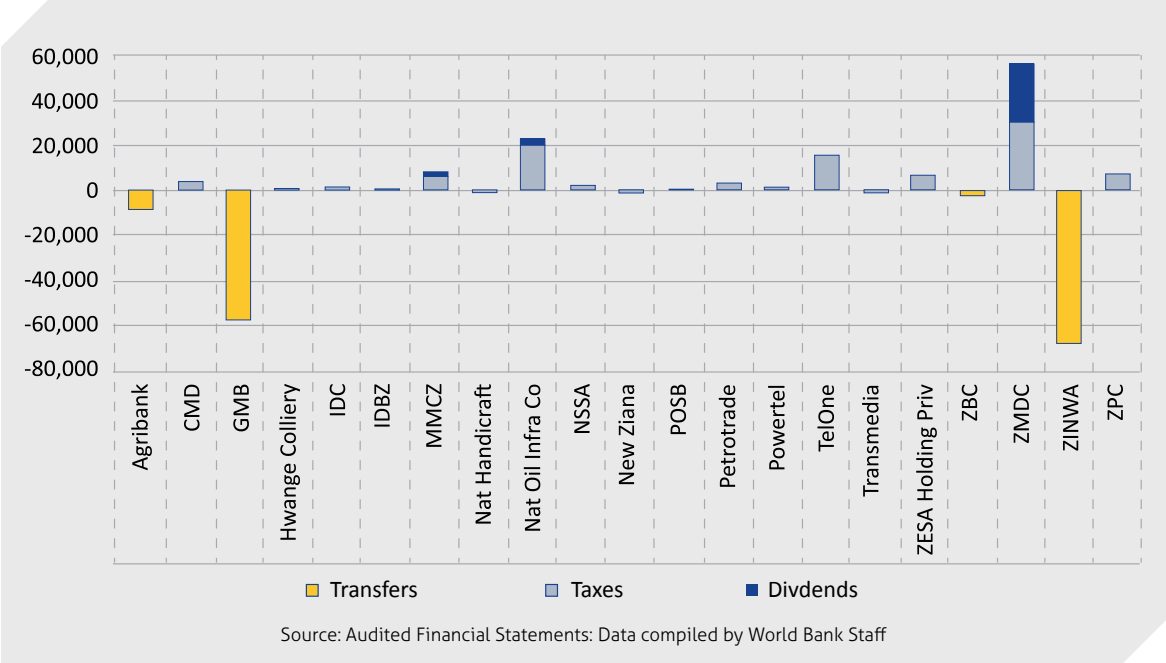
TRANSFERS TO SEPs AVERAGED **US$ 135 MILLION** SEP TAXES AND DIVIDENDS AMOUNTED TO **US$ 50 MILLION**

Large SEP financing gaps pose significant macroeconomic and fiscal risks. As public enterprises, commercial SEPs are expected to contribute to government revenue in addition to advancing their policy objectives. SEP dividends accrue to the Treasury, which is also implicitly responsible for SEP losses. Consequently, the poor performance of SEPs can create contingent liabilities that weaken the government's fiscal position.

SEPs' overall net contribution to the Treasury is negative, as transfers from government exceed dividends and taxes paid. Public transfers to SEPs averaged US$135 million between 2011 and 2015, while SEP taxes and dividends amounted to just US$50 million. Dividends plummeted from US$73.4 million in 2011 to US$7.3 million in 2015, with only 4 of the 38 commercial SEPs paying into the Treasury. Annual SEP tax payments have been much more stable, averaging about US$20 million, but tax liabilities have more than doubled from US$32 million in 2011 to US$69 million in 2015. These aggregate figures mask considerable heterogeneity among SEPs, as a combined 85 percent of government transfers accrue only to ZINWA and GMB.

85% OF GOVERNMENT TRANSFERS ACCRUE TO **ZINWA** & **GMB**

Figure 21: SEPs Net Contribution to the Treasury (Average 2011-2015)

