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DSP PAPER NUMBER THREE BY K.A.FINAN

ZIMBABWE'S PROPOSED ECONOMIC REFORM PROGRAM

I. Background

Paper number one examined Zimbabwe's performance against indicators of human development and concluded that the Government had achieved its independence goal of equitably distributing the benefits of development. Paper number two, through an analysis of the balance of payments, determined that the Government's performance was not economically sustainable This paper asks the question, "Will Zimbabwe's proposed economic reform program (as outlined in the attachment A policy matrix) actually create the conditions for sustained economic growth?"

In order to answer this question, the paper will look at three elements of the economy that effect the program's chance of succeeding: Private investment is discussed because substantial growth in investment in the productive sectors is critical to sustained economic recovery, The industrial sector is discussed in more depth because of its role in meeting the increased demand for capital stock which would follow a recovery in investment; And finally, reducing the public sector fiscal deficit is discussed because that is essential for making room for private sector-led growth. After looking at the conditions necessary to generate investment and expand capital goods production, the paper will raise some concerns about the proposed economic reform program

II Private Sector Investment

Can private sector investment be generated?

As observed in Graph PI-1, real private investment in Zimbabwe has steadily declined since 1981. This decline has implications for the sectoral pattern of investment as illustrated in graphs PI-2 and PI-3, that is, the private sector dominates investment in the goods-producing sectors while the public sector invests in

infrastructure and social services Future growth in output and employment, which are necessary for economic growth, will require a recovery in private investment.

An examination of the pattern of finance seen in the Table 1, Sources and Uses of Funds Statement, indicates that there has been little demand for commercial financing by the corporate sector They have relied on self-financing rather than debt-financing for fixed investment and have only depended on external financing for shortterm working capital and financing trade debtors. The high degree of self-finance cannot be attributed to a weak financial sector because Zimbabwe has a sophisticated, albeit conservative, financial intermediary system with a broadly-based institutional structure spanning banks, finance companies, pension funds and insurance companies. Nor can it be attributed to policy related disincentives to borrowing, since the lending rate is lower than the cost of capital and interest payments are tax deductible Therefore, the extent to which internal finance has predominated is concluded to be a result of the availability of internal finance (profits) and the lack of demand for fixed assets (environment for growth). The extent to which an economic reform program (1) creates a desire for corporate expansion, and, (2) reduces profits by exposing corporations to free market competition, is the extent to which firms will be forced to seek out external debt financing

To create a desire for expansion, the economic reform program will need to focus on establishing an appropriate macroeconomic environment, eliminating supply side constraints (see part II B below), and defining a less cumbersome regulatory environment In order to have longterm debt financing available to the private sector, the Government will need to manage its deficit (see part IV below) so that it isn't monopolizing bank funds for non-productive investments. And in order to draw in small investors, the financial system will have to be become more competitive; that is less conservative and more innovative in its choice of financial instruments.

III The Capital Goods Sector

What is the potential for local industry to increase exports and to supply the local economy under free market conditions?

The capital goods sector in Zimbabwe is well integrated. It is supplied by one of Africa's largest iron and steel industries It is both a major supplier of and jobber for plant, machinery and equipment to the mining, agriculture, construction and manufacturing sectors in Zimbabwe and throughout the Preferential Trade Agreement (PTA) region. Recovery in investment in Zimbabwe would lead to an urgent demand for capital goods to replace the productive sector's aging capital stock. To some extent, the success of an adjustment program depends on the whether the capital goods sector has the capacity to efficiently meet the rise in investment demand

A Performance

Graph CG-1 illustrates the capital goods sector's performance with respect to exports from 1979 to 1987, while graph CG-2 illustrates the sector's success in meeting the domestic market demand for its products from 1966 to 1984. In 1980, 81% of the local market was being supplied domestically and there was a 13% increase in the export of capital goods. In 1982, only 58% of the domestic market was being supplied locally and exports had fallen 40%. By 1984, there was some recovery in local market share and a boom in non-steel exports. But, as seen in the trade balance analysis (paper #2) imports have leveled off and as seen in graph CG-1 capital goods exports have leveled off and the economy began stagnating.

As depicted in Graph CG-3, the capital goods sector achieved its highest levels of capacity utilization in the first ten years of UDI sanctions when domestic expansion was at its peak Utilization then declined prior to independence, picked-up slightly afterwards but has never really recovered (attributed to the

effects of a shortage of foreign exchange to replace equipment and uncertainty over the supply of spare parts). Note that the manufacturing sector has had a less volatile fluctuation in its capacity utilization rate, possibly because it can sustain itself with fewer external inputs than the capital goods sector. However manufacturing is dependent on the capital goods sector and, as the capital goods sector's utilization rate drops, so too does the manufacturing sector's.

