Report No. 7646-ZIM

Zimbabwe
Private Investment and Government Policy

May 30, 1989
Southern Africa Department
Africa Region

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**ZIMBABWE**

**CURRENCY EQUIVALENTS**

**Annual Averages**

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**FISCAL YEAR**

July 1 - June 30

**ABBREVIATIONS AND ACRONYMS**

- CPI = Consumer Price Index
- CSO = Central Statistical Office
- CZI = Confederation of Zimbabwe Industry
- IDC = Industrial Development Corporation
- IPC = Industrial Projects Committee
- POSB = Post Office Savings Bank
- RBZ = Reserve Bank of Zimbabwe
- ZDB = Zimbabwe Development Bank
- ZSE = Zimbabwe Stock Exchange
Preface

It is increasingly recognized that the response of private investment is central to the effectiveness of adjustment measures in bringing about structural change and sustained growth. There is, however, very little analysis of this issue for Africa. The depth of the private business sector varies enormously across African economies—in some countries there is little or no indigenous business sector, while in many foreign corporations play an important role. Zimbabwe’s business sector is relatively well-developed by African standards and, since there is a working Stock Exchange, the accounts of an important part of it are in the public domain. This study focuses largely on the behavior of this part of the private sector, though this is placed within the context of overall determinants of private investment. In the examination of the influences on investment behavior it was found to be necessary to adopt a very broad approach that goes beyond estimating a reasonable investment function—which is often a thankless task in the African context—into issues relating to corporate finance, the pattern of investment incentives, the influence of risk and the regulatory environment. In view of the major role that multinational corporations play in the economy of Zimbabwe, special attention is given to foreign investment (and disinvestment) throughout the analysis.
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This report was prepared by Mansoor Dailami (Country Economics Department) and Michael Walton (mission leader, Southern Africa Department) on the basis of a mission to Zimbabwe in May 1989. Tony Hawkins and Brian Conheady (consultants) provided, respectively, a valuable background paper and the data basis on the listed companies; Vargha Azad provided assistance in the econometric analysis; and Rajakumari Stephen typed the report.
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i. This paper is concerned with the relationship between government policy and investment by the private corporate sector. It starts from the following considerations: first, that substantial growth in investment in the productive sectors is critical to any sustained economic recovery; second, that the Government of Zimbabwe is committed, in broad terms, to the continued existence of a mixed economy in Zimbabwe; and third, that the Government has a range of other objectives, especially on the structure of ownership of the capital stock, that need to be taken into account in assessing policies designed to get investment going. This summary is divided into an account of the current situation and a set of policy recommendations.

A. The Current Situation

ii. There is widespread concern over the depressed state of private corporate investment in Zimbabwe, but sharply contrasting views on the sources of the current malaise. Some observers emphasize low returns to multinational parent companies, the extensive government restrictions over decisions over most aspects of production and investment, and the high degree of political and economic uncertainty surrounding any new investment. Others point to high profits, a comfortably protected economic environment and the dearth of new investment inflows from parent companies, despite a stream of remittances. Both views have some truth in them, and the extent of divergence reflects the politicized nature of the debate within Zimbabwe, especially over the issues of the role of foreign capital and the role of government. This paper attempts some sorting out of the principal issues. The quantitative analysis is restricted to the listed companies on the stock exchange and macroeconomic data, but the issues are largely applicable to the whole private business sector.

iii. Ownership and investment. Around two-thirds of the listed companies on the stock exchange are foreign-controlled (in terms of total assets). This is somewhat above other estimates of the overall degree of foreign control of the business sector in the 1980s, since multinationals have a higher presence amongst the listed companies. Corporate investment since independence has been equivalent to about a third of total private investment in all sectors in Zimbabwe and a much higher proportion of investment in manufacturing and mining. Corporate and total private investment have moved closely together, with a sharp rise in the 1980-82 period followed by a drop in 1983 and little subsequent growth. Foreign-controlled companies experienced the sharpest rise and fall—in real terms, average investment in 1985-87 was 42 percent of the 1981-82 peak level for foreign companies, but 74 percent for domestic companies. The decline in investment by existing foreign-owned firms is central to the overall depression in investment.

iv. Macroeconomic conditions and private investment. Analysis of the historical experience indicates a strong relationship between private investment behavior and general economic conditions in the economy.
Changes in the level of economic activity are the dominant explanatory factor, but there is also empirical support for private investment being negatively affected by the opportunity cost of investments abroad and rises in the relative price of investment goods—the latter has risen sharply in period of reduced availability of imported capital goods in the economy. Domestic interest rates have a minor influence, while the exchange rate and wages do not appear to have a significant effect; nor do simple indicators of changes in the environment for foreign investors since independence. This picture is, to some extent, reassuringly consistent with a "normally" behaved private sector whose investment demand is driven by the expected need for replacement and new capital to meet future sales and indicators of the domestic and foreign cost of capital. However, there is cause for deep concern that the levels of investment in the sectors in which the private sector is dominant (notably mining and manufacturing) appear to be substantially below the levels required for future growth in output.

v. The financial system and corporate finance. Zimbabwe's financial system is sophisticated and diversified, and, in particular, has a well-established capital market. There are also strong incentives to use debt finance owing to the tax deductibility of interest payments. Yet the corporate sector makes remarkably little use of debt finance for its investment. Borrowing accounted for only 13 percent of total sources of funds between 1980 and 1987, and this was predominantly associated with current uses (for inventory accumulation and trade finance). Retained earnings, including capital consumption allowances, have been equivalent to, or larger than total fixed investment since independence. This is quite unlike other relatively industrialized developing countries (such as Korea), but is similar to the pattern of UK corporate finance. The other side of low investment demand by the corporate sector is relatively little activity on the corporate side of the capital market. While borrowing equivalent to corporate debentures occurs, this is reportedly largely on a private placement basis. Despite increased activity on the stock exchange in the recent past and a sharp rise in its value, new activity has been limited to rights issues and the market remains undervalued relative to book values.

vi. This pattern of heavy self-finance confirms the picture of a financially robust corporate sector. However, projections of typical corporate accounts indicate that this pattern is likely to be inconsistent with an investment recovery. With growth rates of nominal investment rates of 15 percent or more, the debt-equity ratio of both foreign and, especially domestic companies will have to rise sharply, though without exceeding prudent limits. This raises two questions: first, will the sector be willing to contract the debt, or will this constitute a deterrent to investment?; second, will the financial sector be able to supply the loans (at moderate real interest rates)? The latter question is itself associated with two issues: whether the public sector's borrowing requirements can be reduced in line with growth in demand from the corporate sector; and whether financial institutions will move into new areas of financing of business investment.

vii. Incentives, profitability and rates and return. The paper then looked at the adequacy of rates of return in the business sector to see
whether there is a problem in this area. Both company results and the expected impact of the tax structure were reviewed. Despite the high average corporate tax rate (over 50 percent) taxes paid are a relatively moderate 28 percent of profits, owing to the generous investment allowance (through full expensing of new investments) and, to a lesser extent, tax deductibility of interest. This is not an unusually high rate of taxation by international standards. More significant, from an investment perspective, is that the marginal effective rate of taxation has been close to zero, and is potentially significantly negative for firms that use debt finance. The actual performance of the corporate sector from 1980 to 1987 further confirms a picture of a healthy business environment: the pre-tax return on capital employed (after taking out depreciation) was on average 15 percent for foreign companies and 18 percent for domestic ones, while the after-tax return on shareholder’s equity was respectively 16 and 23 percent for foreign and domestic firms. Unusually low profits and weak tax incentives do not appear to be the problem.

While rates of return appear reasonable, these must be compared with the cost of capital. This appears to have been unusually high, especially since 1984, at well over ten percent in real terms for both local and foreign companies. This was not due to high real interest rates, however—the component of the cost of capital has been close to zero since independence. It derives rather from the two other components of the cost of capital: the rise in the relative price of capital goods, that was noted in para. iv, and, even more importantly, a high cost of equity once allowance is made for the perceived risks of obtaining future income from an investment. The latter is particularly important for foreign companies.

In contrast to the healthy historical rate of return, private sector representatives repeatedly emphasize the restrictions on the remittances of dividends imposed by the foreign exchange regulations. Dividend remittability was set at 50 percent of after-tax profits at independence, was temporarily suspended completely from 1984 to 1985, and then cut to 25 percent from May 1987. While this may appear onerous to a layman, it is not, however, out of line with business practices in countries without restrictions. Many Zimbabwean firms have UK parents where average dividend payout ratios were 23 percent in 1980-84—its high level by international standards. Moreover for the bulk of firms, this derives from an original investment made prior to 1965 with subsequent expansion financed entirely by domestic profits. Finally, for investments subsequent to 1980 that have been accorded “venture capital” status, remittability of 50 percent of after-tax profits has been allowed throughout the period.

How is this picture reconciled with the image of inadequate rates of return for existing and new foreign investors? Two points are relevant here. First, much of the returns have in the past derived from capital appreciation. This can only be realized for a parent company to the extent that capital can be repatriated. This can be done at a high cost for pre-1979 investments: either through domestic sale of the assets and purchase of 20-year convertible bonds; or (since about 1985) through obtaining approval for a domestic sale at a discount of between 40 and 70 percent of a company’s book value with expatriation of the proceeds of
between one and five years. Second, the degree of dividend remittability has been subject to changes in macroeconomic conditions—and in particular allocations of foreign exchange for investment income on foreign equity has been subordinated to the service of external debt. Although post-1979 investments have been exempt from these changes, this has contributed to the general perception of high risks associated with investment in Zimbabwe.

xi. Foreign exchange and the regulatory framework. The final issues in the explanation of depressed private investment concern the availability of foreign exchange and the regulatory framework. These are associated because investment regulation is intimately tied up with the administrative allocation of the country's own foreign exchange resources. Rationed foreign exchange, and the time-consuming process of investment approval, are clear deterrents to new investment. While there have been some improvements, especially for investments from blocked funds since the May 1987 package, the general perception remains one of a costly, time-consuming and uncertain process. Uncertainty over future foreign exchange availabilities for current requirements further increases the perceived risks associated with future profits. Finally, other aspects of the regulatory framework, especially job security regulations and wage and price controls, further increase the perceived cost of investment and the uncertainty over the future.

xii. Conclusion: profits, risks and procedures. The sources of the divergent views are clearly based in contrasting features of the system. The problem of weak investment is not due to inadequate profits, poor tax incentives, low rates of returns, a weak financial state of corporations or even the actual level of dividend remittances. All of these indicators are satisfactory and some are very healthy. It rather lies in three key areas: first, the actual and perceived risks of undertaking investment in Zimbabwe (especially by existing or new foreign firms); second, supply-side constraints, primarily associated with foreign exchange availability; and third, the cost of doing business in a highly regulated environment. The high cost of capital that this paper calculated for Zimbabwe is largely due to the first two of these factors.

B. Policy Recommendations

xiii. There is no simple policy shift that will initiate and sustain a private investment recovery. The President's speech of April 1989 and the subsequent policy document on the promotion of investment amount to an important statement of the direction of policy that could have a major positive impact on the business environment. Within this context, it is recommended that measures be formulated in a range of areas designed to improve the environment for corporate investment, without compromising the Government's distributional objectives. The policy recommendations are organized here with the following six goals: relaxing supply-side constraints; reducing risks; facilitating investment decision-making; encouraging the underlying demand for expansion of capacity; improving incentives for investment to be economically efficient; and dealing with
the ownership issue. The focus is on relieving supply-side constraints, defining new, and clearer, rules of the game and reducing perceived risks, and not on measures to raise current profits. In addition the necessity for a supportive macroeconomic environment is emphasized. Together the proposed measures would constitute a radical shift in the business environment, but this need not lead to either a rise in the share of profits or in the share of foreign capital in the economy. The measures laid out in the new policy document on the promotion of investment fall clearly within this framework. Their effective implementation, combined with action in the complementary areas discussed here, should form the basis for a robust recovery in private investment. The recommendations are discussed further in Chapter 6 of the report.

xiv. Relaxing supply-side constraints on investment. The key actual or potential supply-side constraints lie in the areas of the availability of imported and domestically produced investment goods and financial resources.

- foreign exchange for capital goods imports: increasing the availability of foreign exchange for private investment may require external borrowing, especially in the short term, and new mechanisms for passing the foreign exchange on to firms. The borrowing could be done directly by the private sector, but it would probably be preferable to make use of some form of investment facility, channelled through the financial system. In either case it is recommended that borrowing for private investment continue to be controlled in line with projected foreign exchange availabilities and prudent overall debt management.

- the capital goods and construction industries: these sectors share the general problem of being constrained by lack of intermediate imports and an aged capital stock. It is important that any framework for investment also supports their (efficient) expansion—the mechanism for effecting this will depend on the Government's policy choices over the foreign exchange allocation system, but this should be explicitly dealt with in any reform in the latter area.

- financial sector policy: both sufficient quantitative availability of credit and an adequate range of financing instruments in the capital market will be important, and both the monetary and non-monetary parts of the financial sector have a major role to play in corporate finance. There is already the financial infrastructure to respond to a rise in demand. However, to support this, a reduction in the share of financial resources going to the public sector will be essential and it would be desirable to complement this with measures to encourage more, and more innovative, investment finance, especially by the capital market; this could include a gradual reduction in prescribed assets requirements, the encouragement of the use of the stock exchange and corporate debentures, and the encouragement of new and riskier lending activities through allowing new institutions (subject to appropriate prudential requirements), new instruments and greater interest rate flexibility.
Reducing actual and perceived risks. Probably the single most important factor for a sustained private investment recovery is the formation of an economic environment that is sustainable, and is perceived to be sustainable. There are a number of aspects to this.

- **the macroeconomic framework**: macroeconomic management has to satisfy many objectives, but the key one for a sustainable environment is convincing fiscal adjustment, that assures the public that the Government is in control of the size of the public sector deficit—and can choose to adjust public spending and revenues in response to changing circumstance. This will require, in particular, a reduction in "structural" components of the deficit that cannot be adjusted in the short run. This has to be complemented by measures to stimulate export demand and, with greater care, private domestic demand.

- **the incentive framework**: (i) The country has been living with the uncertainty of the debate over trade liberalization for some time, with the consequence that firms are unclear over the nature of the future environment they are investing into. The resolution of this debate, in a manner that gives the private sector convincing signals on the endpoint and sequencing of any trade policy reform, will go a long way to reducing this uncertainty, whatever the expected pattern of gainers and losers. (ii) Relaxation of job security regulations will both reduce the risks associated with investment and increase the labor-intensity of new investment. It could be substituted by other measures to give workers some income security. (iii) Current plans to continue to unwind the price freeze, limit specific price controls to a restricted set of commodities and allow greater automaticity in price adjustment, are fully supported. Similarly a shift away from the system of administered wage setting is desirable; this is consistent with a continuation of reasonable minimum wages.

- **the environment for foreign investment**: the continuation of a differentiated stance vis-a-vis foreign investors is appropriate in the Zimbabwean context. Allowing disinvestment at a discount by those pre-1979 investors who wish to leave makes sense, but it is important to reduce the adverse impact on the business environment. One way to do this is to distinguish between the domestic sale, which could be at a market price in domestic currency, and the foreign exchange transaction, which would be at a discount. Additional measures are then desirable to clarify the environment for new investors: the focus of the new guidelines, as laid out in the April 1989 paper, is entirely appropriate. The existing "venture capital" concept is reasonable, but it is desirable both to substantially streamline procedures and reduce uncertainty: the proposed "one-stop" investment center, more secure remittability, and the signing of the Multilateral Investment Guarantee Agency, as well as better publicity, will all help. However, too much should not be expected in terms of new investment inflows in view of the global pattern of new foreign investment.

- **foreign exchange risk**: the new facility for covering foreign exchange risk is an understandable response to the private sector's concern. It is quite generous and some risk-sharing with the private sector could also be considered. However, since the origin of uncertainty
over the exchange rate lies in macroeconomic conditions and there are no market mechanisms whereby the private sector could cover its risk, it can make sense for the Government to assume the risk. This should not, of course, place any restrictions on exchange rate policy.

xvi. **Facilitating investment decision-making.** Some streamlining of the investment approval process is generally recognized to be required. This is in part related to the approval procedures for foreign investments and would be expected to be covered by the new investment center, provided this has autonomy and authority. It would be desirable to complement this with changes in the way foreign exchange for capital goods is allocated. This will depend on the Government's overall decisions on trade policy reform, but as a general principle it is recommended that the burden of project appraisal be shifted from the committee system to the financial sector. This could be associated with the proposed new private borrowing through an investment facility. Government priorities over the allocation of investment resources could still be included in the system through a combination of continued approval requirements for large projects, and negative restrictions on lending, though it is recognized that there may be a case for continued (quick) approval by Government for medium-size projects in the short term.

- **the importance of uniform treatment:** it is recommended that the incentive structure for investment be, as far as possible, uniform for different sectors or projects. There is a tendency to use, or consider using, both discriminatory and discretionary measures to allow the Government to provide special inducements for particular activities, for example in tax and dividend remittability policy. This gives less clear signals, adds to the regulatory burden and has, in other countries, often become associated with corruption. This report recommends a transparent, reasonable, and sustainable incentive structure—rather than the uncertain prospect of more generous incentives if a Committee grants them. Where non-uniform treatment is used (e.g. for pre- and post-1979 investments, or on locational grounds) it is important that these be both public and consistently applied.

xvii. **Encouraging the underlying demand for expansion of capacity.** The historical evidence strongly supports the intuitive conclusion that investment demand is sensitive to changes in aggregate demand. Steady growth in demand from exports and the domestic market to increase capacity utilization and raise sales expectations are necessary to increase the underlying desire for investment. It is equally important that this be perceived to be sustainable, as noted above, and fiscal management will be central here.

viii. **Encouraging efficient investment choices.** A shift to a system of product market incentives that encourages efficient investment choices is clearly important. Trade liberalization can play a crucial role in this area, but this was not a primary focus of this report. However, specific aspects of the tax system were reviewed.

- **direct tax incentives:** major changes in corporate tax policy are not required in the short term: the system already supports reasonable
profits from new investments. The major anomaly concerns the coexistence of tax-deductibility of interest and full expensing of investment outlays on many fixed assets, that together constitute a subsidy on investment. The Government should consider some reductions of allowances here—preferably through removing the tax deductibility of interest on borrowings for fixed investment and the substitution of an equivalent reduction in the corporate tax rate. Since firms are generally not highly levered, this is a relatively good time to do this.

**Indirect taxes:** the major anomaly in the indirect tax system derives from the recent shift to reducing custom duties on imported capital goods (that are virtually entirely non-competing) whilst domestically produced capital goods enjoy much higher de facto protection (through the foreign exchange allocation system). To avoid encouraging excessively import-intensive investment choices, it would be preferable to shift toward a uniform treatment.