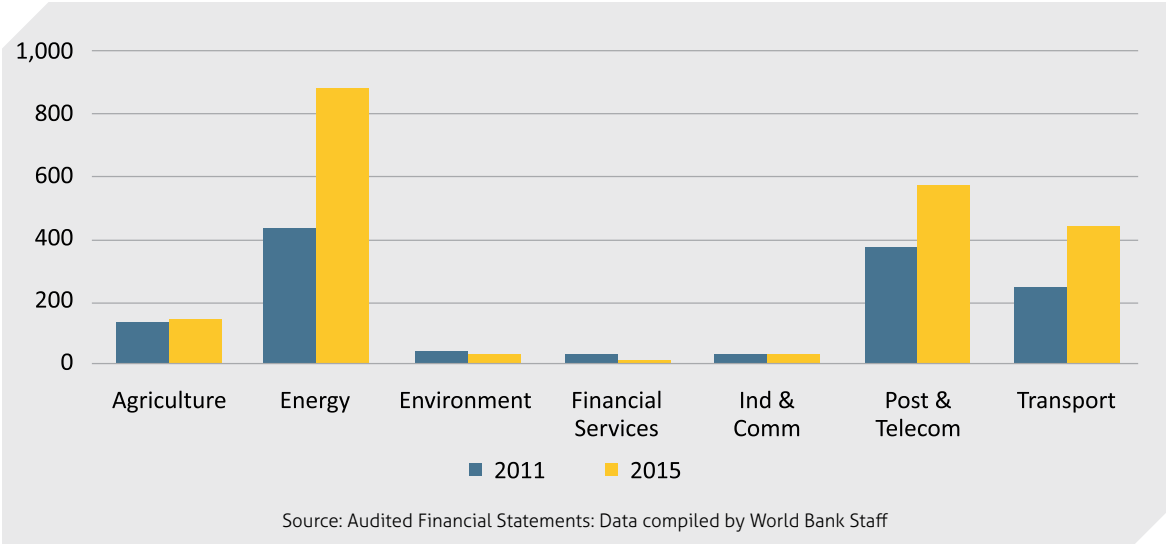


Source: Audited Financial Statements: Data compiled by World Bank Staff

Meanwhile, contingent liabilities are mounting. Explicitly government-guaranteed debt represents 90 percent of all quantified contingent liabilities of SEPs, while implicitly guaranteed debt of strategically important SEPs make up the remaining 10 percent. Infrastructure investment financed by external loans but guaranteed by MoFED drove the accumulation of contingent liabilities, which rose from US$1.6 billion in 2011 to an average of US$2.1 billion during 2014-15. Energy-sector SEP's were responsible for more than half of the growth of quantified contingent liabilities, and they currently hold 43 percent of the total stock, followed by communications-sector SEPs, which hold about 25 percent (Figure 22). Transportation-sector SEPs also experienced a sizeable increase in contingent liabilities during this period. In addition to these quantified contingent liabilities, unquantified contingent liabilities may exist through SEP performance offtake or other contractual obligations.

CONTINGENT LIABILITIES REACHED **13%** OF GDP IN 2015

Figure 22: Explicit Contingent Liabilities by Sector, 2011 and 2015



Source: Audited Financial Statements: Data compiled by World Bank Staff

THE **PUBLIC DEBT MANAGEMENT ACT** (2015) PROVIDES FOR STRONGER OVERSIGHT OF SEP BORROWING AND GOVERNMENT GUARANTEES

Some SEP contingent liabilities have become public debt. Some liabilities have not been serviced by either the government or the relevant SEP since 2000 and are now recorded as debt in the government accounts. Approximately US$1.1 billion of Zimbabwe's external payment arrears to bilateral and multilateral creditors stem from government-guaranteed SEP debt.

Complex financial linkages and cross-debts between SEPs amplify fiscal risks and hinder reform efforts. During 2011-14, related-party loans payable exceeded related-party loans receivable, indicating poor payment discipline between SEPs in terms of both accounts receivable and payable.

The Public Debt Management Act, passed in December 2015, provides for stronger oversight of SEP borrowing and government guarantees, but its implementation procedures require further elaboration. Most outstanding guarantees were issued prior to the passage of this law.

3.5 SEP Governance

SEP oversight involves many institutional actors and requires significant coordination. Some commercial SEPs operate under the Companies Act, while others are governed by specific institutional legislation. Line ministries provide the overall policy direction for SEPs and appoint the boards of directors that oversee their management and operations. The boards of directors are responsible for appointing senior management, establishing organizational strategies, strengthening commercial and operational performance, and meeting appropriate accountability, transparency, and reporting standards. The Office of the President and Cabinet designs the overall corporate governance framework for SEPs, while MoFED is responsible for approving SEP budgets and borrowing and assessing their financial status. The State Enterprises Restructuring Agency coordinates the SEP reform program, and sectoral regulators approve tariffs and technical operating rules.

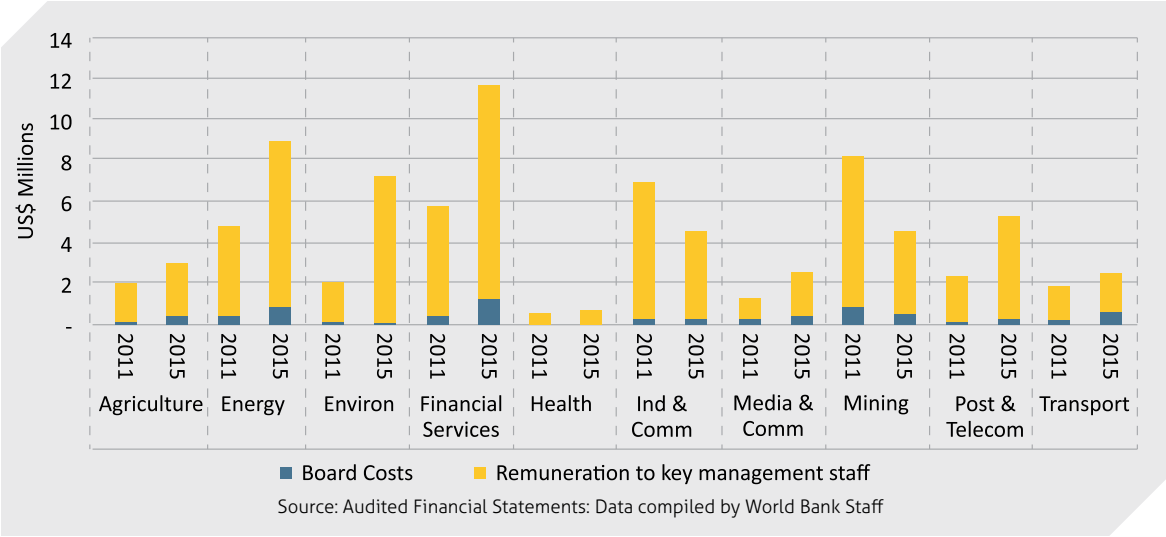
EXECUTIVE COMPENSATION AMONG SEPS **DOUBLED** BETWEEN 2011 - 2015 DESPITE DETERIORATING PERFORMANCE