Currently, the sector is faced with: (1) the availability of surplus skilled labor; (2) plants which are operating only one shift for an average of only 268 days per year, (3) an overvalued wage sector (see comparative wage levels in graph CG-4), (4) no R&D capabilities; (5) atrophied marketing capacity; and, (6) antiquated equipment which contributes to wasteful production methods. Items 1 and 2 imply capacity to meet increased demand, item 6 would be resolved through access to foreign exchange and credit, and items 4 and 5 will only result from exposure to unprotected markets

B Policy Impact on Capital Goods Sector

The principal policy interventions that have influenced the capital goods sector are tariffs and quantitative import restrictions inherent in the foreign exchange allocation system Table 2 provides data on nominal protection rates (NPR), effective protection rates (EPR) and domestic resource costs (DCR) that can be analyzed to provide information about the effects of an open market environment on the sector.

As noted in column 1, Zimbabwe's tariffs vary according to whether or not the imported item competes with a locally manufactured product. The variation in the nominal protection rate in column 2 indicates that certain industries, because of competition or high transportation costs can produce domestic inputs at less than or relatively close to the border price, while other industries that require economies of scale cannot compete with international prices (note, the item with the worst NPR also

carries the highest tariff rate) The great variations in NPRs and the virtually uniform rate of tariffs suggests that quantitative restrictions are more of an influence than tariffs To the extent that down-stream industries use locally produced capital goods as inputs, the costs of protection are being passed on to the domestic industries and/or the final consumers. To the extent that user industries rely on these products as inputs to their export production, the additional costs serve as taxes on exports.

The effective protection rate for import substitution commodities in Column 3 indicates that, in all but one of the industries, valued added adds more to cost under current policy conditions than if there was free trade (as a result of receiving higher profits or paying higher wages or taxes) If firms in these industries had to compete under free-trade conditions, their value added would fall sharply. One of the main worries of a phased trade liberalization program is that firms with high EPRs would have more incentive to seek access to foreign exchange as long as they are operating in a protected environment and these firms would expand at the expense of more efficient firms

The asymmetrical impact of policies on exporters and import-substituters can be seen by comparing the average of the ISI EPR in column 3 with the export EPR in column 4. The ratio of the former to the latter is a measure of Zimbabwe's anti-export bias which, as indicated in column 5, varies by industry according to both policy interventions and market conditions Graph CG-5 illustrates the relative contributions to value added of exports from transportation costs, quantitative restrictions and tariffs. In order to increase exports both the tariff levels and the quantitative restrictions need to be adjusted.

Using the direct resource cost as a measure of economic efficiency, columns 6 through 9 suggest that the capital goods sector is fairly efficient and that in all but two cases ISI production is efficient while only 50% of the export situations are efficient when the cost of capital is included (exports have higher transportation costs).

If the proposed trade liberalization program moves the economy toward a neutral position with respect to imports and exports, it would expose the economy to greater import competition and would not harm the capital goods sector. Rather it would facilitate restructuring through strengthening efficient and viable product lines and through forcing restructuring of inefficient operations which would benefit other productive sector enterprises. The caveat is that removal of quantitative restrictions and reduction in tariffs would have to be applied equally across all industries

IV Fiscal Deficit

Will the Government be able to reduce the fiscal deficit?

Table 3's historical presentation of government revenues and expenditures, can help in assessing the government's plans to manage the fiscal deficit. Since independence, the government has raised tax rates, shifted the composition of taxes from direct toward indirect, enlarged the tax base and moved away from quotas toward tariffs. By 1984, tax revenue as a share of GDP was a large 34%. Additional tax increases are unlikely to bring about substantial increases in revenue since personal tax rates are high and the tax base is narrow, and, while company taxes are not high, increases in company tax rates would reduce savings and jeopardize the firm's ability to finance investments from its own sources

The recurrent expenditures listed in table 3 account for 85% of all government expenditures. Fixed public sector investments account for the remaining, undisplayed, 15%. Major areas for recurrent expenditure reduction include subsidies to public enterprises and indirect subsidies. Table 4 provides a more up-to-date view of the impact of inefficient parastatal operations on the budget. The government has a detailed plan for making these corporations self-financing and autonomous over the next three years - primarily by eliminating direct subsidies, civil service intermediation and subsidized pricing. In the document that supports attachment A, the government also details a plan for

eliminating indirect subsidies and instituting cost recovery programs in the health and education sectors The same document calls for a reduction in the civil service wage bill but is less specific regarding how that is to be accomplished.