**Broadening ownership.** There are two objectives in this area: the dilution of foreign ownership in the economy, and increased participation by black Zimbabweans in the business sector. Current disinvestment policy supports this effectively, but, as noted above, has had adverse consequences for the investment environment. It is important that this be designed in a way that does not lead to increased perceived risks for other prospective investors. The other area of potential importance is the financial sector, where measures to encourage lending to new, riskier ventures (through allowing new institutions or lending activities, broader collateral requirements etc.) and wider ownership by small investors in the stock exchange would help. There can also be a role for public agencies in spreading risks taken by private financial institutions. The existing credit guarantee agency has an appropriate design—it has joint public-private ownership and a maximum of 50 percent of credit risk is taken. Its activities could be encouraged and expanded.

**Investment in the small-scale sector.** The focus of this report has been on the large-scale sector, though some of the recommendations—notably on encouraging greater lending to new black Zimbabwean entrepreneurs—concern medium sized firms. The problems of the small-scale, or informal, sector are of equal importance. Although this now accounts for a fraction of the country's capital stock, it will play a critical role over the next decade, especially in the area of employment creation. While the corporate sector will continue to have a central role in the expansion of Zimbabwe’s productive capacity, the associated increase in employment can only account for a minor part of the projected growth in the labor force. The bulk of employment creation will have to occur in the agricultural, rural non-farm and urban informal sectors. Appropriate investment policy in rural and urban infrastructure, urban policy that encourages—rather than restricts—small enterprises, increased subcontracting by the formal sector and small-scale credit and extension activities can all help. However, the development of specific recommendations will require further analysis.
1. INTRODUCTION

1.1 The continued sluggish behavior of corporate business investment in Zimbabwe is a major source of current concern. With the exception of the short-lived economic boom of the early 1980s, business fixed investment has, since independence, been depressed and has experienced a significant decline over the past few years. This decline has been particularly pronounced in the investment patterns of large companies and among these especially foreign controlled ones (see Table 1.1). Given the dominant role of these companies in the country's total business investment activity, their reluctance to invest has prompted serious concern. At stake is not just the current economic recovery, but also the prospects for future growth in output and employment, and the effectiveness of any structural adjustment measures. Both the Government of Zimbabwe and the business community are keenly aware of the present situation and the implications that it may hold for the future. There is, however, less agreement about the underlying causes or the required policy measures to support an investment recovery.

1.2 The present weakness of investment demand in Zimbabwe is due to a range of socio-political and economic factors. Previous analysis undertaken in the context of the 1987 Country Economic Memorandum 1/ and discussions with government officials and the business community have identified three broad sets of constraints: (i) supply-side factors, related primarily to shortage of foreign exchange necessary for imports of essential capital goods and industrial inputs; (ii) excessive administrative intervention in the areas of investment decision-making, labor relations and price controls; and (iii) socio-political factors reflecting the country's history, strategic location, and political evolution. There is no easy way to disentangle the influence of these factors or to establish their quantitative dimensions. Some of these factors are not amenable to quantification and their influence cannot be assessed within the conventional models of private investment behavior. 2/ Yet, their importance is underlined by the fact that conventional indicators of investment incentives, such as profitability, a supportive tax incentive scheme, and the lack of any apparent financial constraint, have been rather favorable in recent years.


2/ Analysis of private investment behavior is difficult and controversial, even in ideal situations when the influence of political and strategic factors are not considered. The controversy among various approaches to determinants of private investment in industrial countries, which has persisted in the economic literature over the past fifty years, is one manifestation of the intractability of assessing how investors respond to changes in the underlying economic and financial environment. See for instance, Abel, (1980) and Shapiro, (1986), for further discussion.
Table 1.1 Corporate Investment Outlays, 1980-1987  
(current and 1980 prices)

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a/ 48 listed companies in the Zimbabwe Stock Exchange.
b/ Deflated by the investment price deflator.

Source: Zimbabwe Stock Exchange.

1.3 A comprehensive view of business investment in Zimbabwe needs to take account of four basic factors: (i) the desire for investment; (ii) the availability of funds to pay for the investment; (iii) the cost of capital, including the influence of the incentive system; and (iv) the regulatory and institutional environment. The desire for investment is related to macro and structural factors that underlie the companies' motives for business expansion, cost reduction or replacement, and renewal of aging and obsolete machinery and equipment. The availability of funds depends on the level of internal cash generation, on the willingness and capacity of firms to raise funds externally, and, of course, on planned investment. The incentive system embraces both the various inducements of tax shields, accelerated depreciation schemes, interventions on interest rates and guaranteed finance that governments resort to in order to stimulate investment expenditures, and interventions on resource allocation that also affect the incentives for investment. These interact to affect the cost of capital and so the required rate of return for new investment. These three factors are, to a large extent, complementary to each other. Ample supply of funds and generous incentives would not necessarily lead to higher investment outlays if firms lack motives or reasons for such an expansion. Alternatively, lack of an appropriate incentive system could frustrate the desire for investment, even if finance is not a binding constraint. Finally, the financial constraint could be binding when both desire and incentives are favorable.

1.4 Investment desire, incentives and finance interact within a regulatory and institutional framework. Such a framework defines the ground rules and determines the degree of autonomy that businesses can exercise over the crucial areas of project selection, project approval,
labor relations and financing, and dividend policies. Such a degree of autonomy bears strongly upon the potency of the incentive system. For instance, generous depreciation allowances are less effective if investment decision-making and implementation processes are constrained by excessive government intervention.

1.5 This paper assesses the determinants of business investment in Zimbabwe in the four areas outlined above. The quantitative analysis of the corporate sector covers the local and foreign companies that are listed in the Zimbabwe Stock Exchange (ZSE), for which reliable balance sheet and income expenditure data are available for 1980-87. This constitutes a small sample in terms of number (only forty-eight companies), but a group that is critical in terms of both share of total business capital formation and economic function. These are generally large companies with an intensive network of production and distribution activities in the mining, manufacturing, construction, and retail sectors. They account in aggregate for slightly more than one-half of the private business investment, and their total capital assets measured at book value amounted at the end of 1987 to about ZS2 billion or 20 percent of GDP.

1.6 The remainder of the paper is divided into five parts: Chapter 2 presents the macro context for private investment and the results of an econometric investigation of the determinants of private investment; Chapter 3 analyzes the pattern of corporate finance in Zimbabwe, highlighting the self-financing characteristic of the corporations; Chapter 4 provides an analysis of past rates of return and the present investment incentive system in Zimbabwe, including an analysis of the cost of capital in Zimbabwe; Chapter 5 discusses the regulatory framework for domestic and foreign firms; and Chapter 6 pulls together the conclusions of the analysis for government policy. Finally, Annex I discusses the determination of the marginal cost of capital for the non-financial corporate sector.
2. PRIVATE INVESTMENT IN THE MACROECONOMY

The Historical Pattern of Investment

2.1 The private sector has accounted for half or more of total fixed investment in the past. It has had two principal characteristics: first, it has experienced sharp fluctuations in response to changes in the overall level of economic activity; and second, it has dominated investment in the goods-producing sectors.

2.2 The variation in total fixed investment since 1968 is illustrated in Figure 2.1. There have been two major peaks: in the major expansion of the early 1970s and in the brief post-independence boom of 1981-82. There has been a significant subsequent decline--to the real levels prevailing in 1972-73--and only a weak recovery following the agriculture-led expansion in economic output of 1985. Figure 2.2 then gives the breakdown between private and public fixed investment 3/. This reveals that the variations in private investment have been sharper: the decline in private investment started in 1982, before public investment, and the subsequent depression has been deeper, to an investment level below that prevailing in 1970 or 1979, that was the trough of the previous depression. There also appears to have been a shift in the overall composition of investment: the private sector accounted for about 60 percent of the total through 1981 but for less than half subsequently.

2.3 The relatively sharp decline in private investment has implications for the sectoral pattern of investment. As Figures 2.3 and 2.4 show, there are radical differences in the composition of private and public sector investment. The private sector dominates investment in the goods-producing sectors: in the 1980-84 period, manufacturing and mining accounted for over half of total private investment and agriculture for a further 15 percent. This represented only minor changes from the composition in the 1970s; it reflects, of course, the predominance of private sector ownership of the capital stock in these sectors. The public sector, by contrast, has mainly invested in economic infrastructure and, to a lesser extent, public services. At least until 1984, the public sector has accounted for a small fraction of total investment in the goods-producing sectors. While there is not evidence of any significant increase in public investment in these sectors in the 1985-88 period, this may be gradually changing following the recent increase in state participation in the corporate sector.

2.4 This pattern of a relative predominance of the private sector in the goods-producing sectors suggests these have been particularly adversely affected in the post-1982 investment decline. This is worrisome in view of

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3/ CSO only publishes a breakdown of investment up to 1984: this paper used direct estimates of public investment (from budgetary and parastatal sources) and derived private investment as a residual for 1985-87.
Figure 2.1
Real Fixed Investment, 1968-1987
(millions of Z$ at 1980 prices)

Figure 2.2
Private and Public Fixed Investment, 1970-87
(millions of Z$ at 1980 prices)
Figure 2.3: The Composition of Private Fixed Investment (1980-84)

- Agriculture: 15%
- Mining & Manufacturing: 52%
- Services: 30%
- Construction & Infrastructure: 3%

Figure 2.4: The Composition of Public Fixed Investment (1980-84)

- Mining & Manufacturing: 3%
- Agriculture: 2%
- Construction & Infrastructure: 50%
- Other Services: 39%
- Health & Education: 5%
the critical role of these sectors for future growth. Both government and other analysis has documented how post-independence growth in production has been to a large extent associated with growth in services—with the exception of bumper agricultural years. 4/ An inadequate investment level in the goods-producing sectors, especially in the mid-1980s, further jeopardizes future growth from this source.

2.5 The final descriptive point of importance here concerns the large role of corporations within the private sector in Zimbabwe. The business sector accounts for the bulk of investment in mining, manufacturing, construction and finance, and is also important in trade and transport. In agriculture, commercial farmers and some businesses account for most recorded investment, while the smallholder investment that has occurred has probably largely gone unrecorded. Small-scale and household enterprises play a relatively small role in other sectors, but probably a rising role in the urban informal sector; again it is likely that much of this activity is going unrecorded.

Determinants of Private Investment

2.6 To provide the overall context for the behavior of the business sector, the study undertook an econometric analysis of the determinants of private investment for the 1968-87 period. This is essentially an analysis of the relationship between investment and national income, using an extended accelerator model, with the hypothesis that the principal economic determinants of private investment would be expected to lie in three areas: expectations on the requirements for capacity expansion to meet future growth in sales (that would drive the underlying desire for investment); the cost of investing for domestic and foreign investors—including the price of investment goods; and relative price factors that could influence the expected profitability of investing. In addition to these determinants, we also explored possible changes in the environment for foreign investors. This is not a complete model of investment behavior—this would require both dealing with the simultaneity between output and investment determination and a full specification of the supply side. Some supply-side factors were explored in the econometric analysis, and are briefly reported on here, and a more rigorous approach is planned for follow up work.

2.7 The following approach was adopted to the major variables.

   (i) Income and capacity. Expected future sales were generally captured by using changes in current national income. 5/ There is no direct indicator of capacity utilization so this was explored by alternative

4/ See, for example, Government of the Republic of Zimbabwe, (1986).

5/ All the results reported are based on changes in GNP; similar results were obtained when GDP was used. The influence of the external terms of trade—that affect national income—was also explored, but the results were not significant and are not reported.
indirect measures, including constructed indices of overall utilization in the economy--from either the ratio of actual to trend GDP or a derived capital stock series--and total intermediate imports (on the grounds that the short-run output is import-constrained).

(ii) The cost of capital. It is argued in Chapter 3 that the appropriate formula for the cost of capital should take account of three factors--the cost of borrowing, the cost of capital goods and the cost of equity, with risk factors playing a large role in the last. It is also concluded there that the cost of capital is quite different for domestic and foreign investors. It is not possible to construct a long enough time series for the full synthetic estimate of the cost of capital to be used for estimation purposes; however, it was feasible to use measures of the domestic cost of borrowing and of the relative price of investment goods (obtained from the implicit investment deflator in the national accounts) for domestic investors. We then used the yield on long-term bonds in the UK as an indicator of the perceived opportunity cost for foreign investors. 6/

(iii) Relative prices. Two areas of possible influence were explored. First, wages may exert an influence through the indirect impact on profitability; they may also affect the capital intensity of new investment. Second, the real effective exchange rate was explored for the possible influence on the profitability of the tradeable goods sectors (which accounts for a large portion of total private investment, as Figure 2.3 showed.)

(iv) Other influences on foreign investors. In addition to the foreign cost of capital, we explored the possible influence of changed expectations on the environment for investment, notably on remittability of profits and dividends, through using dummies for 1980 (for independence and a rise in the level of remittability for most firms) and 1984 (when remittability was cut for pre-1979 investments, with a reportedly broader impact on perceptions of the business environment).

2.8 Table 2.1 provides the results of a number of alternative specifications using ordinary least squares. These are all based on a log-linear investment function--a linear formulation was also explored but with greatly inferior results. The results reveal a highly plausible account of private investment behavior with significant coefficients, with the expected signs, for most of the major variables. The core of the dynamics

6/ The real rate of return in both British and Zimbabwean currency terms was explored: the former would be relevant for new investment of a British firm and the latter for the re-investment of retained earnings of a firm already in Zimbabwe. The former was insignificant, but the latter highly significant--see below. It would be preferable to use an index of the alternative rate of return on investment--in the UK or in competing countries for the investment for multinationals--and we are implicitly assuming well-functioning capital markets in the UK.
### Table 2.1 Results of an Econometric Analysis of the Determinants of Private Investment, 1970-1987

<table>
<thead>
<tr>
<th>Equation</th>
<th>Constant</th>
<th>log GNP</th>
<th>log GBYUK</th>
<th>log DRR</th>
<th>log RPIC</th>
<th>log RIR</th>
<th>log REER</th>
<th>log WAGE</th>
<th>log POF CF</th>
<th>R²</th>
<th>D.W.</th>
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<td></td>
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<td></td>
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<td>(3.3)</td>
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<td></td>
<td>(-0.8)</td>
<td>(2.1)</td>
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**Notes**

- T-statistics are given in parentheses.
- POF CF = Private gross fixed capital formation deflated by the investment deflator.
- GNP = GNP deflated by GNP deflator.
- GBYUK = Real long term government bond yield in UK deflated for the change in Z$/$Pound exchange rate.
- DRR = Differential rate between government bond yield in UK adjusted for the change in Z$/$Pound exchange rate and internal rate.
- It has been entered in the form (1+DRR).
- RPIC = Relative price of capital goods = Investment deflator/GDP deflator.
- RIR = Real interest rate; The nominal interest rate deflated by the CPI, calculated by the formula 1+r/1+cpi.
- REER = Real effective exchange rate.
- WAGE = Real wage; nominal wage deflated by GDP deflator.
- POF CF1 = Lagged dependent variable (one period).
lies in the strong relationship between investment and changes in GNP, with a coefficient between 1.3 and 1.8, and lagged investment, with a coefficient around 0.4, implying quite rapid adjustment to changes in other variables.

2.9 The effect of the cost of capital on investment is then of particular interest. The real foreign interest rate, converted into Zimbabwe dollars, is significantly negative, while the relative price of capital goods is sometimes significantly negative and the real domestic interest rate has the right (negative) sign, but is generally insignificant. This is consistent with the view that there are two groups of investors within Zimbabwe: foreign-controlled firms that are influenced by perceptions of the opportunity cost of investment (as measured here by the U.K. interest rate) and domestic investors. Quite good results were also obtained using the difference between the U.K. interest rate (exchange rate adjusted) and the domestic interest rate. The fact that surplus profits of foreign firms cannot be expatriated in the short run makes no difference to the argument, since this will still provide a measure of the perceived future cost of a long-term investment decision. A foreign-controlled firm with investible resources will take into account what could be earned with these resources—over the long term—outside the country even if there is uncertainty over when either a surplus could be remitted or the company will be able to disinvest on reasonable terms. However, neither foreign nor domestic firms borrow significantly domestically to finance investment (see Chapter 3) and the domestic interest rate is only of weak significance. The relative price of capital goods is, on the other hand, an important variable for all investors—this is further analyzed in the assessment of the cost of capital in Chapter 4 and Annex 1.

2.10 Both the real wage and the real exchange rate were generally insignificant (including in formulations with lags). This is probably a reflection of the dominance of quantitative controls and regulations in these areas, though, to the extent the exchange rate influences exports, it would be expected to have an indirect influence on investment through an increased supply of imports. These results remain useful, since they indicate that the Government does not need to be too concerned about the consequences for investment of changes in these variable to meet other objectives. There is some uncertainty over the exchange rate since this would be expected to influence the relative price of investment, in view of the relatively high import content of investment. However, historically the effect of changes in import prices appear to have been swamped by other determinants of this relative price—that we hypothesize are associated with restrictions on supply. Thus if exchange rate depreciation were associated with increased availabilities of capital goods, any adverse price effects should be moderated or reversed. It would, of course, be important to monitor this.

7/ Fixed investment has, on average, an import content of about 40 percent, compared with about 20 percent for other expenditures.
2.11 Finally, the use of dummies for changes in the business environment in 1980 and 1984 had no significant impact—an interesting result that suggests neither a sharp break in the behavior of the private sector at independence, nor any major effect on investment of the changes in the level of remittability in these years. (That does not mean that variations in remittability are unimportant—it is argued in Chapters 5 and 6 that they are—only that the specific changes did not have an additional short-run impact on the investment climate).

2.12 Two of the relationships are illustrated further in Figures 2.5 and 2.6. The first clearly shows why the coefficient on income is high—in the two major cycles that occurred in the period in question, private investment has fluctuated sharply in response to changes in national income. As we know from previous analysis on the economy, this is in part because total, and especially private, investment has characteristically borne the brunt of adjustment when the emergence of macroeconomic imbalances or external liquidity constraints have forced the Government to make macroeconomic corrections. This implies the econometric results cannot be interpreted as a simple demand relationship. On the supply side, the adjustment has generally been effected through cutbacks in import allocations for investment, rather than any squeeze via the financial system. Conversely, in the two major upswings, of the early 1970s and the beginning of the 1980s, there has been both a need to catch up with previously postponed investment and a relatively large relaxation in the import constraint. It should be noted that in both cases it is reasonable to suppose the recovery in output was expected to be sustained—in the early 1970s because of the strength and extent of the period of growth, and in the early 1980s because of the strong general improvement in expectations after independence—the stock market index reached a record high in 1980 (see Figure 4.1). By contrast, the short-lived recovery in 1985 was entirely due to an excellent harvest and was associated with only a moderate and temporary recovery in investment.