Despite these extensive oversight structures, the governance of commercial SEPs has deteriorated over time. The appointment process for SEP leadership often fails to comply with basic corporate governance requirements, resulting in boards of directors that are not well equipped to manage their respective SEPs. Thirty percent of commercial SEPs have neither a board charter nor a code of ethics. Numerous boards have had little training, and do not effectively manage conflicts of interest. Some members sit on as many as seven different SEP boards.

Executive compensation among SEPs doubled between 2011-15 despite their deteriorating financial and operational performance (Figure 23). Senior management generally set their own remuneration levels, in many cases ignoring statutory limits on compensation. CEO performance contracts are often based on inadequate data, and some CEOs bypass their board of directors entirely and report directly to the respective line ministry.

30% of commercial SEPs have neither a board charter nor a code of ethics

Figure 23: Executive Compensation by Sector



Source: Audited Financial Statements: Data compiled by World Bank Staff

A combination of poor SEP performance and weak oversight has prompted ad hoc government interventions, which have further undermined the credibility of SEP governance. Many SEPs are locked in a vicious cycle in which poor performance leads to government interventions, followed by inadequate short-term oversight and weak compliance with corporate governance practices, resulting in poor performance. Some SEP managers lack the capacity to implement good-practice principles for corporate governance, and in many cases diminished accountability has weakened expenditure discipline.

The government is working to improve corporate governance, administrative oversight, and financial transparency among SEPs. In 2015, Zimbabwe adopted a National Code of Corporate Governance based on OECD standards that reflects international good practices. While compliance with this code is voluntary, the government is currently considering a draft bill that would make many of its provisions mandatory for SEPs. If enacted and adhered to, this new law should enhance the transparency and performance of SEP operations.

ZIMBABWE HAS ADOPTED **A NATIONAL CODE OF CORPORATE GOVERNANCE** BASED ON OECD STANDARDS WHICH COULD BE APPLIED TO SEPs

3.6 Policy Options

Consolidating and clarifying institutional responsibilities for SEP oversight could strengthen monitoring and accountability. The government could even restructure the institutional framework for SEPs, designating a single entity to coordinate the SEP reform agenda. The government could also pilot a more centralized ownership approach for commercial SEPs as has been implemented in several other developed and developing countries.

Reforming SEP management could enhance performance. Developing a comprehensive SEP policy with clear objectives for each SEP and enforcing corporate governance standards—including management selection processes, performance evaluation mechanisms, and reporting requirements—could strengthen the institutional and policy framework for the SEP sector. The authorities should align SEP management policies with principles of good corporate governance, including a comprehensive remuneration policy that links executive compensation to the financial performance of SEPs.

Clarifying the financial relationships between the central government budget and SEPs, as well as relationships among SEPs, would improve transparency. SEP annual reports should include payments arrears, outstanding tax liabilities, and transfers from the central government. The central government's budget should summarize this information and record bilateral transfers, cross-debts, and quasi-fiscal operations between SEPs. This would provide the basis for cleaning balance sheets without direct fiscal transfers. A cost-benefit assessment of social policies implemented through SEPs would shed light on their efficiency and impact on the public finances.

Strengthening SEP reporting requirements provides the foundation for evidence-based policies. The authorities should insist that SEPs immediately begin publishing annual reports, strategic plans, and progress reports. Establishing a central database that systematically consolidates performance information could improve SEP management by allowing policymakers to rapidly identify emerging problems and take swift corrective action.

ANNEX A

COMMERCIAL SEPs INCLUDED IN THE ANALYSIS IN CHAPTER 3

Company	Sector
Allied Timbers	Agriculture
Agricultural Marketing Authority	Agriculture
Cold Storage Commission	Agriculture
Agricultural and Rural Development Authority	Agriculture
Grain Marketing Board	Agriculture
Petrotrade	Energy
ZESA Enterprises	Energy
National Oil Infrastructure Company of Zimbabwe	Energy
ZESA Holdings (Company not the Group)	Energy
Zimbabwe Electricity and Transmission Company	Energy
Zimbabwe Power Company	Energy
Zimbabwe National Water Authority	Environment
Small Medium and Enterprise Development Corporation	Financial Services
People's Own Savings Bank	Financial Services
Agricultural Bank of Zimbabwe	Financial Services
Infrastructure Development Bank Zimbabwe	Financial Services
National Social Security Authority	Financial Services
National Pharmaceutical Company	Health
Industrial Development Corporation Zimbabwe Group	Industry and Commerce
New Ziana	Media and Communication

Company	Sector
Transmedia Corporation	Media and Communication
Printflow	Media and Communication
Zimpapers	Media and Communication
Zimbabwe Broadcasting Corporation	Media and Communication
Minerals Marketing Corporation of Zimbabwe	Mining
Zimbabwe Mining Development Corporation	Mining
Hwange Colliery Company	Mining
Powertel	Postal and Telecommunication
Zimbabwe Posts	Postal and Telecommunication
TelOne	Postal and Telecommunication
NetOne	Postal and Telecommunication
Road Management Services	Transport
National Handling Service	Transport
Zimbabwe United Passenger Company	Transport
CMED	Transport
Air Zimbabwe	Transport
Civil Aviation Authority Zimbabwe	Transport
National Railways of Zimbabwe	Transport

ANNEX B

ZIMBABWE PUBLIC EXPENDITURE REVIEW 2017

Jointly prepared by the Government of Zimbabwe and the World Bank (www.worldbank.org), Executive Summary.