The government recognizes that these expenditure reduction steps will take several years to fully implement. Since they intend to simultaneously relax restrictions on the private sector's access to foreign exchange and credit, they intend that the present inflation rate of 16% continue for a few years. The combination of the reduction of direct and indirect subsidies, the institution of cost recovery programs and the high inflation rate are likely to result in hardships for vulnerable groups. Safety net programs and exemptions from cost recovery schemes are planned for those groups as indicated in attachment B

V. Issues Effecting Program Success

An effective exchange rate and the removal of administrative restrictions are the two critical elements to creating the conditions for private sector investment and industrial sector expansion Unfortunately, although the exchange rate has been fairly well managed (paper #2), further devaluation is indicated by the heavy demand for foreign exchange which is creating the need for quantitative restrictions The proposed policy on the exchange rate is fairly vague on the timing or willingness to devalue until equilibrium is achieved With respect to the many administrative restrictions that distort market signals (foreign exchange allocations, price controls, wage controls, etc.), the proposed policy agenda outlines a plan for total elimination but lacks transparency with regard to the timing and prioritization. A lack of clarity on these two issues (in a plan which is proposed for implementation over a five year period), risks a loss in investor confidence and also creates an environment for subversion by special interest groups. The government's detailed elaboration of the measures it intends to take with respect to expenditure

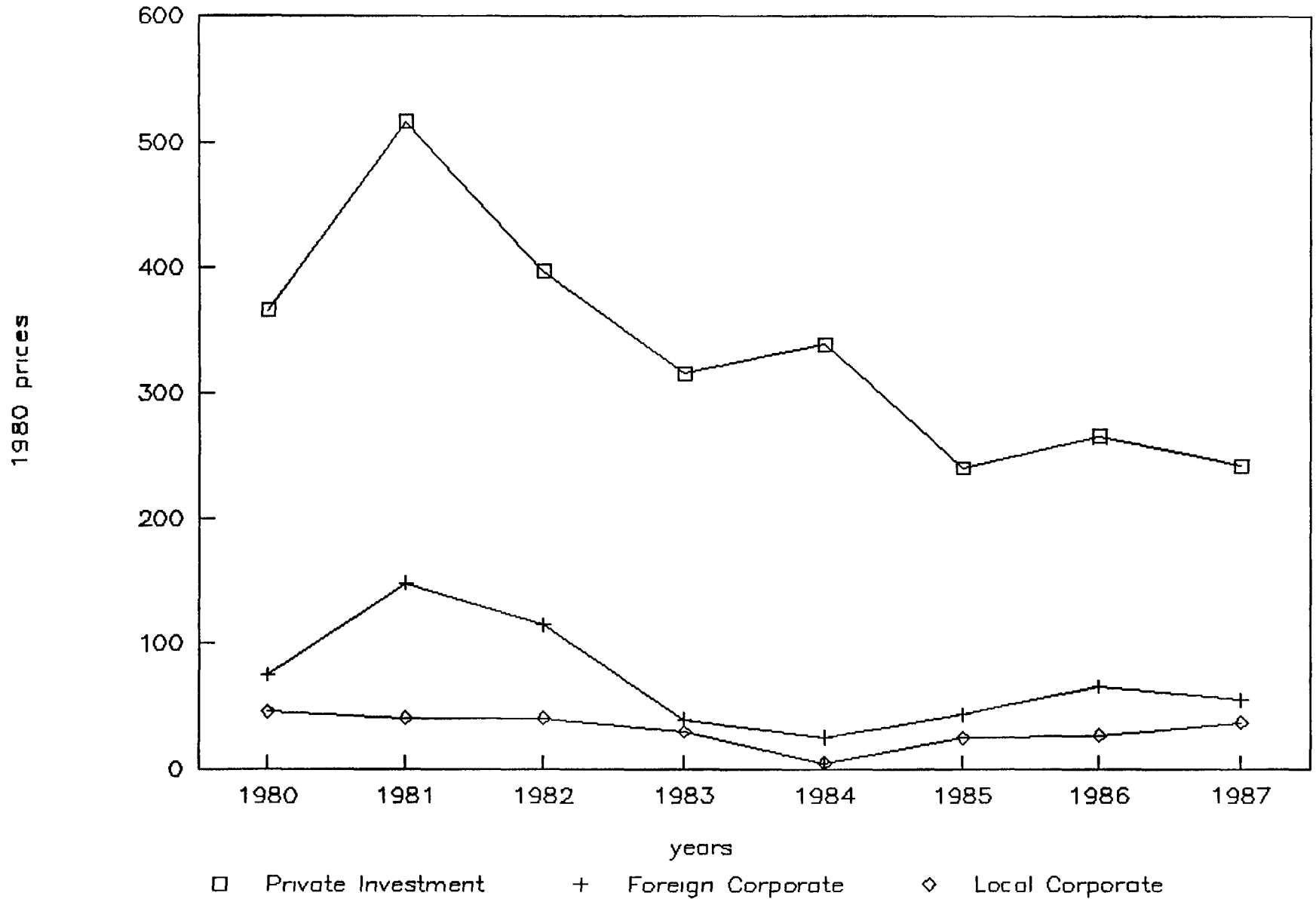
reduction stand in stark contrast to its lack of transparency on the exchange rate and administrative restrictions