2.13 Figure 2.6 then shows the rise in the relative price of investment: here the two periods of sharp increase, in the late 1970s and the mid-1980s, coincide with periods of contraction of private investment. While some secular rise in the relative price of capital goods may occur over the long term, this is an unusually large and rapid increase. As noted above, the most plausible explanation in the Zimbabwean context is that restrictions in the supply of capital goods (effected by tightened import rationing) have been reflected in their relative price. This account is consistent with the workings of the price control system, that is based on allowable mark-ups for most products—such a system is much

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8/ As noted in para. 2.9, this is not due to real exchange rate movements—the relative price of investment rose much more rapidly than the average border price of imports of manufactures in domestic currency. Note that the econometric results should be treated with caution, since the investment deflator is also the index used to deflate nominal private investment. For this reason, we systematically explored the influence of other variables with the relative price of investment excluded.
Figure 2.5

Real Change in GNP and Private Fixed Investment
(in percent at 1980 prices)

Figure 2.6

Real Private Investment and the Relative
Price of Investment Goods

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- GNP at market prices
- Private fixed investment

---

- Ratio of investment to GDP deflator
- Priv. fixed inv., at 1980 Z$'000
more effective in moderating price increases for relatively homogeneous commodities and very difficult for engineering products.

2.14 **Supply-side factors.** As noted above, the supply side was not rigorously treated, but we did explore the influence of import variables. The principal supply-side constraint in the system--as everybody in Zimbabwe emphasizes--is the rationing of imported capital goods within the administrative allocation system. This was explored as an independent variable. 9/ Both imports of capital goods (a proxy for government allocations under the foreign exchange allocation system) and indicators of the overall level of foreign exchange availability added slightly to the overall explanatory power of the equations, with a marginally significant positive impact on private investment. While it is unconventional to treat this as an exogenous factor, this could be justified in Zimbabwe because of the import rationing system: the Government decides on the foreign exchange allocation for this purpose. While it is probably only "weakly" exogenous (i.e., policy decisions will be influenced by other factors, including changes in income) it is appropriate to have it as an independent variable. It is actually surprising that it has as little explanatory power as indicated in the empirical results, but there are two important interpretations of this: first, the resultant scarcity in capital goods is already partially captured in their relative price; and, second, despite the obsession with import rationing within Zimbabwe, other factors--sales expectations, business confidence and the cost of capital--are of equal or greater importance for the level of private investment. The latter point is a major theme of this paper.

**Implications for the Future**

2.15 The results reported above are quite good in econometric terms and they support the view of a private sector that responds to underlying economic variables. The overall explanatory power of the equations is surprisingly high in view of the evidence from firms on the importance of other factors on investment--including perceived risks and regulations. However, this is consistent with the absence of major changes in these structural aspects of the business environment over the period; the negative results on the tests for changes at independence, and the highly significant constant term, also support the conclusion of a significant, but relatively unchanging, determinant of the level of investment outside the independent variables that we explored. Although valuable, the results should be treated with caution for any forward-looking analysis. Apart from the customary caveats with the results of an analysis with limited data, it was suggested that the strength of the relationship between private investment and national income derives in part because of the nature of the cycle and macroeconomic adjustment process. It would be

9/ This is, of course, the opposite of the normal direction of causation, in which the demand for imported goods would be treated as a function of the level of investment demand and the relative price of imported and domestically produced capital goods (to the extent that these are competing products).
foolhardy either to predict that a rise in GDP alone would lead to a sustained rise in investment of the strength indicated by the equation results, or that cuts in the relative price in investment goods would have a similar effect. The private business sector's investment behavior is (unfortunately) much more complex than that, and the Government will have to deal with a range of other factors in supporting an investment recovery. Indeed, much of the remainder of the report is devoted to a more detailed account both of some of the key factors influencing the explanatory variables in the estimated equations (for example the financial and cost of capital variables) and to some of the factors that this approach cannot capture (notably in the areas of risks and regulations).

2.16 To provide the context for the required role for private sector investment in future growth, we undertook an indicative analysis of investment requirements up to the mid-1990s, based on plausible targets for growth in output and estimated investment requirements for replacement and new investment. It is limited to the key mining and manufacturing sectors and, for simplicity, a constant degree of capital efficiency is assumed. However, to make some allowance for the backlog in investment we assumed a rise in the depreciation rate from 3.5 percent (that has often been used for historical analysis of Zimbabwe) to five percent. This may still be unduly conservative. As Table 2.2 shows, if the mining and manufacturing sectors are to grow by 2.9 percent per annum and 4.6 percent per annum through the mid-1990s 10/, investment levels in the combined sectors have to rise to 74 percent above the 1981 peak and to over 200 percent above the 1984 level (that was probably above the 1987 level for these sectors). While the assumptions are subject to a range of errors—productivity increases would reduce investment requirements while an under-estimated backlog would increase these—there is clearly a need for a major rise in private investment.

| Table 2.2 Projected Investment Requirements for the Mining and Manufacturing Sectors in 1995 |
|---------------------------------|---------------------------------|---------------------------------|---------------------------------|
| Assumptions                     | Results                         |
|---------------------------------|---------------------------------|---------------------------------|---------------------------------|
| Growth in output 1987-95 (%) p.a. | Depreciation rate (%) | Capital output ratio by 1995 relative to 1981 to 1984 (%) | Increase in real investment by 1995 relative to 1981 to 1984 (%) |
| Mining                          | 2.9                             | 5.0                             | 4.4                             | 40                             | 246                             |
| Manufacturing                   | 4.6                             | 5.0                             | 2.4                             | 100                            | 191                             |
| Total                           | n.a                             | n.a                             | n.a                             | 74                             | 206                             |

10/ These happen to be the growth rates from projections undertaken with an accounting (RMSM-type) model—they are consistent with the maintenance of external balance.
2.17 The result is of importance for the private sector because of its predominance in these sectors. It was suggested above that there is considerable uncertainty over the future growth in private investment. A mechanistic use of the estimation results for forecasting could predict a quite rapid recovery in investment following an output recovery, especially if this were also associated with a decline in the relative price of capital goods. But there are a number of reasons for not being optimistic about the responsiveness of private investment, especially since the only significant rise in private investment in the post-independence period quickly petered out in response to worsened macroeconomic conditions. The subsequent depression in investment has been deep and there has been very little new foreign investment inflows by either new or established foreign investors. If the endogenous private sector response is weak, this implies that one of two courses will be necessary if capital is not to constitute a brake on future growth in these sectors. Either other measures will have to be implemented to change the relationship between private investment and macroeconomic conditions or the public sector will have to play a much larger role in investment in these sectors. The latter course brings risks of less efficient resource use, a further worsening in the public sector's resource position and potential negative influence on private sector investment. This warrants further analysis, but is not the focus of attention of this paper. The main interest here lies in examining potential areas for getting private investment going, based on an assessment of the current situation. The following sections turn to an account of the financial, incentive and regulatory framework for domestic and foreign corporate investment.
3. THE STRUCTURE OF ZIMBABWEAN CORPORATE FINANCE

3.1 This chapter turns to the first specific area of potential importance in determining current and future investment levels—the pattern of corporate finance. This is of importance to an understanding of the extent to which financing constraints are important influences on investment behavior, of the relations between the corporate sector and the financial system, and the implications for future financial sector development and policy. It starts with an analysis of the sources and uses of funds, then discusses the reasons for the high degree of self-financing and concludes with projections of the future demand for debt.

Sources and Uses of Funds

3.2 A high degree of self-financing is a central feature of corporate finance in Zimbabwe. Corporations generally rely on internal sources of funds, consisting of retained earnings and capital consumption allowances, for the bulk of their financing requirements. The composition of sources of funds is shown for listed companies in Table 3.1. 11/ Between 1980 and 1987 company retained earnings and depreciation allowances accounted for 60 percent of the total sources of funds. Issuance of new shares has accounted for eight percent of total sources for the period as a whole, but its contribution has been erratic, often reflecting the funding behavior of only one large company. Most notable has been the very low contribution of debt capital. Public issuance of corporate bonds has been virtually non-existent (though reportedly long-term borrowings do occur on a private placement basis), and recourse to bank borrowing has amounted to only 13 percent of total companies' needs for funds. However, it is worth noting that there appears to be a high correlation between debt finance and the level of investment: total debt finance averaged 34 percent of sources of funds during the 1981-82 peak in investment outlays (Table 1.1). The remaining 16 percent of sources of funds has been met through trade credits (and a minor outflow on "other" sources).

11/ This is derived from flow of funds and balance sheet data for the listed companies on the Zimbabwe Stock Exchange. For the non-listed companies, there exists no comparable information. These companies are not legally obligated to publish income-expenditure and balance sheet data. Indirect evidence, based on field interviews and the low ratio of total credit to investment in Zimbabwe, suggests that self-financing is high in these companies as well.
Table 3.1 Financing Sources of Non-Financial Corporations
1980-1987
(percentage of total sources of funds)

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<td>Gross internal funds</td>
<td>59.2</td>
<td>54.0</td>
<td>40.1</td>
<td>40.9</td>
<td>50.9</td>
<td>87.5</td>
<td>82.6</td>
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<td>Retained earnings</td>
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<td>28.2</td>
<td>20.0</td>
<td>10.9</td>
<td>35.4</td>
<td>54.3</td>
<td>37.6</td>
<td>53.9</td>
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<tr>
<td>Depreciation</td>
<td>22.2</td>
<td>16.2</td>
<td>12.0</td>
<td>20.9</td>
<td>40.1</td>
<td>52.1</td>
<td>28.3</td>
<td>16.1</td>
<td>20.2</td>
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<td>New stock issues</td>
<td>8.3</td>
<td>26.6</td>
<td>10.8</td>
<td>0.6</td>
<td>9.4</td>
<td>6.4</td>
<td>0.5</td>
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<td>Medium/long term loans</td>
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<td>14.0</td>
<td>32.4</td>
<td>4.4</td>
<td>-3.6</td>
<td>-13.7</td>
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<td>2.2</td>
<td>13.4</td>
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<td>-28.9</td>
<td>6.6</td>
<td>27.3</td>
<td>4.7</td>
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<td>Trade credits</td>
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<td>16.5</td>
<td>17.5</td>
<td>17.1</td>
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<td>37.0</td>
<td>19.2</td>
<td>16.5</td>
<td>13.9</td>
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<td>4.1</td>
<td>0.7</td>
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<td>1.7</td>
<td>4.8</td>
<td>1.6</td>
<td>-0.2</td>
</tr>
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</table>

Source: Company accounts of 48 listed companies in the Zimbabwe Stock Exchange (ZSE).

3.3 Table 3.2 then provides a breakdown of the uses of funds for listed companies over the 1980-1987 period. These companies have, in the aggregate, used over half of their resources on investment in fixed assets. Roughly one-quarter has been used to finance debtor accounts or to finance long-term financial investment. This ratio of fixed assets is much larger than in other developing countries and is strikingly close to the pattern observed in industrialized countries, particularly the U.S. and the U.K. (See Table 3.4). Despite the large share of fixed assets in the uses of funds, the degree of self-financing is even more striking in relation to fixed investment. As Table 3.3 and Figure 3.1 show, internal sources of funds were equivalent to over 100 percent of fixed investment in the 1980s for both local and foreign-controlled companies. This suggests that, as far as fixed investment has been concerned, the listed companies would have been more than able to meet their own financing needs, with no dependence on financial intermediaries (though again the ratio rises in years of lower investment). Firm interviews confirm that external finance is little used for fixed investment and predominantly for the companies' operating requirements, including funds for working capital to pay for stocks and work in progress, financing trade debtors and for holding cash and other liquid assets.
Table 3.2 Uses of Funds of Non-Financial Corporations 1980-1987 (percentage of total uses of funds)

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<tr>
<td>Capital formation</td>
<td>77.4</td>
<td>74.3</td>
<td>78.7</td>
<td>91.6</td>
<td>88.7</td>
<td>52.6</td>
<td>74.9</td>
<td>72.4</td>
<td>78.8</td>
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<td>53.1</td>
<td>46.1</td>
<td>55.3</td>
<td>62.8</td>
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<td>Inventories</td>
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<td>28.3</td>
<td>23.4</td>
<td>28.8</td>
<td>9.3</td>
<td>-3.6</td>
<td>26.2</td>
<td>33.0</td>
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<td>Cash</td>
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<td>13.5</td>
<td>5.0</td>
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<td>Debtor</td>
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<td>10.9</td>
<td>13.0</td>
<td>31.1</td>
<td>12.5</td>
<td>23.1</td>
<td>18.8</td>
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<td>Long term loans and</td>
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<td>0.6</td>
<td>-0.4</td>
<td>1.3</td>
<td>1.0</td>
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<td>-0.1</td>
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<td>Other Uses</td>
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<td>3.5</td>
<td>1.4</td>
<td>6.5</td>
<td>2.6</td>
<td>2.5</td>
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Source: Company accounts of 48 listed companies in the ZSE.

Table 3.3 Self-Financing over Fixed Investment Ratios Local and Foreign held Companies (in percent)

<table>
<thead>
<tr>
<th>Year</th>
<th>Internal Funds</th>
<th>Local Companies</th>
<th>Foreign Companies</th>
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<tr>
<td></td>
<td>Internal Funds</td>
<td>Internal Funds and New Stock Issues</td>
<td>Internal Funds</td>
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<tr>
<td></td>
<td>1980</td>
<td>90.1</td>
<td>118.5</td>
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<td></td>
<td>1981</td>
<td>76.4</td>
<td>121.3</td>
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<td></td>
<td>1982</td>
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<td>70.6</td>
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<tr>
<td></td>
<td>1983</td>
<td>41.7</td>
<td>70.0</td>
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<tr>
<td></td>
<td>1984</td>
<td>94.7</td>
<td>126.4</td>
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<tr>
<td></td>
<td>1985</td>
<td>89.5</td>
<td>92.0</td>
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<tr>
<td></td>
<td>1986</td>
<td>124.9</td>
<td>133.5</td>
</tr>
<tr>
<td></td>
<td>1987</td>
<td>101.4</td>
<td>110.1</td>
</tr>
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</table>

Source: Company accounts of 48 listed companies in the ZSE.
Table 3.4 Composition of Corporate Business Assets in Selected Countries, 1983
(percentage of total assets)

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<tr>
<td>1. Fixed Assets a/</td>
<td>32.24</td>
<td>32.38</td>
<td>41.75</td>
<td>27.19</td>
<td>39.62</td>
<td>34.90</td>
<td>41.76</td>
<td>61.00</td>
<td>55.85</td>
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<td>2. Inventories b/</td>
<td>15.38</td>
<td>21.18</td>
<td>29.97</td>
<td>14.01</td>
<td>17.72</td>
<td>19.80</td>
<td>20.39</td>
<td>14.62</td>
<td>23.15</td>
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<tr>
<td>4. Liquid Assets d/</td>
<td>6.48</td>
<td>4.01</td>
<td>6.31</td>
<td>13.32</td>
<td>10.93</td>
<td>5.72</td>
<td>7.13</td>
<td>5.59</td>
<td>2.49</td>
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<tr>
<td>5. Other Assets e/</td>
<td>19.88</td>
<td>12.44</td>
<td>1.51</td>
<td>8.67</td>
<td>15.16</td>
<td>15.42</td>
<td>7.35</td>
<td>5.21</td>
<td>4.61</td>
</tr>
<tr>
<td>6. Total</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
</tr>
</tbody>
</table>

a/ Net of accumulated depreciation.
b/ Work in progress and raw materials.
c/ Trade and other account receivable.
d/ Cash, bank deposits and marketable securities.
e/ Includes investments and other deposits.
f/ Includes short term bills and bonds.

Source:
1/ Superintendencia de Sociedades. Boletín Estadistico No. 6, 1983.
   Non Financial Corporations in Germany, Japan (total sample), U.K. (large companies in all industries) and U.S.A.
Figure 3.1

The Ratio of Internal Funds to Fixed Investment in the Corporate Sector

- Local Corporations
- Foreign Held Corp.
3.4 The similarity on the asset side of corporate balance sheets between Zimbabwean and British companies extends also to the liability side. It is a well known feature of British corporate finance that companies rely heavily on internal sources of funds. Gross internal funds accounted over the period 1970-1985 for about 70 percent of total sources of funds. 12/ Furthermore, in terms of financing of fixed investment, the non-financial corporate sector has been completely self-financed. In the words of one expert, "in terms of financing of physical investment, the non-financial corporate sector could have been floated off separately from the financial corporate sector, with no net consequence for corporate investment." 13/ Such a degree of similarity in the pattern of corporate financing between Zimbabwe and the United Kingdom is not surprising. Apart from the strong historical linkages and influences, a majority of foreign-controlled companies are subsidiaries of British-based multinationals (or South African companies with British traditions).

The Structure of the Financial System

3.5 A high degree of self-finance might be expected to be associated with a relatively weakly developed financial system, especially at the long end of the market. The opposite is true. Zimbabwe has an unusually deep financial sector in terms of the range of financial institutions and, in particular, a high proportion of long-term assets and liabilities. The British influence is again strong: the commercial banking sector is dominated by the presence of branches or subsidiaries of British banks. There are also important similarities in the structure of financial intermediaries and capital markets. In both countries, institutional investors, notably insurance companies, are dominant players in financial intermediation. Also, in both countries, bond markets are characterized by the exclusive role of the public sector and the conspicuous absence of the corporate sector.

3.6 These ties and similarities cannot, of course, be stretched too far. There are important differences in Zimbabwean industrial structure, degree of financial intermediation, and the size and role of equity markets, to mention only a few. Yet, this degree of similarity observed in the financial structure and in the pattern of corporate finance serves to provide a useful point of reference and to underline the relative sophistication of the financial intermediary system in Zimbabwe. Compared to many developing countries, Zimbabwe has a highly sophisticated financial intermediary system with a broadly based institutional structure spanning over banks, finance companies, pension funds and insurance companies. In terms of the overall degree of intermediation, the country's financial system is comparable with the average performance of middle-income


13/ Ibid, p. 1172.
developing countries, but its capacity to supply long-term capital, as exemplified by the important role of institutional investors and the depth of the country's capital market, places Zimbabwe ahead of many countries, including Chile, Korea, India, Singapore, and Greece (see Figure 3.2).