Zimbabwe is at a critical juncture. After dollarization and favorable economic factors fueled a recovery during 2009-12, Zimbabwe today faces slowing growth, a financial crisis, increasingly erratic weather patterns and rising poverty and inequality. To help respond to these issues, the Government of Zimbabwe (GoZ) has sought to examine and ultimately better manage its public expenditures, with a view to ensuring public spending is effective, efficient, equitable, and well-targeted to the needs of its changing population, especially the poor.

A joint product of the GoZ and World Bank, this Public Expenditure Review (PER) aims to inform GoZ's efforts to reform and improve fiscal management. The report, which draws on government revenue and expenditure data from 2011 to 2016, seeks to provide a common evidentiary framework for collaboration between the GoZ and the World Bank, and stimulate debate on the nature and orientation of public spending among representatives of the GoZ, the private sector, and civil society. To be productive, such a debate should consider all public revenues and expenditures – irrespective of agency and how they are managed. To ensure a complete narrative, this PER reviews information on public sector expenditures of the central government, extra-budgetary funds, local authorities, State-owned Enterprises and Parastatals (SEPs), and development partners.

In brief, this report argues that Zimbabwe's ability to formulate and implement effective fiscal policy – a key function of government – is slipping away given the lack of robust controls over public finances, and the deferment of key policy choices on the role and structure of the state. Zimbabwe's comparatively large public sector provides opportunities to boost investment and growth, but, absent strong controls and management, can become a stumbling block for economic development. Total government revenues and expenditures in Zimbabwe exceed 50 percent of GDP, which is comparable with public sectors in high-income European countries, further underscoring the importance of appropriate controls. The initial observations below help to elucidate this premise.

Fiscal policy is a main power of government and more so under Zimbabwe's dollarized economy. Governments apply their fiscal power to raise taxes and revenues, and finance goods and services in the public interest. In areas where public and private interests diverge and the private sector underprovides critical goods and services, governments use fiscal policy to finance and provide public services. Fiscal policy can be leveraged to achieve inclusivity and equity, though achieving such goals sustainably, requires balancing the needs of present and future generations. To promote sustainable growth and protect social welfare, fiscal policy must create an environment where private effort and investment can yield steady incomes for households. In addition, governments use fiscal policy to help stabilize macroeconomic fluctuations from exogenous shocks.

But Zimbabwe's fiscus today is not healthy. Past developments and choices made in difficult circumstances have created a bloated fiscus, which is difficult to maneuver, and may be inadvertently creating – rather than resolving – inequities. As such, Zimbabwe's fiscus is severely limited as an effective tool for Government.

Today, Zimbabwe has very little fiscal space to stimulate the economy amid slowing growth, despite the GoZ's high effectiveness in raising taxes and revenues. Occupying about half of the economy, Zimbabwe's state has become so unwieldly that it may impede rather than support households, families, communities, and firms to improve social welfare. Employment costs for public servants, who represent some two percent of the population, consume more than 20 percent of Gross Domestic Product (GDP), while the state's high domestic borrowing crowds out credit to the private sector, including large and small businesses. Overall public debt, including

international arrears, represents 79 percent of gross domestic product. Meanwhile, State-Owned Enterprises (SOEs) and local governments continue to generate contingent liabilities for the sovereign.

Today, Zimbabwe's fiscus has limited flexibility to respond to economic and social challenges. Public wages represent 87 percent of the central government revenue, and 40 percent of local government expenditures and over 20 percent of total SOE expenditure, leaving little for Operations and Maintenance (O&M) and capital investments. The state faces difficulties redirecting public expenditure from government consumption to investments. Each new hire creates a long-term liability, including pensions for government workers, yet Ministries, Departments, and Agencies (MDAs) continue to demand more personnel without effective hiring and HR planning systems. Despite limited flexibility, pressing concerns remain. Though school enrollment has increased, many children still attend schools without adequate infrastructure and qualified teachers, especially in Early Childhood Education (ECD). Limited O&M for facilities and infrastructure across sectors has required expensive rehabilitation and reconstruction, increasing the costs of public services. Moreover, such inefficiencies limit the quantity and quality of basic services that the fiscus is able to finance for the public.

The state also faces difficulties in protecting the poorest households. The El Nino drought revealed the extent to which social safety nets have deteriorated. In education, the Basic Education Assistance Module (BEAM), which covers school fees for economically disadvantaged children, has all but ceased to operate, and reports suggest that schools periodically turn away vulnerable students. Though families contribute directly to public education through school fees, this financing model may perpetuate rather than reduce inequities, as children from wealthier families consistently reap better education outcomes than those from poorer households. Poor households continue to defer medical care because of rising fees and charges needed to maintain health facilities and services.