The history of the development of the reform program offers the most positive indication of its chance for success. Although the World Bank had been earnestly analyzing various aspects of the economy of Zimbabwe in since 1987, the Government convened its own group of private sector (taking into account the stakeholders whose cooperation mattered the most for program success) and public sector economists during 1989 to analyze and recommend the various elements of the program outlined in attachment A. The program was formally announced after President Robert Mugabe's reelection in March 1990. The program is deeply phased in order to give those industries which have been successfully operating under administrative restrictions since 1965 a chance to restrategize, retool and prepare to compete in an open market economy. The Government hopes that a donor review of the program at the end of March will result in commitments for the concessional financing necessary to fully open the foreign exchange system

GRAPH PI-1

REAL PRIVATE INVESTMENT

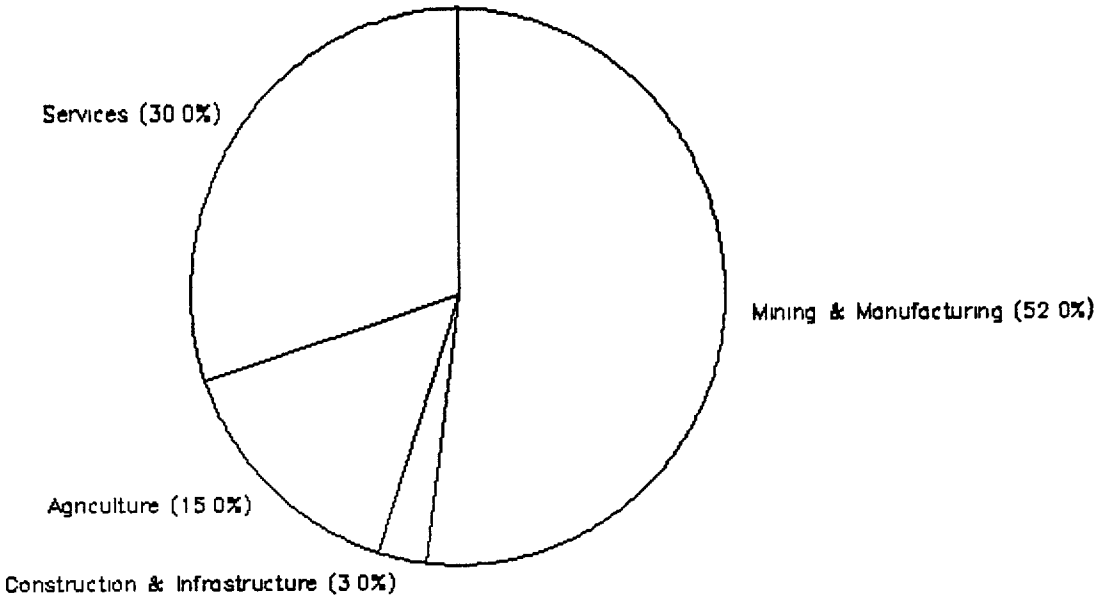
ALL PRIVATE VS CORPORATE



GRAPH PI-2

PRIVATE FIXED INVESTMENT

(1980–1984)



GRAPH PI-3

PUBLIC FIXED INVESTMENT

(1980–1984)