3.7 What is this sophisticated financial system doing if it is not lending much long-term capital to the corporate sector? A dominant function, especially since the mid-1980s, is doing a very effective job of intermediating between the private and public sectors. Private corporate and household savings are captured in a range of financial assets, including commercial bank deposits, post office savings accounts, pensions and life insurance. Much of this is onlent to the public sector, most notably in the form of short-term loans (that are automatically rolled over) to the Agricultural Marketing Authority and medium to long-term public bonds. This is facilitated by a range of required assets requirements that effectively channel the resources into these public liabilities. It should be emphasized, however, that there is little evidence of direct crowding out of the private business sector, owing to its weak demand for credit in this period. In addition, the financial system already plays a major role in three important areas for the private sector. First, it provides a range of services related to short-run finance of the corporate sector: indeed, the unusually low proportion of the assets of corporations in debtor accounts is probably a direct reflection of the efficiency of the banking sector. Second, there has been continued (and worrying) growth in credit to the private farming sector, with commercial farmers having the dominant share in indebtedness. While other parts of the private sector were reluctant to borrow and able to avoid this, farmers appear to have had no choice. Third, there has been both growth and diversification in private housing finance, with lending by the building societies for low-cost housing of rising significance.

Explaining the Pattern of Finance

3.8 What causes corporations in Zimbabwe to depend to such a large extent on internally generated source of funds to finance their fixed capital formation and so little on debt financing? To the extent that the cost of debt financing falls below the rate of return on invested capital, there would appear to be good reason for companies to increase leverage. This has been the case in Zimbabwe since 1980, at least if the cost of debt financing is narrowly defined to refer only to interest charges. Return on capital employed (net of depreciation) has averaged 15.8 percent over 1980-1987, as compared to interest rates for the corporate sector slightly above the minimum lending rate of 13 percent (compared with an average of 10.3 percent on bank certificates of deposit in the 1980s, and 13 percent on government 25-year bonds). Add to this the tax deductibility of interest payments and the effective cost of debt finance drops to around

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14/ The total assets of insurance companies in Zimbabwe in relation to GNP was in 1985 21.5% compared to a corresponding figure of 9.1% in Korea, 6.9% in Malaysia, and 5.17% in Chile.
seven percent, creating a large positive differential between company profitability and the interest rate.

3.9 However, the preference for internal funding in the face of the apparent economic advantages of debt finance is not unusual, but is a well-established feature of developed corporate sectors world-wide. Given their needs for funds, corporations are generally known to resort first to internally generated sources of finance, then to debt, and lastly to issuance of new stocks. This financing order, which is referred to in the literature as the "pecking order," has an economic and practical rationale; it reflects both the comparative advantage of availability and lack of any associated direct cost that internal finance offers, and also a general reluctance on the part of management to go outside for funds, with the associate reduction of control. 15/

3.10 The extent to which internal finance predominates then depends, of course, on the availability of internal finance and the level of demand for funds for both fixed assets and alternative uses. Here the Zimbabwean corporate sector is distinctive. On the availabilities side there are two factors. The sector is both reasonably profitable, as we'll see in the next chapter, and it enjoys generous depreciation allowances. These tax shields, earmarked under prevailing tax codes to compensate for the portion of fixed assets which are used up during the process of production, constitute important and often stable and predictable sources of internal funds in many countries. The higher these allowances, the lower the incentive to draw on the tax benefits of debt financing. 16/ Zimbabwean firms can enjoy the full expensing provision permitted under the Special Initial Allowance (SIA), which has been in effect since April 1977. For a large set of assets, including plant and machinery, vehicles, and the industrial buildings constructed by the company, the allowances permit full deduction of the cost of assets in the year of purchase. 17/

3.11 There are also low requirements for finance because of demand factors. We saw that the Zimbabwean corporate sector has relatively low requirements for its operating needs--probably a reflection of the

15/ This preference of corporations to resort to internal sources of finance was first elaborated and empirically documented in the context of the United States economy by Gordon Donaldson (1961). Recent research by S. Myers (1984) and Majluf (1984) have provided strong theoretical rationale for this hypothesis.

16/ For a theoretical discussion of the substitution between non-debt related tax shields with debt related tax shields see De Angelo and Masulis (1980), and for empirical evidence, see Titman and Wessels (1988).

efficiency of this part of the financial system. On top of this is the fundamental factor in the mid-1980s of the depressed state of fixed investment demand. With this state of demand for fixed investment, companies have had no reason to borrow, irrespective of the existing strong incentives in favor of debt. In other words, the answer to the above question—why have companies relied so much on internal resources?—lies in the combination of a preferred "pecking order" in sources of finance and a lack of growth on the demand side. To see the quantitative logic of this argument, it is only necessary to understand the dynamics of asset accumulation of a purely self-financing firm, which in the tax environment of Zimbabwean economy, is determined by one basic parameter: the rate of the firm's operating profits. If it is considered that operating profits, before taxes and interest, in the corporate sector of the Zimbabwean economy averaged approximately 15.8 percent of total capital employed \(^{18}\) over the 1980-1987 period, and corporate income taxes averaged 28 percent of operating income, it follows directly that the highest rate of growth in total capital that could have been achieved under a self-financing strategy (i.e. if firms paid no dividends or interest) would have been about 11.5 percent per year. \(^{19}\) This is equal to almost 80 percent of the actual rate of growth achieved during that period.

The Future Demand for Debt Finance

3.12 What are the implications for the future? To assess the interaction between growth and demand for debt capital, it is necessary to expand the scope of the analysis to incorporate the influence of firms' dividend policy and various provisions regarding interest payments and capital consumption allowances. This is illustrated in Table 3.5, which shows the projected increase in demand for loans for both local and foreign-controlled companies, under three alternative scenarios of fixed investment expansion: 15 percent, 20 percent, and 25 percent per year. Under the lowest case scenario, the local companies' aggregate debt to capital ratio increases from 33 percent in 1987 to 70 percent in 1992. For foreign-controlled companies, the rise in the aggregate leverage ratio is more modest, from 17 percent in 1987 to 32 percent in 1992. In the second scenario, when investment is assumed to grow at an annual rate of 20 percent, corporate debt increases, by 1992, to reach levels of 73 percent and 36 percent respectively for local and foreign-controlled companies. With fixed investment growing at an annual rate of 25 percent, the corresponding rise in leverage ratios is to 76 percent and 40 percent.

\(^{18}\) Capital is defined as fixed assets plus inventories.

\(^{19}\) The average 28 percent measures the effective corporate income tax rate. This is (as will be explained below) much lower than the 52 percent average statutory tax rate.
### Table 3.5: Projected Financing Requirements for Various Investment Expansion Scenarios, 1987-1992 a/

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<td>A. Increase in Company</td>
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<td>7.8</td>
<td>31.5</td>
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<tr>
<td>b1. Foreign</td>
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<td>0.19</td>
<td>0.21</td>
<td>0.24</td>
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<td>b2. Local</td>
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<td>0.70</td>
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<td>a1. Foreign</td>
<td>(19.6)</td>
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<td>a2. Local</td>
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<td>a3. Total</td>
<td>(8.8)</td>
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<td>28.1</td>
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<tr>
<td>B. Leverage Ratio c/</td>
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<tr>
<td>b1. Foreign</td>
<td>0.17</td>
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<td>0.31</td>
<td>0.36</td>
<td></td>
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<tr>
<td>b2. Local</td>
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<td>0.73</td>
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<td>b3. Total</td>
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<td>0.37</td>
<td>0.43</td>
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<td><strong>3. Investment Growth Rate: 25%</strong></td>
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<tr>
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<td>18.1</td>
<td>25.4</td>
<td>30.2</td>
<td>32.8</td>
<td>33.7</td>
<td></td>
</tr>
<tr>
<td>a2. Local</td>
<td>7.8</td>
<td>35.1</td>
<td>34.4</td>
<td>33.4</td>
<td>32.3</td>
<td>31.3</td>
<td></td>
</tr>
<tr>
<td>a3. Total</td>
<td>(8.8)</td>
<td>26.1</td>
<td>29.9</td>
<td>31.9</td>
<td>32.5</td>
<td>32.4</td>
<td></td>
</tr>
<tr>
<td>B. Leverage Ratio c/</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>b1. Foreign</td>
<td>0.17</td>
<td>0.19</td>
<td>0.23</td>
<td>0.28</td>
<td>0.33</td>
<td>0.40</td>
<td></td>
</tr>
<tr>
<td>b2. Local</td>
<td>0.33</td>
<td>0.41</td>
<td>0.50</td>
<td>0.59</td>
<td>0.68</td>
<td>0.76</td>
<td></td>
</tr>
<tr>
<td>b3. Total</td>
<td>0.22</td>
<td>0.26</td>
<td>0.32</td>
<td>0.38</td>
<td>0.46</td>
<td>0.53</td>
<td></td>
</tr>
</tbody>
</table>

a/ Model simulation, using following parameter values:
   (i) dividend payout ratio: 25% foreign companies and 50% local companies.
   (ii) effective corporate income tax rate of 51.75%.
   (iii) constant interest rate of 14.14% for local companies and 12.33% for foreign companies.

b/ Short-term and long-term debt.

c/ Ratio of total outstanding debt to total capital employed.

3.13 Even under the higher growth scenario, these ratios are quite reasonable by the standards of other developing countries, and are comparable to the observed ratios in Colombia and Korea, for example. However they have important implications in three areas.

(i) The pattern of credit growth. If the corporate sector is to have a much larger role in credit demand this will have major implications for monetary management and the affordable level of domestic finance of the fiscal deficit in order to avoid major pressures on the financial system (and on the overall equilibrium of the economy).

(ii) The development of the capital market. As noted above, the capital market is largely oriented toward government bond finance. This is fine as long as there is little demand for investment finance from the corporate sector, but, if there is to be an institutional shift toward increased use of the financial system, much greater reliance on the capital market would be desirable. Apart from allowing a greater quantitative allocation of resources to the corporate sector (i.e. less channelling of long-term money into government stock) greater use of the stock exchange and the development of a corporate debenture market would be both natural and desirable developments.

(iii) Regulations over borrowing. For most foreign companies, these levels of debt would exceed current limits on domestic borrowing and so would only be consistent with current regulations if the companies concerned significantly increased foreign borrowing for the foreign exchange content of investment.

These questions are taken up in the policy conclusions in Chapter 6.
4. RATES OF RETURN AND THE COST OF CAPITAL

4.1 If macroeconomic conditions provide the basis for an underlying demand for the replacement and expansion of capital, then the decision to invest will depend on the relationship between the rate of return and the cost of capital. Both of these are influenced by the pattern of specific incentives for investment and other factors in the economic environment, of which factors affecting perceived risks are of particular importance for the corporate sector. In the end, private investors will compare the expected rate of return on a potential project with the marginal cost of capital. It was not the objective of this report to look into possible rates of return on new projects—that is the job of the private sector. The focus is rather on two questions: have historical rates of return between unusually low in the private sector? and what are the principal influences on the cost of capital, and how are these affected by policies? In this report we used historical evidence on the rate of return on capital and the various factors influencing the cost of capital (of which the interest rate is only one component) to examine these questions.

4.2 Determinants of the investment decision. The decision to invest is based on weighing up the required rate of return to the owners of a firm with the expected return on corporate capital assets. This is somewhat more complicated than it seems. The required rate of return to shareholders will depend on alternative investment opportunities and the perceived risks of investment, while the relationship to the required return on a project—the hurdle rate that projects must pass to be considered viable—will be influenced by the pattern of taxation and investment incentives offered by governments. Investment incentives refer to the inducements offered through various tax shields, accelerated depreciation schemes, investment tax credits and risk-sharing arrangements aimed at encouraging companies to undertake projects that they otherwise would not have undertaken. They can be viewed as catalysts serving to increase the supply of projects that meet the corporations' investment criteria by lowering the hurdle rate that projects must pass. 20/ To illustrate this point, it is useful to refer to a numerical example. Consider a company that contemplates investing in a project costing $1,000 that operates under the following conditions:

(1) required real rate of return on shareholder's equity = 8%
(2) corporate income tax rate = 50%
(3) nominal rate of interest = 14%
(4) rate of inflation = 10%
(5) rate of economic depreciation = 5%

20/ The implicit assumption here is that firms do have the desire to invest, but their action is constrained by lack of economically viable projects. The critical role of investment incentives is then to transform non-viable projects into viable projects by favorably affecting investors' expectations of return on projects relative to the cost of financing projects.
4.3 Table 4.1 then presents the results of some alternative simulations. These are simplified—they do not properly deal with the time dimension—but they illustrate the main points. Based on these parameters, it can be calculated that if the company is fully self-financed, and if there is no tax depreciation deduction, the project must generate a pre-tax return of $260, or 26 percent, in order to break even and provide the required return to shareholders. With standard tax deductibility of depreciation (straight-line with an allowable asset life of ten years), the required pre-tax rate of return drops to the equivalent of 16 percent. This is roughly equivalent to the impact of a reduction in corporate income tax rate from 50 percent to 25 percent, that would lower the required return on the project to $173, or 17 percent. Alternatively, if the company is assumed to finance half of its initial project cost through debt capital, and if interest payments are fully tax deductible, the required return on the project declines to $150, or 15 percent.

Table 4.1 Simulating the Impact of Alternative Investment Incentives on the Required Return on a Project

<table>
<thead>
<tr>
<th>Case I: Self-financing, no tax deductible depreciation</th>
<th>Case IV: 50% debt financing and no tax deductibility of depreciation allowances</th>
</tr>
</thead>
<tbody>
<tr>
<td>Return to shareholders : 80</td>
<td>Return to shareholders: 40</td>
</tr>
<tr>
<td>Economic depreciation : 50</td>
<td>Economic depreciation : 50</td>
</tr>
<tr>
<td>Corporate income tax : 130</td>
<td>Interest payments : 70</td>
</tr>
<tr>
<td>Total required return : 260</td>
<td>Debt tax shield : -35</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Case II: Self-financing, with depreciation tax allowances a/</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Return to shareholders : 80</td>
<td></td>
</tr>
<tr>
<td>Economic depreciation : 50</td>
<td></td>
</tr>
<tr>
<td>Tax-depreciation allowance: -50</td>
<td></td>
</tr>
<tr>
<td>Corporate income tax : 80</td>
<td></td>
</tr>
<tr>
<td>Total required return : 160</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Case III Decline in corporate income tax to 25% 1</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Return to shareholders : 80</td>
<td></td>
</tr>
<tr>
<td>Economic depreciation : 50</td>
<td></td>
</tr>
<tr>
<td>Corporate income tax : 43</td>
<td></td>
</tr>
<tr>
<td>Total required return : 173</td>
<td></td>
</tr>
</tbody>
</table>

a/ Based on straight line depreciation scheme with ten years allowable asset lifetime.

Source: World Bank staff calculations.

4.4 Both the full calculations and Zimbabwe's systems of tax shields are more complex than this. Zimbabwe currently has full expensing of
investment for many fixed asset categories—that is more generous than the straight-line depreciation illustrated here—as well as tax deductibility of interest. Together these constitute a more generous package than the tax incentives in the simulations and, as will be shown in the section on the cost of capital, these can lead to negative marginal tax rates for investments. This cannot be captured in such a simple model, but it is clear that the relationship between the required return to shareholders and the hurdle rates for projects is not simple and is strongly influenced by the structure of tax allowances.

4.5 More broadly, it is useful to examine the influence of both investment incentives and other factors—the required risk premium, financing costs and the cost of capital goods—on the relationship between the return on potential investment projects and the marginal cost of capital. This ratio can be viewed as the key variable for a business' investment decision, as well as for the behavior of the whole corporate sector. While marginal returns (on new investment projects) are not observable, this does suggest a useful approach to evaluating investment incentives. There are two aspects to the approach: (i) the determination of the return on corporate capital assets, and its distribution among the three major claim holders, the shareholders, the Government and the creditors; and (ii) the determination of the cost of capital and its sensitivity to changes in taxes, interest rate, the real price of capital and investors' required rate of return. In the remainder of the chapter, we discuss the relevance of each and establish their quantitative dimensions for the corporate sector in Zimbabwe.

Profitability and the Rate of Return on Capital

4.6 The relevant concept of profitability, from the viewpoint of potential investors, is the future expected after-tax rate of return on investment. As noted, this is not directly observable. What is possible, instead is to rely on historical trends to infer such estimates

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21/ To elaborate further on the significance of this ratio, it is useful to explore its relation with the Tobin q-ratio. Define \( q = \frac{MV}{K} \) where MV and K are respectively the market and replacement value of capital, \( c = \frac{Y}{MV} \) and \( r = \frac{Y}{K} \) as the cost of capital and return on capital where \( Y \) = operating profit. From these equations, it follows that \( q = \frac{r}{c} \); though note that for an investment decision it is the marginal value of these variables that is of relevance. For further detail and application in the context of developing countries, see Dailami (1986).

22/ Relevant to this expectation is not only the profitability of the underlying capital base, but also taxes and companies' dividend and financial policy. For foreign investors, there are also the additional factors of remittability of dividend and profit proceeds and exchange rate fluctuations. In the analysis in this paper we deal with uncertainty over remittability in the cost of equity.
of return on corporate investment. Two possible sources are available: securities markets and company accounts. We used the latter in this report, but first discuss the issues associated with the stock exchange.

4.7 The Zimbabwe Stock Exchange. There is considerable doubt on the reliability of estimates of the return on capital generated by securities markets. This doubt exists even when markets are highly developed, broadly based and considered to be efficient, as for instance in the case of the U.S. 23/ These doubts naturally multiply when market imperfections are serious and when major disparities persist between market valuation and the book value of assets. In Zimbabwe, the equity market has characteristically underestimated corporations' asset values in relation to book values. This undervaluation has, since 1981, averaged more than one-half of the book value of corporate equity, and is conceivably higher if assets were valued at their replacement costs. In addition market fluctuations have been considerable, leading to wide variations, even in yearly observations (see Figure 4.1). Based on the performance of industrial share prices, the market has registered an annual growth rate of 9.2 percent over the 1980-1987 period, which fares poorly given the corresponding rate of inflation of 12.2 percent over the same period of time. There has, however, been very rapid growth since 1984 (that has continued in 1988 and 1989) that could lead to a changed assessment of market performance if it is sustained.

4.8 There are two possible accounts of the apparent past undervaluation of the equity market. First, the undervaluation could only be apparent, and the stock exchange could be doing a good job of assessing expected future returns on the capital of the companies. This would imply either that book values overstate the economic value of firms' capital, i.e. a substantial portion of assets are not worth much, or that there is a very high risk premium attached to future returns, that is reflected in a discounted market value. Second, the market could be inefficient, especially because of the very low level of primary and secondary market turnover. Since most firms also have a fairly fixed group of shareholders, the market valuation could be a poor guide to the value attached to them by these shareholders or by potential buyers. The evidence suggests a combination of both factors. On the one hand, there are reasons why company values may be discounted--this is especially true for foreign companies interested in getting their money out, even at a major discount--and there are also a range of reasons for there to be high actual and perceived risks. On the other hand, the exchange is clearly also not performing fully efficiently as an open market in company shares. There has been a dearth in new issues and those that have occurred have been rights issues. The infrastructure for an active market is also weakly developed, though the potential is there. A major consequence of these factors is that the market is in a vicious cycle--the perception that it was a weak, and until the past few years, a moribund, institution, served

23/ See Brainard, Shoven and Weiss (1980), and Cohn and Modigliani (1985) for reasons for securities market failures for valuing corporate assets rationally and efficiently in the U.S.
Industrials Share Price Index, 1975-88

Figure 4.1
as a disincentive to use it (and especially to seek a listing) and this perpetuated the low level of activity.