Finally, the state may have overstretched through its direct interventions and is no longer supporting private sector development. Zimbabwe's public sector has a long tradition of directly participating in the market economy to support industrial development, as embodied in the long list of Zimbabwean SEPs. Yet some functions of SEPs have not evolved, despite large structural changes in the economy. Many SEPs are now a drag on the fiscus, even as the private sector has filled gaps that SEPs left in the market. In other cases, the GoZ's investment, tariff and subsidy policies are not sufficiently coordinated to achieve desired impacts, while protecting state revenues.

Nevertheless, the Zimbabwe state can leverage its strengths and emerging opportunities to recover a healthy fiscus that can support growth and ensure the public good.

First, the institutional framework for control over central government public spending is comparatively well developed but remains to be comprehensively applied. The 2013 Constitution re-affirmed the principles of good stewardship by the state at all levels. Efforts are underway to modernize and update legal and regulatory instruments for Public Financial Management (PFM), public procurement, and external audit in line with these principles. Authorities will need to extend and implement these principles at the local level and within SEPs.

Second, Zimbabwe's ability to raise taxes and revenues is proven, and citizens and firms are willing to contribute to the exchequer and pay for public services. Yet the GoZ should work to ensure current approaches for mobilizing resources, including private fees, are progressive, and transfers and subsidies support equitable development. In addition, the state must refrain from crowding out the private sector. Fortunately, innovations in financing mechanisms, such as results-based financing (RBF) of rural health clinics and the Harmonized Social Cash Transfer Program (HSCT), have potential to rapidly improve service delivery and outcomes. Zimbabwe's private sector is also willing to partner on financing and providing infrastructure and services, but these arrangements must be scrutinized and transparent to protect the public interest.

Finally, the authorities' plan to fully re-engage with the international financial system should increase access to both development financing and private investment flows. In October 2015, the GoZ submitted a proposal to clear its arrears to the World Bank, the International Monetary Fund (IMF) and the African Development Bank (AfDB), and to reschedule bilateral debts to Paris Club members. In October 2016, the GoZ subsequently cleared IMF arrears. The settlement process is expected to expand Zimbabwe's access to international resources, including funding from the World Bank and the AfDB.

Seizing these opportunities will require the GoZ and the country to confront policy questions that have been deferred for some time. These include questions about: (i) whether and how the size and role of the state might evolve to respond to new economic realities; (ii) the division of labor across all state arms for financing and equitable service delivery; and (iii) the balance between promoting private sector development, preserving benefits of public servants, and protecting the poor. Zimbabwe would benefit most from a fiscus based on deliberate national choices informed by a broad, government-led debate on such questions, rather than one that evolves unevenly responding to fluctuating challenges, shifting interests, and entrenched positions.

As such, this PER reviews the options facing the Zimbabwe fiscus in terms of: (a) challenges; (b) capacities; and (c) choices. Past policy choices have gradually limited the GoZ's control over the fiscus. Renewed control of the public sector will allow the GoZ to effectively implement public policy options. To effectively implement these policy choices, Zimbabwe will need to ensure strong coordination among policy makers, and transparency and accountability.

The Macroeconomic and Fiscal Context

Zimbabwe is suffering from declining growth and serious macroeconomic challenges, including a financial crisis. Zimbabwe adopted a multi-currency regime in early 2009, with the US dollar as reference currency, which effectively dollarized the economy. From 2009 to 2012, Zimbabwe achieved high economic growth, partly due to the stabilization effort, high commodity prices, and an unfettered credit boom. Yet since 2012, economic growth has fallen as the commodity super-cycle ended, the South African Rand depreciated, and credit contracted following a sharp rise in Non-Performing Loans (NPLs) and capital inflows contracted. Zimbabwe has taken steps to improve its business climate, but continues to face low credit for businesses and consumers, acute cash shortages in banks, and a severe drought hurting agriculture production and rural incomes. As a result, per capita GDP has fallen by two percentage points in 2016 and poverty has also increased.

Macroeconomic and fiscal policy options to stimulate the economy have narrowed during the review period. As growth decelerated since 2012, pressures intensified to use macroeconomic and fiscal policies to buttress growth, but the GoZ has increasingly exhausted instruments to implement fiscal policy. During the high-growth years after adopting the multi-currency regime in 2009, Zimbabwe did not adopt a counter cyclical fiscal policy that would have helped the GoZ to manage growth over the long-term, thus few reserves were accumulated.

As Zimbabwe remains in arrears to external creditors, the GoZ has tapped domestic capital markets to finance its budget, which has reduced liquidity and exacerbated cash shortages. During 2016, the GoZ rapidly expanded its use of Treasury bills to cover pre-existing arrears to the Reserve Bank of Zimbabwe (RBZ) and other liabilities, which has limited scope for further domestic financing of the budget deficit. In parallel, the GoZ's practice of using commercial banks to finance the public budget has destabilized the banking system and constrained liquidity, as evident in sharp limits on cash withdrawals from bank deposits, and irregular payment of imports.

The financial crisis is linked to the fiscal situation and a successful resolution of the crisis will require very strong fiscal policy credibility. This means addressing the current fiscal imbalances and making the system much more transparent to assure depositors and investors.