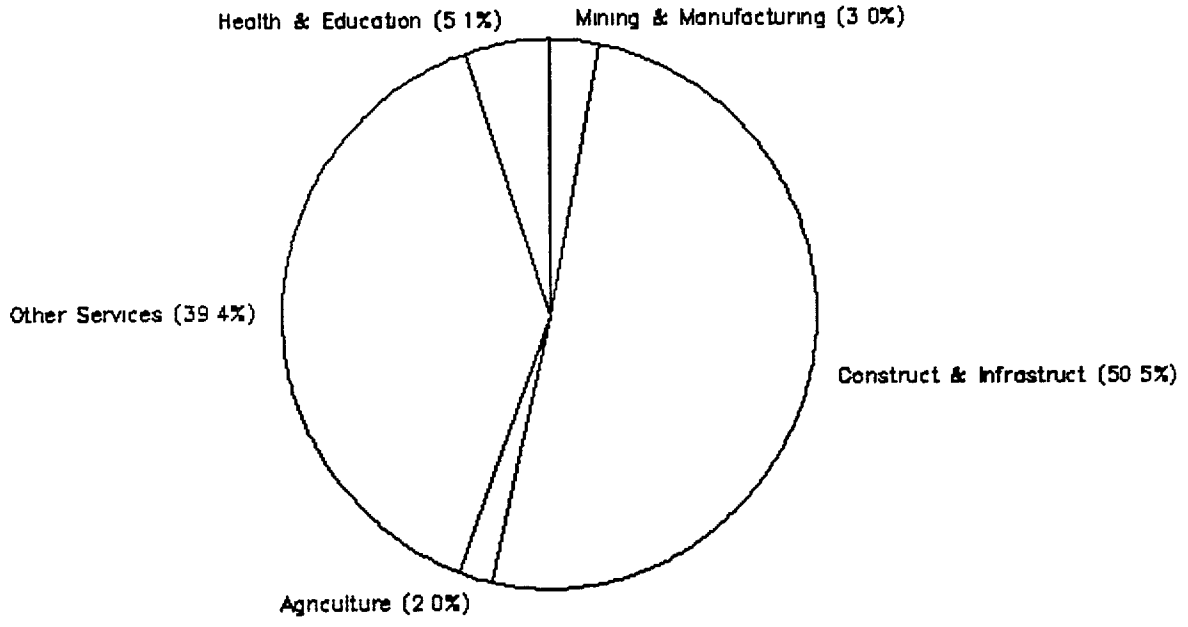


TABLE 1

Financing Sources of Non-Financial Corporations
1980-1987
(percentage of total sources of funds)

Source	1980	1981	1982	1983	1984	1985	1986	1987
Gross Internal Funds	54 0	40 1	40 9	50 9	87.5	82.6	53 6	74.1
Retained Earnings	37 8	28 2	20 0	10 9	35.4	54.3	37.6	53.9
Depreciation	16.2	12.0	20 9	40 1	52.1	28.3	16 1	20.2
New Stock Issues	26 6	10.8	0 6	9 4	6.4	0.5	1.2	14.7
Medium/Long term Loans	-1 0	14.0	32 4	4 4	-3.6	-13.7	-0 2	-7.2
Shortterm Loans	2.2	13.4	8 3	18.7	-28.9	6.6	27.3	4.7
Trade Credits	16.5	17 5	17 1	12.5	37.0	19.2	16.5	13.9
Other Sources	1.7	4.1	0 7	4 1	1.7	4.8	1 6	-0.2

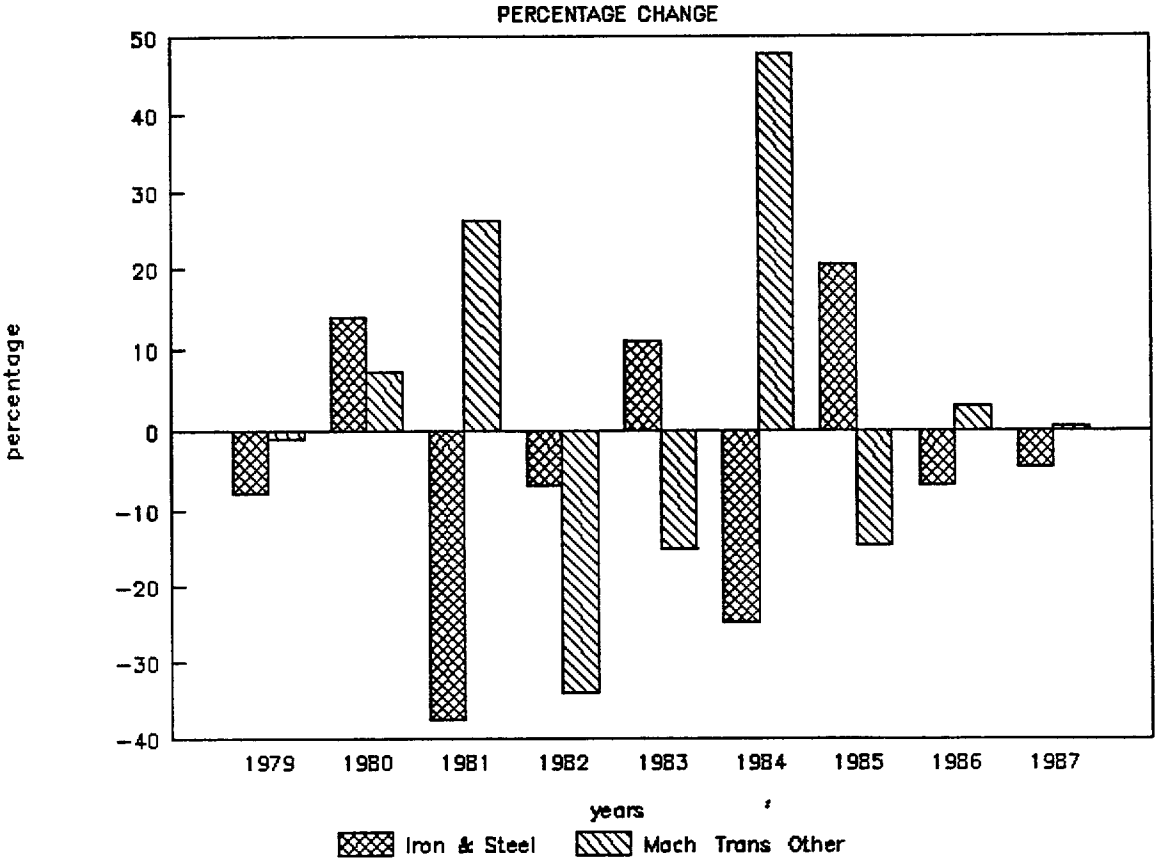
Uses of Funds of Non-Financial Corporations
1980-1987
(percentage of total uses of funds)