4.9 While it was decided not to use it for the rate of return calculations, there are clearly important issues of how to get it going again, since it should lie at the core of capital market activity. There are encouraging signs in the sustained growth in share values since 1984 to new peaks in 1988 and 1989 and there is clearly potential for parts of the financial system (notably the merchant banks) to support its activity. But this has not yet led to much apparent interest in new listings. A push on the demand side—to get more companies interested in using it—and on its capabilities, e.g. through technical assistance, is likely to be necessary.

4.10 Rates of Return from Company Accounts. The measurement of the return on corporate investment from company accounts is not free of problems either. There is first the problem of what concepts of capital and profits are to be adopted, since there are many ways that both capital and profits can be defined and measured. At one extreme, capital can be defined narrowly to include plant, equipment and inventories and, at the other, it can be defined broadly to include total tangible assets, as well as intangibles, such as property rights, goodwill and special earning opportunities. Similarly, profits can be defined net or gross of depreciation, and inclusive or exclusive of holding gains (losses). Secondly, company accounts record asset values at historical cost, and these, in the case of Zimbabwe, fall considerably short of replacement values; the overall rate of inflation (GDP deflator) has averaged over the 1980-1987 period, 12.2 percent per year; and, on top of that, capital goods prices have increased over the same period on average by 3.5 percent per year. Furthermore, uncertainties about the allocation of foreign exchange and supply of foreign capital goods are considerable in Zimbabwe, implying an important risk premium which needs to be attached to the replacement value of capital assets.

4.11 With these reservations in mind, Table 4.2 uses company balance sheet and income expenditure data to provide measures of the return on capital employed for the two subgroups of local and foreign listed companies over the 1980-1987 period. Capital employed is defined as the sum of plant, equipment, land, inventories, and net monetary assets (cash and net accounts receivable). Profits are defined as operating incomes net of depreciation and excluding holding gains (losses). The estimates are inclusive of company taxes and thus are suitable measures of corporate profitability and productivity of the underlying capital base. The estimates indicate returns of 18.0 and 15.1 percent respectively for local and foreign companies. The higher return for local companies seems to reflect the higher degree of debt financing. Having more flexibility and access to the domestic capital market, the local companies have been in a relatively better position to optimize their financing mixes and, consequently, their overall profitability. For the companies as a whole, the return on capital has averaged 15.8 percent over the 1980-1987 period in nominal, or 3.6 percent in real terms.

4.12 Of course, the returns reported in Table 4.2 refer to the profitability of total capital employed, which needs to be shared among the
three classes of claim holders, the Government, the creditors and the shareholders. Table 4.3 shows the actual distribution of operating income for the listed companies as a whole for the period from 1980 to 1987 into its three components: corporate income taxes paid, net interest, and net equity income. It can be seen that the share of the Government, or the average effective corporate income tax rate, has averaged 27.8 percent. This is considerably lower than the average statutory tax rate of 52.2 percent over the same period. This large differential between the effective and statutory income tax rates in Zimbabwe reflects the availability of generous tax allowances; this is discussed further in para. 4.21.

Table 4.2 Estimates of Pre-tax a/ Rate of Return on Capital Employed b/ for Local and Foreign Non-Financial Corporations, 1980-1987 (percent)

<table>
<thead>
<tr>
<th>Year</th>
<th>Local</th>
<th>Foreign</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980</td>
<td>18.3</td>
<td>19.4</td>
<td>19.1</td>
</tr>
<tr>
<td>1981</td>
<td>22.9</td>
<td>17.6</td>
<td>18.9</td>
</tr>
<tr>
<td>1982</td>
<td>20.7</td>
<td>11.8</td>
<td>13.9</td>
</tr>
<tr>
<td>1983</td>
<td>14.5</td>
<td>10.1</td>
<td>11.2</td>
</tr>
<tr>
<td>1984</td>
<td>13.2</td>
<td>11.1</td>
<td>11.6</td>
</tr>
<tr>
<td>1985</td>
<td>18.2</td>
<td>16.8</td>
<td>17.2</td>
</tr>
<tr>
<td>1986</td>
<td>16.6</td>
<td>15.5</td>
<td>15.8</td>
</tr>
<tr>
<td>1987</td>
<td>19.0</td>
<td>18.9</td>
<td>18.9</td>
</tr>
<tr>
<td>Average</td>
<td>17.9</td>
<td>15.1</td>
<td>15.8</td>
</tr>
</tbody>
</table>

a/ The before-tax rate of return is the ratio of operating profits net of depreciation and before corporate income tax to total capital employed.

b/ Capital employed is defined as the sum of plant, equipment, land, inventories and non-interest bearing net monetary assets.

Source: Company accounts of 48 listed companies on the ZSE.

4.13 From Table 4.3 it can also be seen that net interest payments, as a percentage of corporate operating income, is relatively low in Zimbabwe. For the 1980-1987 period, this amounts to an average of 19 percent for all listed companies. This is consistent with the relatively low share of debt in the corporate capital structure, as discussed in the previous chapter. This, in conjunction with the relatively low effective tax rates, implies in essence that the shareholder in Zimbabwe has the lion's share in corporate operating income. This share has averaged 53 percent for the listed companies as a whole for 1980-87. This, however, still fails to capture the true economic share of the equity holder in corporate operating income. To arrive at such a concept of equity income, it is necessary to make adjustments for depreciation in the real value of debt induced by inflation. Table 4.4 contains the final results, after such gearing adjustments are made. It is thus seen that shareholders have earned,
during the period 1980-1987, an average return on equity of 22.6 and 15.7 percent respectively in local and foreign companies. The relatively higher return on equity in local companies reflects their higher degree of profitability.

Table 4.3 The Distribution of Business Operating Income\(^a/\) into its Components, 1980-87 (percentage of operating income)

<table>
<thead>
<tr>
<th>Year</th>
<th>Net Profit</th>
<th>Taxes</th>
<th>Net Interest</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980</td>
<td>61.8</td>
<td>8.8</td>
<td>9.4</td>
</tr>
<tr>
<td>1981</td>
<td>65.8</td>
<td>25.1</td>
<td>9.1</td>
</tr>
<tr>
<td>1982</td>
<td>47.7</td>
<td>30.3</td>
<td>22.0</td>
</tr>
<tr>
<td>1983</td>
<td>41.4</td>
<td>27.4</td>
<td>31.2</td>
</tr>
<tr>
<td>1984</td>
<td>42.2</td>
<td>29.0</td>
<td>28.7</td>
</tr>
<tr>
<td>1985</td>
<td>58.3</td>
<td>22.5</td>
<td>19.2</td>
</tr>
<tr>
<td>1986</td>
<td>54.5</td>
<td>27.5</td>
<td>18.0</td>
</tr>
<tr>
<td>1987</td>
<td>53.5</td>
<td>31.8</td>
<td>14.7</td>
</tr>
<tr>
<td>Average</td>
<td>53.2</td>
<td>27.8</td>
<td>19.0</td>
</tr>
</tbody>
</table>

\(^a/\) Operating income is defined as the sum of net interest payments, direct corporate income taxes and net profits before taxes.

Source: Company accounts of 48 listed companies on the ZSE.

Table 4.4 Estimates of After-tax Return on Shareholders' Equity \(^a/\) for Local and Foreign Non-Financial Corporations, 1980-87 (percent)

<table>
<thead>
<tr>
<th>Year</th>
<th>Local</th>
<th>Foreign</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980</td>
<td>26.8</td>
<td>21.0</td>
</tr>
<tr>
<td>1981</td>
<td>30.7</td>
<td>21.2</td>
</tr>
<tr>
<td>1982</td>
<td>28.1</td>
<td>13.0</td>
</tr>
<tr>
<td>1983</td>
<td>21.4</td>
<td>12.8</td>
</tr>
<tr>
<td>1984</td>
<td>11.3</td>
<td>8.4</td>
</tr>
<tr>
<td>1985</td>
<td>18.3</td>
<td>16.4</td>
</tr>
<tr>
<td>1986</td>
<td>21.7</td>
<td>16.3</td>
</tr>
<tr>
<td>1987</td>
<td>22.4</td>
<td>17.1</td>
</tr>
<tr>
<td>Average</td>
<td>22.6</td>
<td>15.8</td>
</tr>
</tbody>
</table>

\(^a/\) Includes adjustment for leverage ratio.

Source: Company accounts of 48 listed companies on the ZSE.
4.14 These rates of return on equity are quite reasonable by international standards, especially for domestic investors. However, it should be noted that the foreign investors also needs to take account of the effect of real exchange rate movements--to the extent that the real exchange rate has depreciated since 1980, these investors have also borne a capital loss that needs to be factored into the return on equity for the foreign shareholder. Perceptions on future capital loss--and more generally the risks associated with investments--will clearly affect the required hurdle rate of new investments and the cost of capital. We turn to this now.

The Cost of Capital

4.15 As already discussed, the relevant concept of profitability for investment decisions is the return on capital relative to the cost of capital. What matters for investment is not just how much a dollar of capital invested in a particular project earns, but also how much that unit of capital costs. Like the return on investment, the cost of capital is subject to numerous interpretations and measurements. The most commonly used concept is the cost of funds, which is a weighted average of the cost of debt and equity, with weights reflecting the capital structure of the company or the sector concerned. For corporations in Zimbabwe, this implies that the cost of funds is principally determined by the cost of equity: as discussed previously, the share of equity in the aggregate financing mix of listed companies is almost three times higher than the share of debt. At the same time equity is much more expensive than debt. Interest expenses in relation to total debt outstanding have averaged (over the 1981-1987 period) 12.2 and 12.4 percent respectively for local and foreign companies. These rates are strikingly close to the commercial banks' minimum lending rate, which has remained constant at 13 percent since 1981. Furthermore, taking into account the tax deductibility of business interest payments and inflation, the real effective i.e. after-tax cost of debt has, of course, been considerably lower, as shown in Table 4.5. The average real effective rate over the 1981-1987 period has been negative for both local and foreign companies.

4.16 There is greater uncertainty over the proper concept and measurement of the cost of equity to corporations in Zimbabwe. 24/ For local companies, such a cost can be measured as the return on alternative investment opportunities. If such alternatives are assumed to be long-term government securities, which have yielded an average return of 13

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24/ In theory, the cost of equity has a straightforward interpretation: it is the discount rate that equates in present value the expected future stream of firms' dividend payments to the market value of its stock. Viewed from the perspective of the stockholders, the higher the degree of uncertainty attached to the firms' dividend payments or their repatriation in the case of foreign companies, the higher the cost of equity. In other words, the higher the degree of uncertainty with regard to the firms' future earnings and dividends, the higher the return that investors require in order to be induced to invest.
percent 25/ over the 1980-1987 period, the corresponding cost of equity can be taken to be in the order of 15 to 18 percent, if an equity risk premium of two to five percent is included.

Table 4.5 The Real Effective Cost of Debt$\text{a/}$ for Local and Foreign Non-Financial Corporations.  
1980-1987  
(percent per annum)

<table>
<thead>
<tr>
<th>Year</th>
<th>Local</th>
<th>Foreign</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980</td>
<td>-6.7</td>
<td>-4.8</td>
</tr>
<tr>
<td>1981</td>
<td>-3.8</td>
<td>-2.0</td>
</tr>
<tr>
<td>1982</td>
<td>-1.0</td>
<td>-0.3</td>
</tr>
<tr>
<td>1983</td>
<td>-4.3</td>
<td>-4.3</td>
</tr>
<tr>
<td>1984</td>
<td>1.3</td>
<td>2.4</td>
</tr>
<tr>
<td>1985</td>
<td>0.5</td>
<td>-1.1</td>
</tr>
<tr>
<td>1986</td>
<td>0.2</td>
<td>-0.2</td>
</tr>
<tr>
<td>1987</td>
<td>1.8</td>
<td>1.0</td>
</tr>
<tr>
<td>Average</td>
<td>-1.5</td>
<td>-1.2</td>
</tr>
</tbody>
</table>

$\text{a/}$ The real after tax cost of debt is calculated as $(1-u)r-x$, where $u$ is the corporate tax rate, $r$ is the nominal lending rate, and $x$ is the rate of inflation (GDP price deflator).

Source: World Bank staff calculations

4.17 Foreign-controlled companies, of course, operate under different sets of constraints and objectives than their local counterparts. These companies are often subsidiaries of large multinationals with world-wide operations. As such, their investment and financing policies are dependent not only on local conditions and regulations, but also on the broader objectives and policies of the parents. Viewed from this perspective, the expected rate of return required on an additional dollar of investment in Zimbabwe is the opportunity cost of foregoing an equivalent investment in other subsidiaries in other parts of the world. Returns on these investment alternatives have become increasingly attractive in the 1980s. The average return on capital employed in British industrial and commercial companies, for instance, has doubled from an estimate of 6.4 percent in

25/ This is the average yield on 25-year government stock.
1980 to 11.5 percent in 1987. Similar increases in profitability have been common in other industrial countries. Indeed, the upward trend in the return to capital in industrial countries has been an important feature of these countries' developments in the 1980s.

4.18 What these increasing trends in profitability in industrial countries implies is that the opportunity cost of investing in Zimbabwe (or indeed, in most other parts of the developing world) has increased in the 1980s. On top of this is the question of the degree of uncertainty with regard to future dividend payments and their remittability to foreign shareholders. This constitutes the key factor in determining the risk-premium that is attached to the cost of equity for foreign companies in Zimbabwe. In this respect, the government policy of altering the remittance ratio, most recently to 25 percent of after-tax profits, can be viewed as contributing to an increase in the cost of equity. The precise impact is difficult to gauge, depending on the investor's expectation of the continuation of this level of restrictions on dividend remittability and expected disinvestment options, as well as company earnings and dividend policy. The general effect has been captured in the quantitative analysis by adding an additional risk premium (of four percent) to the required real cost of equity for foreign companies.

4.19 The cost of funds is only one component of the overall cost of capital which is relevant for investment decisions. For investment in fixed assets (plant, machinery, and equipment), the other main components of the cost of capital are: the acquisition price of capital (i.e., the cost of acquiring one unit of machinery and equipment), taxation, depreciation allowances, and the cost of asset decay (i.e., real depreciation in terms of wear and tear and the obsolescence of fixed assets). The procedure for incorporating the influence of these factors on the cost of capital under the Zimbabwean tax code is described in Annex I, where a general expression for the real cost of capital for the non-financial corporate sector is given. The Annex also contains the various assumptions underlying our estimates of the real cost of capital for corporations in Zimbabwe. The results for both local and foreign companies are shown in Figure 4.2. It is clear that the foreign companies face a much higher cost of capital than their local counterparts. The difference for 1987, for instance, is in the order of six percentage points. For the period 1980-1987, as a whole, the cost differential between the foreign and local companies averages 7.5 percentage points. Two reasons explain this cost differential: the higher degree of equity financing by foreign companies and the higher degree of risk premium attached to investment in Zimbabwe by foreign shareholders. In essence, the foreign companies rely relatively more on equity financing, which is in Zimbabwe the more expensive source of finance.

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26/ See Bank of England, Quarterly Bulletin, August 1988, pp 379, for these estimates. Note that these estimates refer to the pre-tax rate of return on capital employed, where capital is measured at replacement cost, and hence they are not directly comparable with Zimbabwean estimates reported in Table 4.2.
4.20 For both the local and foreign companies, Figure 4.2 shows a sharp increase in the real cost of capital since 1984. This stems from a combination of several factors, including: (i) a reduction in the rate of inflation in 1984, from an average rate of 15 percent in the previous three years (1981-1983) to close to ten percent from 1984 (that led to the rise in the real interest rate seen in Table 4.5); (ii) an increase in the corporate income tax rate; and (iii) a sharp increase in the real price of capital goods (see Figure 4.3). The overall impact has been to raise the real cost of capital to an annual average of 9.1 percent over 1984-1987 period for local companies, compared to a corresponding rate of 3.1 percent in the 1980-1983 period. Of this increase, roughly 22 percent can be directly attributed to higher capital goods prices 27/, and the rest to higher real interest rates (i.e. lower inflation) and higher corporate income taxes.

4.21 The role of tax incentives. The influence of tax shields has been illustrated at the beginning of this chapter, while the moderate average effective tax rate of 28 percent was noted in para. 4.12. The tax structure has an important moderating effect on the cost of capital and, since Zimbabwe is often characterized as a high-tax country, it is further discussed here. It is possible, for illustrative purposes, to calculate the marginal effective tax rate (METR)--that can be thought of as measuring the impact of the tax system on the marginal cost of capital (and thereby the hurdle rate for new investments). This can be substantially different from observed average tax rates--countries with relatively high average rates can have relatively low METRs. 28/ This is clearly the case for Zimbabwe: the full expensing for many fixed assets can reduce the METR to zero, and, if this is combined with reduced tax liabilities due to debt finance of the fixed asset, this can become significantly negative, i.e. constitute a subsidy on investment. This is illustrated by the two-period example in Table 4.6 for an investment costing $1000 that lasts one year and earns $100 at the end of the year.

27/ This is based on the comparison between the actual real cost of capital during 1984-1987 period and its value if capital goods prices had remained constant in real terms during 1984-1987 period. Thus, under the constant capital goods price scenario, the real cost of capital for local companies would have averaged over 1984-1987 period to 7.4 percent, compared to the actual rate of 9.1 percent.