Structural impediments, including weak investor protection and uncertain land tenure arrangements, continue to deter capital inflows. The World Bank Doing Business Indicators for 2017 rank Zimbabwe as 161 out of 190 countries, with similar rankings from other classifications. Without capital inflows, Zimbabwe has seen a rapid contraction in imports and a narrowing in the current account deficit.

Zimbabwe faces deeper challenges when considering the consolidated public sector. Since public sector wages consume most central government resources, non-wage expenditures were increasingly paid by user fees and debt of SOEs and local governments. Zimbabwe's public sector deficit expanded even during the period of high growth, so the fiscus now has limited resources to address the deceleration.

KEY CHALLENGES

- **Government's gross expenditures as a share of GDP, when considering all funding sources, has rapidly grown to the level of some high-income countries.** Zimbabwe's central government revenue-to-GDP ratio of 27 percent from 2011 to 2015 was comparable to those of most regional peers, and the country leads peers in collection of Value-added Taxes (VAT).[15] The revenues of central government, including statutory extra-budgetary funds, are complemented by other sources: local government revenues of 5.6 percent of GDP; official development aid estimated at 8.4 percent of GDP; statutory revenues mobilized and spent at source of about six percent of GDP; and SEP revenues – unconsolidated estimates of which are 29 percent of GDP. Zimbabwe's lack of consolidated public accounts makes it difficult to determine the full size of Government, but a conservative estimate suggests the public sector commands resources of about 50 percent of GDP. Such a level is comparable to high-income European countries, which have achieved commensurate levels of government performance, suggesting that Zimbabwe still is under-performing for its size.

- **While a large state may create many important opportunities, the difficulties to prioritize, monitor, account and coordinate can ultimately limit the government's ability to support economic development and sustain gains in social welfare.** States like Zimbabwe must be able to effectively coordinate, prioritize, monitor, and account for all revenue and expenditure, or decisions on policies and programs risk constraining economic development and social welfare. Loss of control over expenditure can translate into accumulation of arrears, debt, and contingent liabilities, and force disorderly adjustments, which may hinder or even reverse the impact of well-intentioned public policies. A state that is too large may also inadvertently crowd out personal and private efforts to create value, and create its own dependency syndrome among households and firms. Such a state may enter a vicious cycle similar to Zimbabwe's experience during 2007-08.

- **Though Zimbabwe has taken steps to better fiduciary controls and monitor spending, further gains are stymied by inadequate reporting and coverage of the PFM system.** Zimbabwe has improved the availability of expenditure reports for decision making by *rebooting* the Integrated Financial Management Information System (IFMIS), which covers central government accounting, but still has limited coverage. For instance, no interfaces are yet in place between the IFMIS and the public service human resource management information system, and the local government and parastatal accounting systems. There are limited controls over the quality of spending and core controls on wages and staffing numbers are insufficient. In addition, Local Authorities have varying capacity to report on their finances: some implement International Public Sector Accounting Standards (IPSAS), while others have difficulties preparing basic monthly and annual financial

[15] The increased emphasis on indirect taxation may raise vertical equity concerns in the future.

statements. Zimbabwe has just recently started to estimate information on the fiscal role of SEPs, and regularly collect consolidated financial, performance and debt data. To accurately determine the size of Zimbabwe's consolidated public sector accounts, officials must integrate the PFM systems of central government, local authorities, SEPs, and development partners.

Zimbabwe faces other difficulties in accounting for public expenditures, especially as public services are increasingly funded outside the remit of the Parliament's budget process, where oversight and coordination is weak. Budget transfers, which make up about 20 percent of the central government budget, are allocated outside the overall budget prioritization framework. By dollar value, half of these transfers support recurrent costs in SEPs, universities, and other institutions. But Zimbabwe does not have a clear mechanism for monitoring or controlling explicit budget guarantees to SEPs. In addition, multiple institutions oversee SEPs, but they lack clearly demarcated roles, which has allowed SEPs to build up complex mutual debt, which contributes to systemic fiscal risk. Local governments face increasing deficits partly because central government transfers and local revenues have not kept pace with their greater mandates for service delivery. Splitting the oversight of urban and rural local authorities into two different ministries requires strong coordination to avoid spending overlaps and duplications, and ensure a consistent policy on fees, charges and tariffs

Zimbabwe's allocation of public sector resources has evolved to be neither effective, efficient, nor equitable. As mentioned, recurrent expenditure, particularly the public sector wage bill, has crowded out expenditures for O&M and capital investments. Despite the GoZ's commitment to channel at least 30 percent of expenditures to capital development, capital expenditure as a percent of budget fell from 15 to eight percent between 2011 and in 2015 – exacerbated by weak budget execution as low as one percent in some categories. Zimbabwe's social protection system once a model in terms of coverage, no longer meets the needs of its population.

Spending on personnel has increased dramatically in recent years, driven by the growing number and remuneration of public employees. The wage bill dominated the growth of public expenditures from 2011 to 2015. Today, Zimbabwe's central government personnel-related expenditures are unsustainable, reaching 22 percent of GDP, 82 percent of total current expenditure, and 87 percent of total domestic revenue in 2015. In key service areas, such as basic education, employment costs represent 98 percent of line ministries' budget, which has left little to fund pressing capital and program-related needs of schools. Within employment costs, allowances such as pensions have grown at rates significantly higher than government salaries. Zimbabwe's pension costs of four percent of GDP outstrip those of African middle income countries, and are driven by comparatively high government subsidization, and very low employee contributions.