Use	1980	1981	1982	1983	1984	1985	1986	1987
Capital Formation	74.3	78 7	91 6	88 7	52.6	74.9	72.4	78.8
Fixed Investment	46.1	55.3	62 8	79 4	56.2	48.7	39 4	53.2
Inventories	28 3	23 4	28 8	9 3	-3 6	26.2	33.0	25 6
Cash	-1.9	0 1	-4 2	-4 8	13.5	5.0	2.2	-0 1
Debtor	20 1	16 7	10 9	13 0	31.1	12.5	23 1	18.8
Longterm Loans & Investments	1.0	1 6	0 6	-0 4	1 3	1.0	-0 3	-0.1
Other Uses	6 4	3 0	1 1	3 5	1.4	6.5	2 6	2 5

Source Company accounts of 48 listed companies on Zimbabwe Stcok Exchange

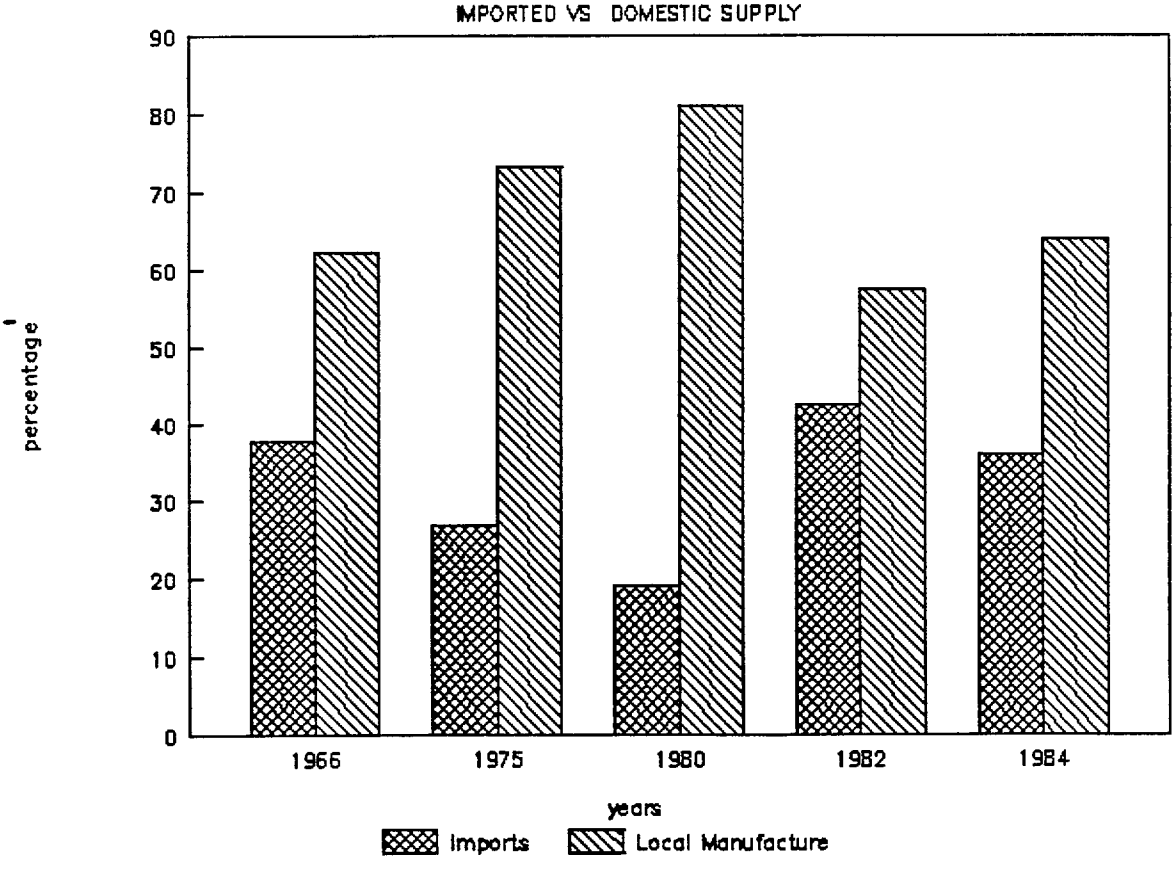
CRAPH CG-1

CAPITAL GOODS EXPORTS



CRAPH CG-2

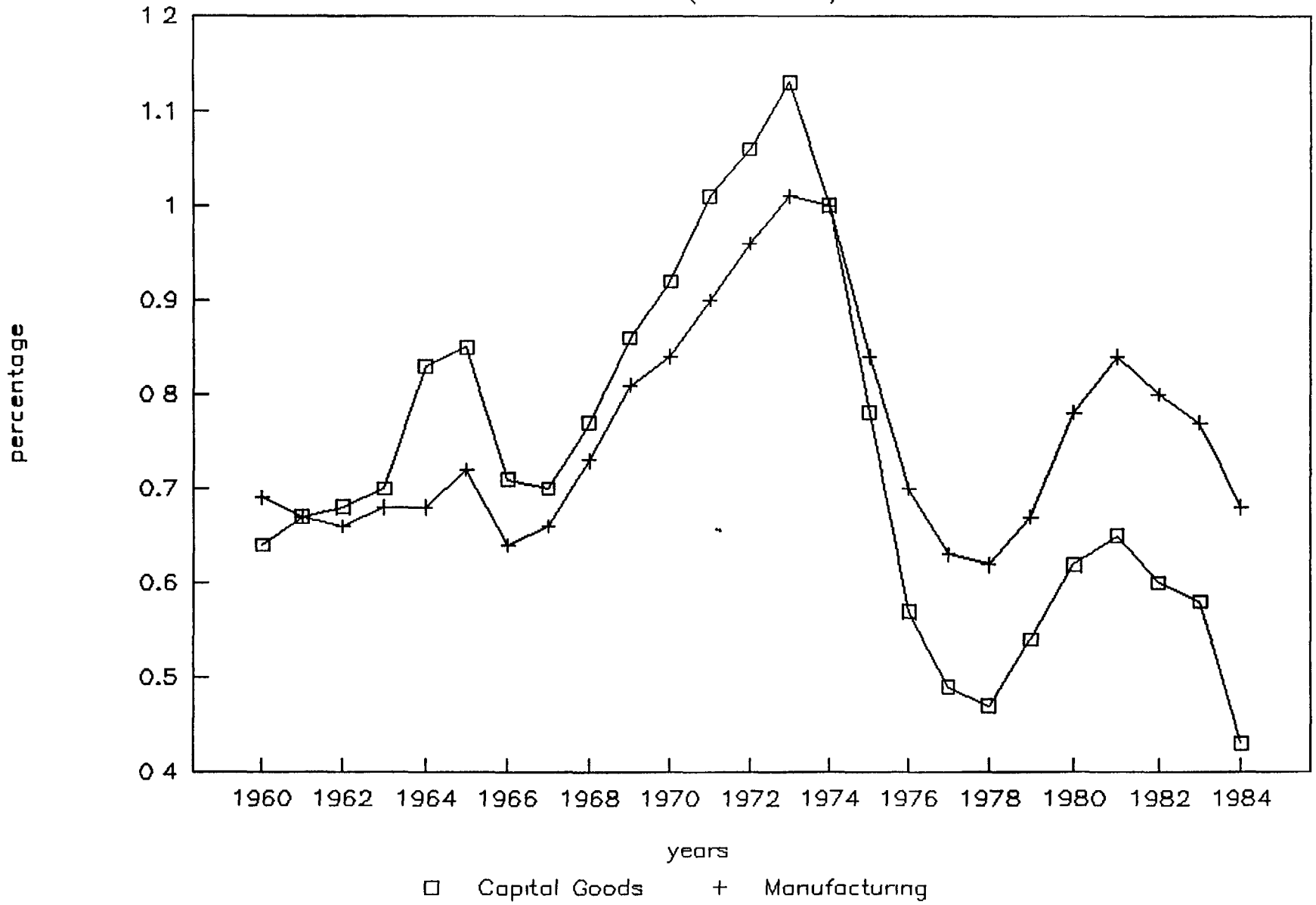
SUPPLY OF CAPITAL GOODS



PH CC-3

CAPACITY UTILIZATION RATE

ZIMBABWE (1974=1 00)