28/ See the 1988 World Development Report, World Bank (1988), p 93, for an illustration of this for a number of countries and a general discussion of the benefits of a system of full expensing.
Figure 4.2
The Real Cost of Capital, Local and Foreign Companies, 1980-87

Figure 4.1
The Relationship Between the Real Cost and Acquisition Price of Capital, 1980-87 for Local Companies

- 40 -

Cost of Capital
Relative Price of Capital Goods
### Table 4.6 Illustration of Marginal Effective Tax Rates

**Results of an investment of ZS1000 a/**

**Scenario I:** no investment allowance; 100 percent equity finance

<p>| | |</p>
<table>
<thead>
<tr>
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<tbody>
<tr>
<td>Net income</td>
<td>100</td>
</tr>
<tr>
<td>Tax</td>
<td>50</td>
</tr>
<tr>
<td>Pre-tax return</td>
<td>10%</td>
</tr>
<tr>
<td>Post-tax return</td>
<td>5%</td>
</tr>
<tr>
<td><strong>METR</strong></td>
<td>(10-5)/10 = 50%</td>
</tr>
</tbody>
</table>

**Scenario II:** 100% investment allowance; 100% equity finance

<p>| | |</p>
<table>
<thead>
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<tbody>
<tr>
<td>Net income</td>
<td>100</td>
</tr>
<tr>
<td>Deduction from investment allowance</td>
<td>-100</td>
</tr>
<tr>
<td>Net taxable income</td>
<td>0</td>
</tr>
<tr>
<td>Tax</td>
<td>0</td>
</tr>
<tr>
<td>Pre-tax return</td>
<td>10%</td>
</tr>
<tr>
<td>Post-tax return</td>
<td>10%</td>
</tr>
<tr>
<td><strong>METR</strong></td>
<td>(10-10)/10 = 0%</td>
</tr>
</tbody>
</table>

**Scenario III:** 100% investment allowance; 100% debt finance (at 10%)

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<table>
<thead>
<tr>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income</td>
<td>100</td>
</tr>
<tr>
<td>Deduction from investment allowance</td>
<td>-100</td>
</tr>
<tr>
<td>Interest deduction</td>
<td>-100</td>
</tr>
<tr>
<td>Net taxable income</td>
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<tr>
<td>Net tax saving b/</td>
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<tr>
<td>Pre-tax return</td>
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</tr>
<tr>
<td>Post-tax return</td>
<td>15%</td>
</tr>
<tr>
<td><strong>METR</strong></td>
<td>(10/15)/10 = -150%</td>
</tr>
</tbody>
</table>

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a/ All calculation are at the end of one year.
b/ This assumes the company has profits from other sources.

Source: World Bank staff calculations.

4.22 A zero METR is desirable, since it implies the income tax structure is imposing no distortions on investment decisions (though it is also desirable to minimize the variation of METRs across sectors and asset categories). However, a subsidy is unlikely to be appropriate. In particular, it tends to add to the preference of firms for choosing capital-intensive investments. To date this has probably not been of major significance in the corporate sector, in view of its unusually low use of debt finance for fixed investment, but this could quickly change if a rise in investment were associated with increased borrowing, as was suggested to be likely in Chapter 3.
Conclusion. The real cost of capital is relatively high in Zimbabwe, and this is especially so for foreign corporations. While we do not have direct information on the marginal rate of return on projects, past average rates of return—though reasonable by international standards—have often been lower than the cost of capital. Again this is especially true for foreign corporations. However, we would place most emphasis on getting at the sources of the high cost of capital, rather than attempting to get profit rates up to raise returns. The high cost of capital is due largely to the high risk premium associated, inter alia, with uncertainties over dividend remittability, that raises the cost of equity, and the high price of capital goods. Both can be traced, at least in part, to the workings of the foreign exchange allocation system. High corporate tax rates also tend to raise the cost of capital, but this is more than offset by the generous tax allowances. Interest rates have risen in real terms since 1984 but remain low and are not an important factor. It might be added that this could still be an underestimate for the average cost of capital for firms, since those prevented from investing because of quantitative restrictions (that flow from foreign exchange rationing) technically face an infinite cost of capital at that moment. Policy measures geared to stimulate corporate fixed investment thus need to deal with the current high cost of capital and especially the high perceived risks of investment. This is taken up in Chapter 6.
5. THE REGULATORY FRAMEWORK FOR CORPORATE INVESTMENT

5.1 Extensive regulation and administrative control was part of Zimbabwe's inheritance at independence and has continued to be central to economic policy. Despite rapid growth of the public sector since 1980, the private sector is still dominant in the commodity-producing sectors. However, the Government exerts considerable influence over the broad areas of price determination for many commodities, allocation of foreign exchange, and the investment decision-making process. In the area of the investment process, these interventions are concentrated in the project appraisal and approval stage, rather than in the planning and implementation stage. Under the prevailing regulatory framework, all companies, regardless of their ownership status, need to obtain project approval from the Industrial Projects Committee (IPC), before they can obtain the foreign currency allocation required for the importation of the necessary capital equipment. The process is cumbersome, entailing lags of 10 or even 14 months. There have been some improvements in the past year, especially for investments from blocked funds since the May 1987 announcements, but the time and uncertainty associated with the process remains a pervasive concern. There are, of course, high expectations of a more radical streamlining once the new investment center is operative, but it is too early to assess the effects of this.

5.2 The extent and nature of government interventions in the planning stage of the investment process varies, however, according to the ownership status of the enterprise concerned. Beside the restrictions implied by prevailing price controls, which is firm-specific, the local companies are generally treated more generously and more favorably than their foreign counterparts. With regard to their choices over project selection and financial and dividend policy, local companies have full autonomy. Thus, their decisions over the amount of investment, type of assets, funding and retention policies are internal to their corporate organization and are governed by relevant macro economic and financial considerations. In contrast, the foreign-controlled companies operate in a tight web of regulations and restrictions. These regulations relate to strict limitations imposed on their ability to raise funds locally and to distribute their earnings, in addition to the slow process of assessment of new investment proposals. Here we first review the context for the regulation of foreign capital and then discuss the complementary aspects of domestic regulation.

Foreign Capital and Government Policy: A Strategic Interaction

5.3 The regulatory framework for foreign companies needs to be cast in a broad context. Because foreign-controlled companies control the dominant share of assets in the Zimbabwean corporate structure, they have unavoidably become targets of public policy debate. The debate has centered, in particular, around three issues: (i) the degree of autonomy and flexibility over project approval and appraisal; (ii) dividend remittability; and (iii) management of financial surplus funds. These represent important aspects of companies' investment and financial policy.
which, in the context of most countries, are subject to the discretion of
the management of the company concerned and are carried out within the
market-determined structure of risks and returns. The difference in the
case of Zimbabwe arises from three factors: the general concern over the
proportion of the capital stock that is controlled by foreign companies;
the Government's policy of subordinating dividend remittances to other
claims within the country's tight supply of foreign exchange; and the basic
policy of exerting direct influence on the process of private investment in
order to allocate resources to social and economic priorities.

5.4 The fact that remittance of dividends has so far fallen victim
to balance of payments adjustments can lead to increased uncertainty and,
hence, to an erosion of foreign investors' confidence. As we saw in
Chapter 4, the inclusion of some measure of this risk premium raises the
cost of capital for foreign firms. The uncertainty over the amount of
dividends that can be remitted to foreign share-holders appears to have
been a major source of tension between the Government and foreign
companies. While much is made of the implicit tax on the companies
shareholders, it should, however, be emphasized that allowable remittances
are not out of line with corporate practices world-wide. In fact, even the
recently reduced 25 percent ratio of after-tax profits, that are remittable
under the May 1987 declaration (see below), is in line with the average
dividend pay-out ratio of companies in industrial countries. 29/ Again it
is the impact on uncertainty--the fear that dividends will be permanently
restricted--that matters. Conversely, a higher remittable rate of return
to shareholders is required ex ante to cover the higher perceived risks of
doing business.

5.5 Perceived from the viewpoint of foreign-controlled companies,
there is also an important element of strategic behavior; thus their
reluctance to invest may be seen as a strategic tactic intended to elicit
more favorable terms and to establish a set of ground rules which would be
more akin to their long-term interest. Within this context of strategic
interaction, companies have the ultimate option of not investing or
disinvesting. This imposes on the Government both the direct cost of
depriving it from the usual tax and other revenues and the indirect social
and economic costs of lower investment levels, including a higher level of
unemployment. Such an option, however, would impose on the companies two
types of costs: the cost of losing investment and profit opportunities; and
the cost of facing a more competitive environment, should the Government
encourage entry of newcomers through discriminatory treatment. For the
existing companies, however, the sheer benefit of being inside, with the
access to information that this confers, and the relative reluctance of new
investors, places them in a strongly advantageous position.

5.6 In terms of examining strategic interactions between foreign
capital and the Government, it is important to emphasize the diversity of

29/ The average dividend pay-out ratio (over 1980-84 period) for the
aggregate non-financial sector of major industrial countries ranges
from 6.4 percent in Finland to 23.1 percent in the United Kingdom.
the foreign-controlled sector. At the cost of oversimplification, three broad groups can be distinguished in relation to their attitude to disinvestment and potential new investment: established investors that have made a strategic decision to leave Zimbabwe; established investors that have made a long-term commitment to stay; and potential new investors. The first group is predominantly interested in the best terms it can obtain for disinvestment and, in the meantime, the maximization of short-run profits. The second would be expected to be more concerned with the underlying rules of the game and, in common with the third group, obtaining the best longer-term position for future investments and profits. Government policy and expectations over the future have, of course, a strong influence over the proportion of existing firms that fall into each of the first two groups.

5.7 There have been a number of changes in the regulatory environment for foreign investors in the 1980s. Despite the Government's public concern over the proportion of the economy owned by foreign capital, there was initially an improvement in the terms for most investor categories after independence. Those firms whose remittances had been fully blocked during the UDI period (primarily British companies) were allowed to remit up to 50 percent of their post-tax profits (subject to a withholding tax of 20 percent that could be offset against taxes in the home country). At the same time, the concept of "venture capital" was introduced for new investments, with relatively favorable disinvestment provisions. This was designed to effectively discriminate between new and pre-independence investments. However, despite these provisions, new investors were clearly reluctant to invest in Zimbabwe. Much was made by the multinationals of the Government's refusal to sign the OPIC agreement. The Government argued that the investor's rights were already covered by the constitution. Then, in 1984, the worsening external position led to the government decision to temporarily disallow remittances for pre-1979 investments--there was a clear choice to subordinate the claims of foreign equity holders to Zimbabwe's foreign creditors. This was lifted in early 1986, with the restoration of 50 percent remittability (and accumulated claims allowed to go out through five-year bonds), but in May 1987 this was again reduced to 25 percent of post-tax profits. In neither case were the terms of venture capital affected, either with respect to remittability or disinvestment rights.

5.8 The May 1987 reduction of remittability was accompanied by other measures designed to encourage foreign-controlled firms to invest in Zimbabwe. This focused on the blocked and surplus funds of established companies. 30/ Two measures were introduced: a reduction in the allowed rate of interest on these funds from ten percent to five percent; and the introduction of new, somewhat liberalized, procedures for approval of domestic investments out of these resources, that would also give the new

30/ Blocked funds are legally eligible for expatriation, but are prevented from this by the current restrictions; surplus funds are owned by foreign firms, but are not eligible for expatriation, for example post-tax profits that are not declared as dividends to foreign shareholders.
investments venture capital status, with the relatively favorable conditions this confers. There is little information on the level of investment activity from these funds. The bulk of the funds have continued to add to the liquidity of the monetary system, and there is also reported to continue to be a significant waiting period while the new committee reviews proposals submitted. In view of the analysis in Chapters 2 and 4 on the main factors affecting the cost of capital and investment levels, it would be surprising if the reduction in interest on alternative domestic financial assets had any influence on the decision to invest. Indeed the principal effect has been to transfer profits to the largely foreign-owned banking sector. In recognition of this, the Government announced in mid-1988 a supplementary tax on banks having this category of deposits, though this had not been implemented by April 1989.

5.9 There has been much more activity in relation to disinvestment. Since around 1985, foreign firms wishing to disinvest have gone through two main routes: sale at a discount of between 40 and 60 percent of net asset value to either the Government, a cooperative or a group with a majority of black Zimbabweans ownership, and subsequent expatriation of the receipts in six-year Z$ bonds bearing an interest rate of four percent; or sale at a discount of 70 percent of net asset value to the same categories of domestic groups, with the sale proceeds expatriated over one or two years. 31/ It was announced in early 1989 that the terms for the second category have changed with a required discount of at least 80 percent and sale to "approved Zimbabwean investors". While figures are not available, there is reported to have been a flurry of disinvestment activity in the past two years, both to the private sector, including a number of leveraged management buyouts, and a smaller number of major sales to the Government. No aggregate figures are available, but the net effect is likely to have significantly reduced the proportion of foreign ownership, and, to a lesser extent, raised that of Government. A recent survey by the Confederation of Zimbabwean Industries found that firms with a majority foreign ownership only accounted for 25 percent of total turnover; this is a lower figure than earlier estimates, that may reflect the pace of recent disinvestment. 32/ It has also been estimated that around 20 percent of equity in the ZSE was owned by the Government in early 1989.

31/ These do not affect the existing alternative of purchase of 12 or 20-year (for individuals and companies) Z$ bonds bearing a four percent interest rate. As noted above, the terms for venture capital are more generous and have not changed.

32/ Note, however, that substantial foreign control can be exerted with minority ownership; for some purposes the Government uses a cutoff of 15 percent foreign equity.
5.10 Finally, the Government issued in April 1989 a new policy document that includes a new investment center to streamline the procedures for investment approval, the potential for better terms for investment (notably on remittability) and improved guarantees, including the signing of international agreements. This could lead to both a substantial streamlining of the investment approval process and a reduction in the perceived risks of investment in Zimbabwe by foreign firms. Much will depend, however, on the implementation of the new measures and it is too early to assess their effectiveness.

5.11 In conclusion, two observations are relevant to the regulation of foreign investment. First, in the design of policy, it is important to distinguish between the different categories of investors noted and outlined in para 5.6. The Zimbabwean Government has been attempting to do just this, but the only area of past "success" has been in allowing an accelerated pace of disinvestment at a substantial discount. Attempts to encourage higher investment from either existing or new investors have had little impact on investment levels. Second, the evidence on rates of return and on characteristic levels of dividend payout suggest that actual profit levels—the terms of the relationship between the country and the foreign investor—are not bad. The focus of attention for new investment needs to be on issues associated with uncertainty and with the perceived rules of the game, including approval procedures for new investments. The new policies announced in April 1989 have the right focus, but, as already noted, everything will depend on the implementation. These policy questions are taken up in Chapter 6.

Domestic Investment Regulation and Foreign Exchange Allocation

5.12 As noted above, there is little direct regulation of investment by domestic firms, in contrast to the foreign-controlled sector. However, this has essentially not been an issue, since the centralized control of foreign exchange allocation and external borrowing by the private sector gives the Government effectively full approval powers over any private investment decision (or any decision by a joint venture or publicly owned business for that matter). Investments with no foreign exchange content are not covered, but these are of negligible importance for the corporate sector. Thus the committee system for foreign exchange allocation constitutes a de facto investment regulation system. The principal reported criteria for approval include net foreign exchange earnings (probably the most critical one), employment, regional location and the priority of the proposed investment. In addition to approval of resources for capital goods imports (or borrowing for this purpose), approval by the appropriate committee in effect confers a right to a share of the cake in future allocations of foreign exchange for current imports. It is clear that any conclusions on investment approval have to be cast within the context of the Government's decisions on any reform of the overall foreign exchange allocation system. Equally, if there is a decision to undertake

some form of trade liberalization, policy toward investment regulation will have to be directly tackled. This is taken up in the final chapter.

5.13 There has been one effective modification to the foreign exchange allocation system for investment, through allowing selected financial institutions to directly lend in foreign exchange to businesses, provided the foreign exchange risk is passed on to the final borrower. The two cases involve the Zimbabwe Development Bank (ZDB) and a merchant bank, udc ltd. In both cases, approval by the Industrial Projects Committee is still required, but it is reported that this generally goes through quickly, in contrast to applications for the IPC's "own" resources. Both have been functioning for several years, but demand for the resources has been much less than would have been expected, given the general emphasis in the private sector on the severity of the foreign exchange constraint. The principal reported deterrent has been the need to assume foreign exchange risk (combined with relatively high interest rates)--while in the case of allocations by the IPC, the Government bears the full foreign exchange risk. This again reveals the high degree of risk aversion of the corporate sector. In response to the private sector's general fears over foreign exchange risk, the Government announced a new facility in mid-1988 that would extend forward cover on foreign exchange to four years at a cost of five percent per annum. This is unusually generous by international standards, but may make sense in view of the absence of any market mechanisms for covering risk; it is now often argued that it is appropriate for the Government to bear the foreign exchange risk in these circumstances.

5.14 The final issue of relevance to investment regulation concerns the potential impact of other aspects of the regulatory system to investment decisions. Job security regulations--the requirement that the Government approve virtually any layoff by a business--raises the expected fixed costs associated with any investment and increase the likely risk of losses, especially in years of recession. It is frequently cited within the private sector as a significant deterrent to investment. Price controls have, at least until recently, had a more ambiguous effect. The private sector has always complained about them, but it is not clear that they actually increased perceived risks in the past, since they have been largely operated in terms of markups over costs, i.e. as a guarantee of reasonable profits! However, the introduction of the price freeze in mid-1987, and the considerable uncertainty over how and when it will be fully unwound, has undoubtedly had an adverse impact on expected profits and investment intentions. There are a number of reported cases of firms either losing money on their operations as a consequence of price controls, or doing their best to switch to new or relatively uncontrolled product lines. This is clearly neither a desirable nor a sustainable situation.
6. POLICY CONCLUSIONS

6.1 The sources of weak private investment are complex. Adjustments in conventional areas of influence on private investment are unlikely to work when the problem also lies in the overall environment for investment decision-making and intangible perceptions of future risks. A recovery in private business investment will require a range of policy adjustments designed to encourage the underlying demand for expansion in capacity, relax supply-side constraints on investment, facilitate investment decision-making, and reduce the perceived risks of investment. The Government has recently issued a new statement on investment policy that focuses especially on the guidelines for foreign investors. 34/ This is an important area, but needs to be cast in the context of other influences on private investment. This section pulls together conclusions in seven areas that could contribute to the development of a supportive overall framework for a recovery in private investment: the macroeconomic and financial framework; foreign exchange and supply-side constraints; investment appraisal; financial sector development; complementary regulatory issues; the tax/incentive framework for investment; and the environment for foreign investment, including the management of disinvestment. The relationship of these policy areas to the key issues in supporting a sustained recovery are outlined in Table 6.1

Table 6.1 Issues and Policy Areas for a Private Investment Recovery

<table>
<thead>
<tr>
<th>Issue</th>
<th>Policy Area</th>
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<tr>
<td>Reducing Supply-side Constraints</td>
<td>Foreign exchange availability and related supply-side factors</td>
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<tr>
<td></td>
<td>Appropriate financial framework and financial sector development.</td>
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<tr>
<td>Reducing risks</td>
<td>Sustainable environment, through macroeconomic adjustment and changes in regulatory environment</td>
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<td>Foreign investment environment</td>
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<td></td>
<td>Foreign exchange risk</td>
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<tr>
<td>Facilitating decision-making</td>
<td>Investment appraisal and the financial system</td>
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<tr>
<td>Encouraging demand for capacity expansion</td>
<td>Macroeconomic framework</td>
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<tr>
<td>Encouraging efficient investment choices</td>
<td>Tax/incentive framework</td>
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<tr>
<td>Broadening ownership</td>
<td>Disinvestment policy</td>
</tr>
<tr>
<td></td>
<td>Financial sector development</td>
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</tbody>
</table>

6.2 As noted at the beginning of this paper, an overall assumption is that the Government is committed to maintaining a significant role for the private sector i.e. the focus is on how to support a recovery in private business investment within a mixed economy. This was reaffirmed in the April 1989 statement. In addition, policy conclusions need to pay attention to two special factors: first, that the key issue is not to improve current profits, but to raise expected future profits, through reducing the perceived risks of investment; and second, that the Government has an objective of increasing domestic, and especially black Zimbabwean, ownership.