Local governments and SEPs face high and rising employment costs, and some SEPs have accumulated arrears for salary payments. In SEPs, employment costs rose from 2011 to 2014 and constituted 22 percent of SEP expenditures in 2014, despite employment numbers declining somewhat. In SEPs, Board costs and remuneration to key management staff increased by 35 percent from 2011 to 2014, though some enterprises accumulated arrears for paying the salaries of rank-and-file staff. In local governments, employment costs rose rapidly to reach 40 percent of total spending in 2015, while administrative, finance and management costs (not directly linked to service delivery) rose to 26 percent.

The high costs of public sector employment raise issues about equity, given the wage gaps between the public and private sectors, and low funding of social services. For example, civil servants make up only 1.6 percent of the population, but consume more than 20 percent of GDP. Even after taking into account that civil servants support their families, their benefits are significantly above average. Real wages have fallen in the private and

informal sectors as firms and workers adjust to be competitive in a dollarized economy, but real wages in the public sector have risen (i.e., nominal wages remained flat, but in a deflationary environment). Zimbabwe spends almost five percent of its GDP on social protection, but most expenditures do not benefit the poor. Two-thirds of social protection spending is for civil service pensions. Expenditure on social safety nets to reach the extreme poor, who represent 22 percent of the population, has fallen, reaching only 0.72 percent of GDP in 2015. Skewed deployment of personnel also raises equity questions. For instance, Zimbabwe's ratio of 1.66 in spending per capita between secondary and primary education far exceeds the OECD country average, despite secondary schools' already benefiting from a much lower pupil-to-teacher ratio. Inequities extend across the education sector, as secondary and urban schools tend to be better resourced than primary, ECD, and rural schools.

To compensate for the lack of resources for non-wage expenses, the GoZ has expanded the use of user fees and charges, creating regressive financing of some basic services. MoPSE's own funding for education is progressive (i.e., weighted toward the poor). But the collection of revenue from private fees is skewing resources in a highly regressive manner. As already noted, growing mandates of local governments to provide services have not been accompanied by increases in targeted transfers, which complicates an already difficult situation. Without appropriate mechanisms to equalize financing of basic services, Zimbabwe could find itself reversing recent gains in improving equity.

Zimbabwe's complex government interventions and vague or conflicting policy objectives on user fees, tariffs, subsidies, and transfers across government also raises concerns about equity and sustainability. For instance, the inconsistent decision to impose fees in all schools, while not financing the BEAM, but funding teacher salaries in private schools, left many vulnerable children at risk, and transferred benefits to less poor households. In addition, Zimbabwe supports a highly varied, diffuse mix of social safety nets interventions, bucking the trend of many African countries toward backing single flagship interventions. For SEPs, Zimbabwe's complex mix of below-cost recovery tariffs, debt guarantees and write-offs, central government arrears and transfers, quasi-fiscal activities, and web of inter-SEP debts, make it all but impossible to clearly unravel the benefits of SEPs to households and the economy. Complexity in the SEP realm also reveals fiscal and economic risks. Representing 26 percent of GDP, most SEPs are accumulating losses, losing equity, and accumulating short term debt. Profits (before comprehensive income) were negative from 2011 to 2014, and explicit contingent liabilities represented 13 percent of GDP in 2014. Most enterprises are illiquid, and just under one-fifth are insolvent.

Recommendations

Building on Zimbabwe's institutional heritage and renewal in the 2013 Constitution, this PER presents recommendations in each of its chapters that could be implemented in the short to medium-term to address the challenges noted above. These have been summarized under six consolidated headings below:

Controlling the wage bill

Besides the step already taken by the GoZ, which estimates suggest will save about 1.2 percent of GDP (in full fiscal year impact), the GoZ might undertake the following measures, which could imply short-term savings of an additional one to three percent of GDP:

- Continue the freeze on personnel and wage increases.

- Continue to implement recommendations of the 2015 public employment audit, which call for eliminating staff duplications and redundancies; reviewing leave policies; rationalizing posts; and reducing employment cost obligations to grant-in-aid institutions, and top-ups to teachers in private schools.
- Adjusting personnel allowances (e.g., removing accommodation and transport from the "13th cheque").
- Increasing public employee pension contributions.
- Strengthen wage controls, mandate reviews of promotions, and establish clear rules for contract workers.
- Establish specific short- and medium-term targets for the wage bill and employment numbers, including spending as a share of public expenditures.
- Integrate the personnel management system with the IFMIS, and consolidate the mandate for all personnel-related expenditures for the civil service, including pensions.
- Improve employment planning and budgeting in all MDAs, Local Governments, and SEPs, including undertaking a review of 'service levels' (i.e., the number of staff required to deliver a particular service, or to support the economic and general administrative functions of government).
- Define a remuneration policy for SEPs, and a mechanism for enforcement.
- Systematize and improve performance contracting for SEPs' Boards and CEOs.
- Convert salary arrears to debt and establish a payment plan.