A. The Macroeconomic and Financial Framework

6.3 The macroeconomic framework needs to have three features if business investment is to recover: first, sufficient growth in demand for firms to experience growth in capacity utilization and thereby increase the underlying desire for investment; second, adjustment in domestic resource imbalances to ensure adequate domestic savings for investment; and third, to the extent feasible, assurances of reasonable stability in overall macroeconomic conditions.

6.4 The management of the budget deficit is the main factor. This is discussed in more detail in the 1987 CEM, so only an overview is given here. At first sight there are conflicts between the first two objectives: growth in demand would seem to imply maintaining or increasing the deficit, whilst freeing up savings for business investment suggests the opposite. This needs to be put into a medium-term context. The current budget deficit is not sustainable--it has been financed in the past few years through the creation of a private sector net savings rate of 8-10 percent of GDP: this is not consistent with a sustained recovery in private sector demand; in addition, the dynamics of rising interest payments on public debt will gradually catch up with deficit finance. Equally important, the private sector clearly understands the unsustainability of the deficit and its inconsistency with the maintenance of a stable macroeconomic environment. So any adjustment needs to include a significant--and convincing--medium-term decline in net public sector resource use in the economy. As discussed in the 1987 CEM, to avoid cutbacks in public services and public investment, the bulk of this would need to come from a reduced level of subsidies and careful control over the growth in the wage bill.

6.5 The objective, then, is to reduce the deficit in the context of steady growth in demand: deficit reduction alone could lead to recessionary adjustment that would quickly choke off any investment recovery. This requires complementary measures to stimulate export and private domestic demand and sufficient flexibility in the public sector resource position to allow temporary stimulation of demand when necessary. This requires a more detailed macroeconomic analysis, that has not been undertaken for this paper, but the following conclusions can be drawn from previous work.

(i) There is a need to stimulate export demand through a mixture of exchange rate movement and other special incentives. This is now an
important part of government policy and central to the assessment of the options for trade liberalization; the issues are not discussed further here.

(ii) Managing the growth in domestic private sector demand is more complex. Obvious instruments—tax reductions, wage increases, reduced (real) prices of controlled products—conflict with other requirements of the structural adjustment process. Of more importance may be a careful relaxation of the import constraint: in view of the past import compression, increased current imports (especially of intermediates and raw materials) can help support a private sector recovery through the direct impact on capacity utilization and indirect effects through input demand and, in some cases, increased labor income. If export growth is sluggish, some increase in borrowing may be necessary, but this needs to be managed carefully to ensure consistency with both aggregate external borrowing limits and the competing demands for foreign borrowing from public and private sector investment. Price adjustments, including exchange rate movement and excises on luxury consumer goods, can also help the process though encouraging switching of the underlying (non-rationed) demand away from imports and moderating the impact of private demand growth on the trade balance.

(iii) The key to effective budgetary adjustment is to combine reduction in the overall deficit with an increase in the "discretionary" component of the deficit, i.e. that portion of the deficit that can be relatively easily adjusted. Past macroeconomic analysis indicates that a reduction in the deficit of between 1.5 and 2.5 percent of GDP per annum over the next two to three years is likely to be consistent with the steady growth in demand that will support an investment recovery. Under these circumstances it would be highly desirable to make adjustments in the "structural" deficit of, say, 2.5 percent of GDP per annum, and either keep some spending in reserve, or include easily postponable expenditure items in the budget, e.g. in the investment program, in order to provide the Government with the flexibility to deal either with overheating or inadequate demand in the economy.

6.6 Reductions in the deficit that are clearly based in structural changes in public sector resource use are also the key to the perceived macroeconomic stability of the country. The business sector is sophisticated and is vividly aware both of the future risks that current deficits bring and of the often gloomy content of recent budget speeches. Thus the perception of a serious effort to tackle the sources of the deficit would be a major gain for the business environment. It will also be necessary to the achievement of greater domestic price stability. However, low inflation rates are less assured in the short run in view of the likelihood of a surge in inflation in response to the unwinding of the price freeze and the need for further adjustments in controlled prices (including continued depreciation of the exchange rate). This is likely to be unavoidable and it is important that both the Government and private sector recognizes this and does not perceive a rise in inflation as a sign of any failure in the adjustment process. The main question concern how to manage a rise without exacerbating relative price distortions and then
how to set in train a disinflationary process that does not lead to a recession in the real economy. 35/

6.7 Adjustments in the real imbalances associated with public sector deficits will have a major influence on the pattern of financial sector resource use. An investment recovery will lead to growth in private sector demand for credit--initially for working capital and subsequently for fixed investment. As Chapter 3 showed, there could be quite a large increase in the corporate sector's demand for funds. The most effective way of providing for this could be a (gradual) relaxation in the restrictions on financial institutions, of which the most important is that 60 percent of institutional investors' assets be invested in "prescribed" (public sector) liabilities. There is also a case for reviewing the liquid assets requirements in the monetary system, though this needs to be undertaken within the context of a review of overall monetary policy. More conventionally, lower use of credit from the monetary sector from the whole public sector (including the Agricultural Marketing Authority) would allow growth in private credit demand.

B. Foreign Exchange and Supply-side Constraints

6.8 A recovery in investment will require an increased supply of its three components: foreign exchange for imported investment goods; domestic capital goods; and domestic construction goods. The first is likely to constitute the severest constraint for the corporate sector, in view of the predominance of modern manufacturing and mining activities whose productive capital has a critical, and often large, import content. So increases in foreign exchange for private sector investment goods is likely to be a necessary condition for growth in corporate investment. Given the general foreign exchange constraint, and the low probability of major foreign investment inflows, it would be appropriate to allow increased external borrowing to finance private corporate investment in the short and medium term. The level of such borrowing would depend on both the overall external debt position and the appropriate division of investment between the public and private sector. In the assessment of appropriate levels of borrowing for public sector projects, it is important to take account of this private sector demand for external finance for investment.

6.9 The form of borrowing for private investment will depend on the policy regime for foreign exchange allocation. If the Government maintains the existing system intact, then increased borrowings could occur either via higher approvals for individual private sector projects by the External Loans Coordinating Committee, or increased borrowing for investment purposes by the Government or financial intermediary (such as the Zimbabwe Development Bank) with the allocation across projects decided at a subsequent stage, by the Industrial Projects Committee or financial institution. If the Government shifted to less specific allocation of resources in this area--as recommended in the next section--it would still probably be appropriate to maintain overall controls on private sector borrowing, but greater reliance would then be placed on external borrowings

35/ See Chhibber et al (1989) for a discussion of these issues.
to finance investment facilities managed within the financial system. While in the long run a relaxation of restrictions on external foreign borrowing by the private sector would be desirable, during the transitional period it would be appropriate for control to be maintained, given both the continuance of controls elsewhere in the system and the initial excess demand for foreign exchange. Levels of borrowing for private investment should then be based on an overall external and domestic financial programming exercise.

6.10 The question of borrowing for private sector investment leads directly to the management of foreign exchange risk. As noted in Chapter 5, until the recent change, the Government operated a dualistic system. For projects funded from Industrial Projects Committee resources, the Government bore the whole risk and private firms financed the foreign exchange purchase from domestic resources (generally internally generated). There are reportedly queues for IPC resources. On the other hand, firms going to ZDB or udc ltd. in the financial system for foreign exchange for investment had to bear the whole risk. Queues have been much shorter here. The new scheme that provides foreign exchange cover for four years represents a compromise in these circumstances: it allows firms to eliminate risk, but at a cost. At a charge of five percent per annum, there would be no transfer between the Government and users of the facility if the exchange rate experiences a nominal depreciation at the same rate of five percent per annum. This compares with a pace of nominal depreciation of 8.5 percent per annum against a trade-weighted basket in the 1983-87 period, i.e. the current terms appear quite generous to users, especially as it provides for full cover, with no risk-sharing. In view of these favorable terms, it would now be desirable to remove the dualism from the system and pass on the foreign exchange risk for resources from the IPC and allow users to cover the risk with the new facility. While many countries have some form of risk-sharing with the private sector, a system in which the Government assumes foreign exchange risk makes sense in the absence of any market mechanism for the private sector to cover its risk. It should be noted that even the full coverage of foreign exchange risk should not be construed as restricting the Government's exchange rate management policy. It just modifies and makes more transparent one component of the complex public-private resource movements that occur when the exchange rate adjusts.

6.11 With respect to supply-side constraints for the capital goods and construction sectors, the most frequently cited factor is again indirect foreign exchange requirements for intermediate inputs and equipment. This implies that measures designed to stimulate an investment recovery, including increased direct foreign exchange, should be accompanied by policies to relax these indirect requirements. If the Government adopts a phased approach to trade liberalization, it would be preferable to include the capital goods subsector early in any sequence of shifts from foreign exchange rationing to a system of tariff-based

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36/ The issues for the capital goods sector are discussed in the companion paper to this, see World Bank (1989).
protection. This would both ensure investing sectors are not constrained in their access to capital goods and that the domestic capital goods sector does not suffer quantitative constraints on its participation in an investment recovery. Similar considerations apply to the construction sector.

6.12 These sectors also suffer from other constraints, though these are less obvious at present since most firms are not running at full capacity. For the capital goods subsector, skilled labor could become a problem in the event of rapid growth--early movement to maintain the quality and output of the system of technical education would be desirable here. It is also necessary that iron and steel policy ensures an adequate supply of quality steel products (that will often have to continue to be imported). In the construction sector, the main problem appears to be the scarcity of middle level management: blacks were excluded from managerial positions prior to independence and the development of a cadre of experienced managers can take well over a decade. Little can be done in the short run: some liberalization of policy on expatriates may be justified, but this is generally a costly and unsatisfactory method of developing domestic experience and expertise. Continued pressure on the private sector to recruit, train and give responsibility to black Zimbabweans would be appropriate, though again this represents a medium to long-term solution. In addition, for all sectors, a reduction in specific interventions associated with the existing regime of resource regulation can directly relieve the burden of working within the system; thereby freeing up all managers’ time for production and marketing-related activities.

C. Investment Appraisal

6.13 The third area of policy focus should be on facilitating the private sector’s decision-making process over investment. The special issues for foreign investors are discussed below and we focus here on other aspects of investment regulation. The current investment committee approval system both restricts the private sector’s autonomy and control over project evaluation and imposes an administrative cost on the Government. There are two ways of responding to this. First, the Government could streamline the approval system through clarifying and publicizing the criteria and giving decisions and handling appeals more quickly. Second, there could be a shift of some of the burden of project evaluation from government committees to financial institutions, utilizing the technical capability and skills that already exist in the financial system. The latter is advocated here; there has been little progress in streamlining investment decision-making in the past few years and such a shift would free up the time of Government officials in favor of a greater focus on strategic questions in industrial policy.

6.14 If project appraisal is to be shifted toward the financial system, its role as an allocator of foreign exchange would be extended. This would go beyond the relatively limited activities of ZDB and udc ltd. This is closely related to the proposal in (B) above to undertake external borrowing for the purposes of private sector investment; this could be undertaken in the form of lines of credit for on-lending to private
businesses. However, as noted in Chapter 5, such a shift would also need to take account on the Government's decision on any overall reform of the foreign exchange allocation system.

6.15 This leads to a more fundamental question of how to deal with government investment priorities in the event of some combination of a shift in appraisal to the financial system and, for example, movement to a tariff-based system of protection. Two approaches are recommended. First, it would be appropriate for large projects, of strategic significance to the country, to continue to be subject to specific government approval. This could be handled in the form of a cutoff in investment size below which specific approval would not be required. Second, government policy could continue to require some negative restrictions (e.g. on selected excluded areas) and positive biases (e.g. on regional policy and employment creation). The former could be handled by regulations that investment approvals would have to satisfy, backed by some monitoring of the approval process. Positive biases are less easy to handle through microeconomic interventions (whoever handles the appraisal process). In the view of this paper it would be preferable to place greater reliance on indirect measures, for example through a more pro-employment regulatory policy, to further these objectives.

6.16 While this report advocates a substantial shift in project appraisal from the committee system to the financial sector, it is recognized that there could be problems of a rapid transition. Two are of importance: first, this role has not been demanded of the financial sector to any great extent in the past and it is likely to take time to expand its project appraisal capability; second, there is considerable mistrust between the Government and the private financial sector—especially the foreign-owned part that accounts for the bulk of the monetary system—and a strong feeling that it could not be entrusted with implementing the Government's priorities. 37/ If the Government is reluctant to fully shift responsibilities from the committee system, it is strongly recommended that the role of the financial intermediaries be enlarged, for example, through the channelling of foreign exchange for investment through the financial system, with the Government (e.g. the new investment center) giving broad guidelines and retaining a final, and rapid, approval for investment projects that satisfy these guidelines.

D. Financial Sector Development

6.17 Despite the depth of the financial system, its role in investment finance has been limited. The problem does not lie with the financial sector's infrastructure—it has a wide range of institutions and a well-established capital market. But there are a number of symptoms of an

37/ In some areas there is a similar mistrust of the institutional investor sector—whether because of its size and concentration, or the perception that there continues to be external influence on its policies, despite the fact that the sector is technically fully Zimbabwean-owned.
insufficiently active role in investment: the stock market has experienced only a limited number of new issues since independence and appears to be substantially undervalued (at least until the recent boom); the corporate bond market is undeveloped, and long-term corporate borrowing appears to be entirely limited to private placements; and the financial system as a whole has a predominant orientation towards financing "blue-chip" companies. If the financial sector is to play a larger role in investment appraisal and finance, there will be a need to encourage more venture capital activities (including the finance of new black entrepreneurs), risk-spreading techniques, a strengthening of the corporate side of the capital market, including the stock exchange, and a strengthening of the system's appraisal capability. The Government fully recognizes that the financial sector could play a more active role in the economy and is currently engaged in an internal review of the capital market and monetary policy.

6.18 Given the underlying strength of the financial system, its further development is likely to be most effectively encouraged through a combination of increased investment demand and allowing a relatively unrestricted response of the sector. The demand side is central: once the corporate sector places more demands on the system, new techniques and institutions will develop. The active response of the merchant banks to the financial opportunities presented by disinvestment in 1987-88 provides strong evidence for this. But some shaking up of the system would also be desirable: it is currently nicely protected and profitable and the Government could encourage the introduction of new techniques and institutions, rather than placing an overriding emphasis on the stability that leads to a sharing out of the substantial available profits from intermediation. This could also involve allowing new entrants into the system or diversification of existing institutions to put pressure on established institutions to move into areas of higher risk. This needs to be done with attention to the regulatory and monitoring capabilities of the system--in Kenya a rapid expansion in non-bank financial intermediaries in the early 1980s certainly took the sector into areas of longer-term credit and greater risk, but ran into problems with many of the new institutions having to close with bad debts. The encouragement of new intermediaries was appropriate, but this would have been more appropriately complemented by more effective regulation.

6.19 If the Government shifts some of the burden of investment appraisal to the financial sector, it is recommended that this not be restricted to a limited number of institutions (such as ZDB), since one of the purposes is to encourage competition and innovation on the financial side, involving both private and public institutions. However, ZDB, and public financial institutions in general, are likely to continue to have an important role to play. There are three reasons for this. First, project appraisal techniques in many financial institutions may be relatively weak and ZDB in particular could play a leading role in a transition phase. It may also be willing to finance economically sound, but relatively risky investments. Second, in view of the generally perceived risks of doing business in Zimbabwe, private corporations may view participation of public sector finance, whether in the form of loans or equity, as a risk-spreading factor in a new investment. This should not, however, be a requirement, since many in the private sector appear to consider that public involvement
increases rather than reduces risk. Third, attention needs to be given to encouragement of investment by black entrepreneurs, who may have not have an established track record. While it would be desirable for the private financial sector to take some initiative in this direction, it may initially be easier to encourage a public body, such as SEDCO, to take on the higher risks associated with new and smaller entrepreneurs.

6.20 The development of the stock exchange would also be facilitated by a general improvement in corporate investment demand. Government support for its future role in the economy would be desirable, to encourage a broader participation both from unlisted companies and potential investors. As noted earlier, there is substantial potential for capital appreciation if the volume of activity picks up. Consideration may also be given to two factors: the encouragement of investment in shares by small investors (once firms begin to make new issues)--this could require review of the current preferential tax treatment to deposits in the post office; and the desirability of some institutional strengthening of the market. Technical assistance may be useful here in the initial stages, though there is already an underlying financial sector infrastructure (notably in the increased attention to corporate finance in the merchant bank sector), that could quickly re-orient toward stock market-related issues.

6.21 Interest rate policy is, of course, relevant to the financial sector. Interest rates for corporations are not directly controlled, but they have been relatively low in real terms owing to weak credit demand. This is likely to change with a rise in credit demand from the corporate sector following an investment recovery. This would not be undesirable, if it reflects sustainable macroeconomic conditions and is not a consequence of an excessive budget deficit. As discussed in Chapter 3, the interest rate has only been a minor influence on the cost of capital in the past. Increases would hopefully be more than offset by reductions in perceived risks (thereby reducing the cost of equity finance) and in the relative price of capital goods following some relaxation of the foreign exchange restriction on imported capital goods. In view of the conclusion that other factors dominate the determination of investment demand, this paper is not too concerned about any dampening effect due to interest rate rises. Indeed an increased role for the financial sector in investment appraisal would be consistent with a greater role for interest rates in investment decision-making.

6.22 On the other hand, the Government's intervention to reduce interest rates on surplus funds of foreign-held corporations from ten to five percent is not justified. The intention is understandable, to reduce the return on financial investments and thereby encourage firms to invest in physical assets. However, all the evidence indicates that low fixed interest investment by foreign companies is not due to attractive alternative domestic financial investments. The net result of the policy has been to transfer profits from the non-financial corporate sector to the financial institutions fortunate enough to have their deposits. The Government's decision to tax these windfall banking profits is justified in this light, but it would be preferable to remove the control over this interest rate; this would have beneficial effects on business confidence at no real cost to the country.
6.23 Finally, firms that use the new facility to cover foreign exchange risk will face higher charges on the finance of the foreign component of investment. This is likely to be substantially offset by the reduction in perceived risks, i.e., this is an example of an intervention that improves expected future profits, without having to raise current profits (it actually lowers them slightly).