Effective planning and budgeting

- Include all budget and externally-funded activities in the RBB framework and in the budget bill with a view to enhancing Parliamentary oversight.
- Ensure the RBB framework is supported by a thorough review of fragmentation and duplication in program areas.
- Ensure that all new policies and strategies are effectively costed in terms of financial and human resources before approval.
- Strengthen the medium term planning of expenditure levels and composition to inform medium term priorities.
- Establish budget floors for key policy priorities, such as social service delivery and the capital development budget.
- Apply RBB solutions and performance measurement and management systems in local government

Improving PFM practices

- Strengthen central government commitment and expenditure controls by rolling out the budget and commitment modules of the IFMIS, and establishing a robust internal audit function.

- Extend the IFMIS to cover all public revenues and expenditures, in addition to consolidating revenues and expenditure from SOEs, extra-budgetary funds, and development partner financing.
- Strengthen public procurement and cash management planning to improve the execution of capital projects, particularly in social sector ministries.
- Strengthen program-level controls (e.g., audits, operational assessments), and introduce beneficiary-level controls (e.g., grievance redress systems, citizens committees, scorecards) in social protection and safety net programs.
- Harmonize data and information management arrangements into a single social registry for all MPSLSW programs.
- Integrate all debt records into a single registry, and improve transparency of debt contracting and obligations.
- Complete the rollout of the GFMIS in local government, and strengthen key functions: revenue projection and collection, procurement, and asset management.

Strengthening transparency and accountability

- Publish consolidated public sector accounts to enable better expenditure planning and accountability.
- Ensure timely publication of publicly financed activities, and timely follow up on questionable activities.
- Streamline and strengthen oversight of SEPs, and establish and disclose a comprehensive central database on SEP performance and ensure compliance with National Corporate Governance Code.
- Strengthen the national student assessment system, and join international assessment programs to help monitor better education outcomes.
- Improve the governance of school fees, better track the costs of delivering education, and support disclosure of EMIS data to help in monitoring education spending, efficiency, and outcomes.
- Broaden service level benchmarking from water supply to other functions of local government, and monitor unit costs of service delivery.
- Work towards a common platform, targeting mechanisms, and harmonized administrative processes for all social protection programs to reduce fragmentation and inefficiencies.

Modernize resource mobilization

- Review the progressiveness and regressiveness of the current tax system, and monitor the impact of foregone revenue on tax expenditure and tax incentives.
- Roll-out a new debt management strategy that integrates domestic and foreign debt, and includes short-term measures to link debt management to the Government's cash position, and medium-term measures on the risk maturity profile of debt.
- Set clear policy on borrowing by and between SEPs, and by local governments.

- Improve the governance of school fees and levies, and address spiraling inflation in education services.
- Cap the share of extra-budgetary funds, including related user fees, in core areas of public service delivery.
- Review the types of approvals required for local government rates and budgets, to ensure the principle of cost recovery is respected.
- Improve the fiscal capacity of local governments by establishing a predictable and equitable transfer system, strengthening their ability to raise and collect sustainable sources of revenue, and achieve cost recovery tariffs for local services.
- Consolidate transfers to better serve core service areas, such as health, education, and social protection.
- Engage development partners around a short- and medium-term strategy for financing and expanding coverage of social protection and safety net programs.

Longer-term choices

In addition to the recommendations above, this PER explores longer-term solutions to Zimbabwe's challenges. Zimbabwe must confront key policy questions to move forward. In certain areas, the 2013 Constitution provides guidance, but choices on implementation remain. In other areas, matters remain open for policy-making. The questions below speak to Zimbabwe's key longer-term policy choices, which should ideally be informed by a broad-based, Government-led dialogue.

Public sector revenues exceed 50 percent of GDP, a level that raises concerns about the role of the state in the economy. ***Is the current level optimal in terms of effectiveness, efficiency and equitability? If not, what size of state would most appropriately meet Zimbabwe's challenges?***

The high public sector wage bill creates rigidity in the budget, and undermines the role of fiscal policy in economic development. It also perpetuates some inequities between public and private sector workers. ***Should conditions of service for the public sector, including SEPs and local governments, be adjusted in line with macroeconomic and fiscal performance?***

Current macroeconomic developments have led to unequal access to public services. In particular, access to education and some social services is financed by fees and charges that limit access by low income families. ***In cases where household contributions finance a significant share of service delivery, could equalization mechanisms effectively offset the regressive impact of private contributions, without disincentivizing those contributions? Or should the focus be on ensuring that public spending is progressive enough to offset the equity impacts over time?***

The 2013 Constitution calls for more decentralization of service delivery, but revenue mobilization by local government remains constrained. Unfunded mandates generally lead to gaps in service delivery and undermine accountability and trust in government at the local level. ***How should resources be shared between central and local levels of government to support effective, efficient and equitable service delivery?***

State-owned enterprises are falling short of expectations in their contributions to the economy, and becoming a burden on the fiscus, while the private sector is actively meeting demands in the market. ***Should the state maintain commercial enterprises in areas where private sector can meet demand? In cases where SEPs provide purely public goods, what oversight arrangements would best protect the public interest in Zimbabwe while ensuring sustainable service delivery?***

Zimbabwe recently approved an ambitious new national social protection strategy. However, a large number of social protection and safety net programs do not effectively reach the extreme poor. The country also has many other pro-poor programs that aim to help poor households raise incomes, but funding is spread thinly and fluctuates a great deal, rendering many programs unsustainable and ineffective. ***How should Zimbabwe prioritize across these programs over the short-to-medium term, in the face of limited resources?***

ANNEX C

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