E. Complementary Regulatory Issues

6.24 Two areas of regulation--job security regulation and price/wage setting--are probably of equal significance to investment regulation for private investment. Both tend to reduce investment, not through slowing the decision-making process, but through increasing the perceived risks of investment.

6.25 Job security regulation. The strong job security regulations (that require government approval for dismissal of employees) have two effects of relevance here. First, permanent labor becomes more like a fixed cost of production, that cannot be adjusted in the event of fluctuations or shortfalls in sales. This increases the probability of temporary or permanent declines in profitability and so increases the economic risks associated with an investment decision. Second, it increases the effective cost of labor, thereby encouraging investments that reduce labor use. Thus job security regulations tend to reduce overall investment and impart a labor-saving bias on the investment that does occur.

6.26 The experience since 1980 provides evidence for these effects in Zimbabwe. An econometric analysis indicates that labor demand was below what it would have been in the absence of the regulations for most industries. It also shows the strongest negative effect on employment in the more rapidly expanding subsectors, indicating relatively high investment in those activities that were able to expand in a labor-saving direction, reducing the risks associated with the labor regulations. The objective of protecting the incomes of workers is desirable. However, it would be preferable to do this in ways that did not depress investment (that is necessary for any employment growth) nor imparted such strong incentives for labor-saving investments. Compensation schemes, for example based on the period of time working with a firm, combined with an active re-training policy, for example through courses for laid-off workers at the technical colleges, would be preferable.

38/ This was discussed in the 1987 CEM, and it has been further analyzed in follow-up work by Fallon and Lucas (1989).

39/ Ibid. This empirical work indicates that the long-run reduction in the level of employment due to the regulations could be over 20 percent on average, compared to a situation without the regulations.
6.27 It was announced in late 1988 that the Government, following consultations with both industry and union groups, is considering changes in the 1985 Labor Relations Act, though no decisions had been made by April 1989. Under discussion have been a relaxation of the job security regulations and an extension of the currently highly restricted right to strike. This appears to reflect both the private sector's emphasis on the constraints imposed by the current restrictions and a possible shift in the stance of the Government vis-a-vis the labor movement to allow a greater role for unions.

6.28 **Price and wage policy.** The price freeze that was initiated in mid-1987 appears to have squeezed profits in many activities, and there are reports of a number of activities operating at a loss. However, the frequently voiced complaints of the corporate sector over price and wage controls are less compelling than other factors in explaining weak investment demand. If anything, the Government has managed price and wage policy since 1982 in a manner that tends to guarantee profits, through allowing cost increases to be passed on in prices--and, as the corporate financial results attest, with quite a healthy impact on profits, at least until 1987. Nevertheless, there are compelling reasons for the continuation of both the unwinding of the price freeze and the complementary shift toward collective bargaining. First, this will allow the emergence of changes in relative prices and wage structures, encouraging resource movements in response to changing patterns of scarcity. As is well appreciated, this is closely associated with trade policy; it is best undertaken in the context of the introduction of foreign competition through a process of trade liberalization, given the widespread monopoly power of the corporate sector, should the Government decide to pursue this route. Second, it will reduce the costs imposed on both business and the Government of preparing, reviewing, negotiating and appealing price applications. At least in public statements, the private sector appears to consider that the price control system increases the risks of fluctuations in profits. Sudden decontrol may not be desirable, in view of widespread monopolistic markets and the risks of a jump in inflation. However, judging by the public debate of the past few years, even a gradual move would provide a valuable signal to the private sector in Zimbabwe and contribute to improved business confidence.

F. **Tax Policy--Corporate Income Taxes and Indirect Taxes**

6.29 **Corporate tax policy.** Major changes in corporate tax policy are not required. The quantitative analysis shows that the existing tax system is quite favorable to firms undertaking investment. In particular, the policy of full expensing for machinery and equipment leads to a sharp reduction in tax liabilities. Nevertheless, the following modifications in tax policy are recommended for consideration.

(i) The major anomaly in the existing system is the coexistence of full expensing with interest deductibility for tax purposes. This, in effect, leads to giving a tax allowance twice on the same expenditure (when it is debt-financed) and is equivalent to a subsidy on investment. There is no case for this: it could lead to excessive investments in inefficient activities. The extent to which this has occurred in the past is likely to
be small in view of the aversion of the corporate sector to debt finance. It is recommended, nevertheless, that interest deductibility be removed if full expensing is kept. This would tend to reduce after-tax profits (since firms do borrow for working capital purposes) and it would be appropriate to offset the projected additional projected revenue through a reduction (probably modest) in the average corporate tax rate. In view of the public visibility of the average rate, such a shift in tax structure could actually have a beneficial impact on business confidence.

(ii) The Tax Commission's recommendation on substituting full expensing with accelerated depreciation constitutes an alternative approach, but is not compelling if taken in isolation: investment expensing is not intrinsically a distortionary form of tax allowance and review of this area may not be a priority for attention of the scarce time of Ministry of Finance officials. However, it should be noted that expensing is currently restricted to fixed assets, and would be expected to lead to excessive investment in fixed relative to other forms of capital. It would be appropriate to revisit this question if the Government undertakes a review of the fundamentals of the tax system i.e. whether to maintain the income-based character of the existing system (as essentially recommended by the Tax Commission) or full shift to an expenditure-based approach. In this context, it should be noted that, since capital income is now weakly taxed, the tax system has already effectively moved in the direction of an expenditure-based approach.

(iii) There is little case for the use of taxes or subsidies as an instrument of foreign investment promotion (and discriminatory or discretionary incentives are especially undesirable). Low domestic profits have not been a feature of foreign corporations and the sources of lack of foreign investment lie elsewhere. This is discussed in the next section.

(iv) Some differentiation of tax allowance policy to further the Government's spatial location policy, through providing a more generous tax position for firms locating outside existing industrial centers may be justified. However this would require further analysis.

6.30 **Indirect taxes.** The recent trend in government policy has been to attempt to reduce the cost of investment through reduction in the cost of imported capital goods. In 1987, it was announced that the customs surtax on imported capital goods would be reduced from 20 to 15 percent. Then, in 1988, the possibility of full exemption on all indirect taxes was announced. At first sight, the results in Chapters 2 and 4 on the impact of the cost of investment goods on the cost of capital and the rate of investment would seem to provide support for this approach. However, there are three reasons why it is not advocated here. First, there is a question of interpretation: it is the judgement of this paper that the primary source of the rise in the cost of investment goods lies in the direct and indirect impact of the rationing of foreign exchange—on the price of imported equipment and of domestically produced capital goods (for which price controls are relatively ineffective). The evidence is limited, but if this is correct, reducing tariffs will not have any effect of significance, while liberalization of supply would reduce the relative price. Second, we would place greater emphasis on other factors dampening
investment demand—if we return to the analysis of the cost of capital, most importantly the factors that raise perceived risks, thereby raising the cost of equity. Third, reducing the tariff on imported capital goods whilst maintaining protection for the domestic capital goods industry has the perverse effect of encouraging relatively import-intensive investment choices (that would exacerbate the other bias toward capital-intensive choices due to the labor regulation system). 40/ The preferred choice would be to have uniform treatment by equalizing tariffs for competing and non-competing capital goods. 41/

G. The Environment for Foreign Investment

6.31 The dominance of foreign capital in the corporate sector has been a pervasive feature of the assessment of the current investment climate. The Government has two distinct objectives vis-a-vis foreign capital: to increase national, and especially black, ownership of productive capital; and to encourage investment by existing and new foreign firms where there are clear gains to the economy. As discussed in Chapter 5, the development of an environment that furthers both objectives has been a difficult task. If this is to be successful, the key issue is a clear differentiation between those existing areas of foreign ownership that the Government would be happy to see diluted and areas where expansion is considered desirable. This complements the distinction drawn in Chapter 5 between those investors that have made a strategic decision to leave whenever they can get acceptable terms, and those with an established or potential long-term commitment to the economy. It is then important to ensure that policies designed to deal with the former group (including dividend and disinvestment policy) do not worsen the environment for potential new investors, through reduced expected returns and increasing perceived risks of investment.

6.32 The Government has indeed pursued a differentiated policy through according "venture capital" status to post-1979 investments: this, inter alia, has included the maintenance of 50 percent remittability of after-tax profits and more favorable provisions for disinvestment. However, this has failed to convince most new foreign investors or the parent companies of existing firms. There appear to be three reasons for this: first, foreign investment procedures remain both restrictive (e.g. on categories of investment by existing foreign firms that might qualify for venture capital status) and cumbersome; second, the perceived risks of investment are high-

40/ See World Bank (1989) for a full discussion on the capital goods sector.

41/ A possible exception is exporting activities: there is a case for giving export industries indirect tax exemptions for imported capital goods, in parallel to the drawback for imported intermediate goods. The principal problem lies in separating the export-oriented content of capital goods. Largely for this reason, drawbacks on capital goods are treated as subsidies by GATT and can be subject to countervailing duties.
in part because the foreign investment community remains skeptical--this was captured in Chapter 4 by the high cost of equity for foreign firms; third, many investment firms have made a strategic decision to minimize investments in Southern Africa. Nothing can be done about the last, but some further policy changes can facilitate the disinvestment process while improving the environment for new investment. The new policy direction announced in April 1989 constitutes a major step in this direction.

6.33 The environment for new investors. The principal feature of a differentiated policy should be a more favorable environment for potential new investors--and potential new investments of established firms. This appears to be the major focus of the Government's proposed new framework for foreign investment. The general conclusion that current profits (at least in Zimbabwe dollars) are not the key issue is important here. The emphasis of any new initiative should not be on any generalized fiscal incentives, but rather on stronger assurances on dividend remittability and disinvestment procedures for investment approval. The moves in the May 1987 package of measures were an initial step, but the more radical streamlining that should occur with the new investment center, is highly desirable. Finally, the decision to sign the Multilateral Investment Guarantee Agency and consider bilateral agreements should also improve the investment climate. Zimbabwe's decision not to sign any such facility after independence is understandable, but it had an adverse impact on perceptions of foreign investors. Apart from the general signal this will give, these facilities provide some comfort to potential investors on their key concern of maintaining access to dividends from their investment.

6.34 As the Government is aware, clear signals on the priorities for foreign investment would facilitate the work of the new investment center--as well as effective publicity of both these priorities and the incentive environment for new investors. However, it is recommended that either discretionary or discriminatory incentives be avoided, whether in terms of additional fiscal incentives or special terms on remittability. As discussed above, the fiscal incentive system is already overly generous, and, if the Government wishes to relax remittability restrictions, this would be better undertaken for all (or all new, or post-1979) investments. It would be preferable to have the guarantee of a 50 percent remittability than the uncertainty of a higher or lower one. Discretionary incentives (whether fiscal or on remittability) both add to approval procedures and have, in other countries, been an open invitation to corruption. Indonesia, for example, had a wide range of discriminatory investment incentives, but scrapped them all as part of its major tax reform of 1983. 42/ The one exception to a completely uniform pattern of rates and incentives for investors is the mining sector: resource depletion requires a different tax treatment (as already occurs) and the unusual character of gold exploitation (in view of the special terms offered by other countries) may also justify special attention. This is a specialized area that would require further analysis before any recommendation could be formulated.

42/ See World Bank (1988) p. 95 for a brief discussion.
6.35 Improvement in the foreign investment regime is important, but high expectations on new inflows would be inappropriate, even with a highly favorable regime. The global shifts in the direction of international investment have been to the OECD and East Asian countries, driven by long-term perceptions over profitability and stability. There is, in particular, now a rising interest amongst multinationals over the planned internal liberalization of the EEC in 1992. By contrast, Africa in general, and Southern Africa in particular, is viewed as a region of high strategic risk. Add to this a widespread tendency in developing countries (from Mexico to Nigeria) to liberalize their foreign investment regimes and the prospects for generalized foreign investment inflows are not encouraging. The major benefits for Zimbabwe are likely to lie in the effects on the overall environment for private investment and in attracting selected foreign investment into specialized areas.

6.36 Managing disinvestment. Parts of the foreign investor community are willing to disinvest at apparent discounts of the order of 70 percent in return for repatriation of the proceeds over one to two years. The Government has allowed this to occur on a case-by-case basis in the past two or three years. This policy allows Zimbabwe to purchase productive capital at knock-down prices, as well as support the transfer to domestic groups (the transactions are reportedly only allowed if the purchasing group involves either substantial state or black participation). This has a number of costs--of loss of precious management skills, technology transfer and market access, and of asset-stripping. If these investors are committed to disinvestment these are, to some extent, unavoidable. However, there is also a potentially broader adverse impact on the business environment through the perception that this represents a measure of the value of foreign capital in Zimbabwe, implying future expected returns should be similarly discounted. It is the view of this report that this is misleading: the substantial discounts are not a reflection of a discount on equity per se, but on the restrictions on capital outflows for the past three decades and the sharp discount on foreign currency transactions for a select group of foreign owners of capital. An additional factor is that increased state ownership can bring both direct costs and fears of pressures for future sales to the state.

6.37 It is recommended that the Government continue to allow disinvestment at a discount at an overall pace dictated by indicative aggregate external and financial programming, but that it explores somewhat different procedures. Two innovations could be considered. First, a division could be made between the domestic sale, which should be at a reasonable market price in domestic currency, and the foreign exchange transaction, that would be at a discount. The level of the discount could be set by the Government, as at present, or it could be set in the market--since these transactions are already fully insulated from other foreign exchange transactions in the economy there are no risks of spillover into other areas. This approach would signal that the discounts do not derive from the low long-term value of capital stock, but the foreign exchange constraint and excess demand for capital outflows. It could be appropriate for the state (e.g. via the Reserve Bank) to be involved as an intermediary, capturing some of the substantial rents involved in the transactions. Second, it would be desirable to encourage a combination of
established and new institutions to broaden local participation in the new
domestic companies, wherever possible involving the Zimbabwe Stock
Exchange. This could also support the Government's other objective of
encouraging a greater role for the capital market in the economy,
especially if this is associated with measures to attract small investors
into the exchange.

6.38 **Swaps and new investments.** To complement general policy on
foreign investment, Government could also consider use of special
mechanisms for swapping foreign-held assets in Zimbabwe for new investment.
Classic debt-equity swaps would probably be undesirable--the Government
has, at some cost, maintained its creditworthiness through a good record of
servicing its debt; indications of value-impaired debt in the market could
jeopardize this. However, schemes allowing discounted swaps of blocked
funds, surplus funds, convertible bonds or existing equity for new foreign
investment should avoid this problem--these categories of foreign liability
have been effectively value-impaired for decades. In addition, there are
two potentially important benefits that are entirely consistent with
current policy toward foreign investment: first, swaps could support the
change in the composition of foreign capital, from investors only
interested in short-run profits and getting out on the least unfavorable
terms, to investors with an interest in long-run profits and therefore in
investing in Zimbabwe; and, second, they could attract foreign risk capital
and expertise into areas that badly need it. As suggested in the May 1988
Conference of the Chamber of Mines, a good initial candidate for this would
be gold exploration. This could be cast as a special case and the response
to a scheme could be explored without commitment to a more generalized
approach.
Annex I

Derivation of the Cost of Capital

1. This annex draws on the modern theory of optimal business investment behavior to derive an equation for the cost of capital services (rental price of capital) for the non-financial corporate sector of the Zimbabwean economy. The cost of capital services refers to the cost of using one unit of capital for a specified period of time, i.e., one year. It depends not only on the cost of funds and the cost of asset decay, but also on the benefits of tax provisions for businesses' depreciations and for deductibility of interest expenses. Also, the determination of the cost of capital relies on the interaction between inflation and taxes. To the extent that interest payments which are deductible against corporate income taxes are in part payments of the principal, the real cost of capital is reduced. This positive aspect of inflation is, however, often offset by the historical cost base depreciation rules, which do not fully compensate the companies for higher replacement cost of capital.

2. In Zimbabwe the current tax code allows for full expensing of business investment outlays. This allows, in essence, businesses to capitalize depreciation allowances to the maximum level, which is $1 for each $1 of new investment in machinery and equipment. Furthermore, interest payments are completely tax deductible. These provisions are quite important. Their influences are explicitly incorporated in the cost of capital derived below.

3. Analytically, the derivation of the cost of capital is facilitated by focusing on the investment decision from the perspective of the equity holder. Consider then an investment in a project costing \( P_k \) at the time of acquisition. If a proportion, \( b \), of that investment is financed through debt, and if the statutory corporate income tax rate is \( u \), the shareholder's share of the original investment outlays, will be \( (1-uz-b)P_k \). For the project to be viable, this must be equal to the present value of the stream of net income; more formally,

\[
P_k(1-uz-b) = \int \exp(-\rho \delta t) \left[ (1-u)qP_y - ((1-u)r + (\delta-x)) b. P_k + uzP_k \right] \, dt...
\]

where:
- \( q \) = real user cost of capital
- \( P_y \) = price of output
- \( \rho \) = required rate of return on equity (nominal)
- \( \delta \) = rate of depreciation
- \( r \) = nominal rate of interest
- \( x \) = rate of inflation
- \( z \) = present value of depreciation allowances

4. Solving equation (1) for the real cost of capital, \( q \), yields:

\[
q = \frac{P_k}{P_y} \left[ (\delta + \delta) \frac{1-uz}{1-u} - \frac{\delta - (1-u)r + x}{1-u} \right]...
\]
where \( \hat{\rho} \) is the real required rate of return on equity, i.e.

\[
\hat{\rho} = \rho \cdot \hat{\alpha}
\]

where \( \hat{\alpha} \) is the rate of inflation in the price of capital goods.

5. Given that businesses in Zimbabwe are permitted to deduct fully their purchase of fixed assets against their current tax income, \( z \) will be equal to the ratio of total fixed assets to total capital i.e.,

\[
a = \frac{\text{Fixed assets}}{\text{Fixed assets} + \text{Inventories}}
\]

Thus, the final form for the real cost of capital will be:

\[
q = \frac{P_k [ (\hat{\rho} + \delta) \frac{1 - au}{Py} \cdot \hat{\rho} - (1 - u) r + x \cdot b ]}{1 - u}
\]

6. This equation was applied to the Zimbabwean data, incorporating the following assumptions:

(i) \( \hat{\rho} \), the real required return on equity taken to be 6 percent for local companies and 10 percent for foreign companies. For the local companies this estimate is consistent with the average (1980-87) return on their equity, after making adjustment for inflation-induced depreciation in the real value of debt. For foreign companies, an additional 4 percentage points of risk premium was added

(ii) \( \delta \), economic depreciation assumed to be 5 percent.

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\[36/ \quad z = az_1 + (1-a)z_2 \]

Where \( z_1 \) and \( z_2 \) are respectively the present value of depreciation allowances on fixed assets and on inventories. Under the prevailing SIA provision in Zimbabwe, \( z_1 = 1 \) and \( z_2 = 0 \).
References