GRAPH CC-4

MANUFACTURING AVERAGE EARNINGS PER MONTH AS A FUNCTION OF GNP PER CAPITA

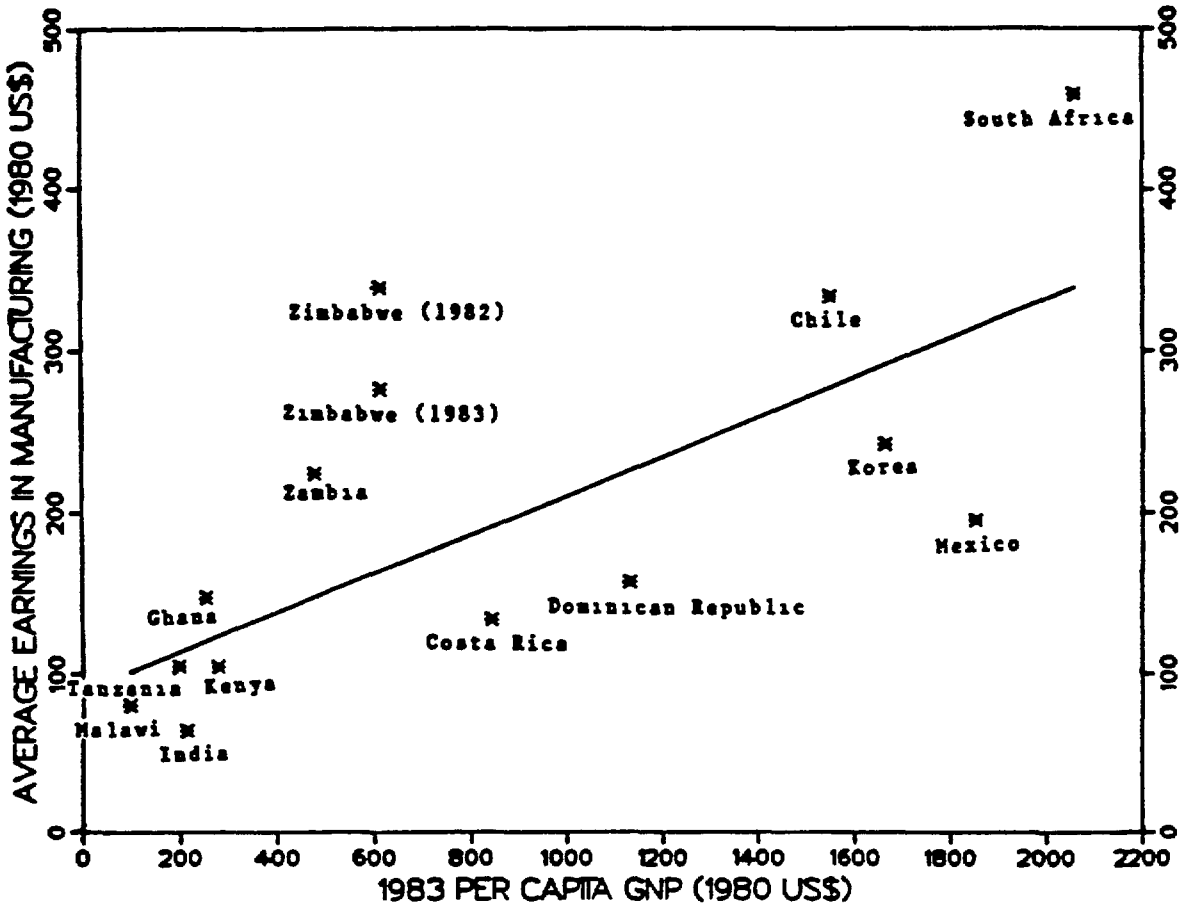


TABLE 2

ZIMBABWE
EFFECTS OF POLICY REGIME
ON CAPITAL GOODS SECTOR

Product	1 Tariff+ Surtax	2 Output NPR	3 ISI EPR	4 Exports EPR	5 Anti-Exp Bias	6 ISI S/T DRC	7 ISI L/T DRC	8 EX S/T DRC	9 EX L/T DRC
Rolling Stock	35	-5	-52	43	0.34	0.27	0.44	0 35	0.57
Steel Casting	35	23	26	20	1.05	0.52	0.71	0.60	0.81
Steam Boiler	2	13	22	49	0.81	0 74	0.97	0.96	1.23
Electric Motors	56	79	167	35	1.97	1.32	1.52	1.63	1.86
Fasteners	35	59	175	59	1.72	0.41	0.70	0.48	0.80
KVA Transformer	35	40	49	30	1.15	0.55	0.58	0.65	0.80
Urban Bus	35	50	87	53	1.23	0.68	1.06	1.21	1.85
Mazda Pick-up	35	32	28	202	0.42	0.27	0.81	0.83	2.27
Mazda Sedan	35	27	8	98	0.55	0.23	0.68	0.44	1.10
Ag. Implements	2	52	89	20	1.58	0.49	0.65	0.60	0.77
Trailers	15	23	24	24	1.00	0.42	0.58	0.45	0.62
Average	32	33	55	25	1 24	0.54	0.79	0.57	0.77

1. Import Duty + Surtax
2. Ex factory prices vs. landed prices net of duties + surtax
3. Value added for domestic sales under present conditions vs. same under free trade
4. Value added in exports under present conditions vs. same under free trade
5. (ISI Tariff&QR/Export Incentive)/ISI Free Trade
6. Domestic resources used per dollar saved in import substitution
7. Same as 6 but including capital costs
8. Domestic resources used per dollar generated in exports
9. Same as 8 but including capital costs

CONTRIBTUIONS TO VALUE ADDED

EXPORTS VS DOMESTIC SALES

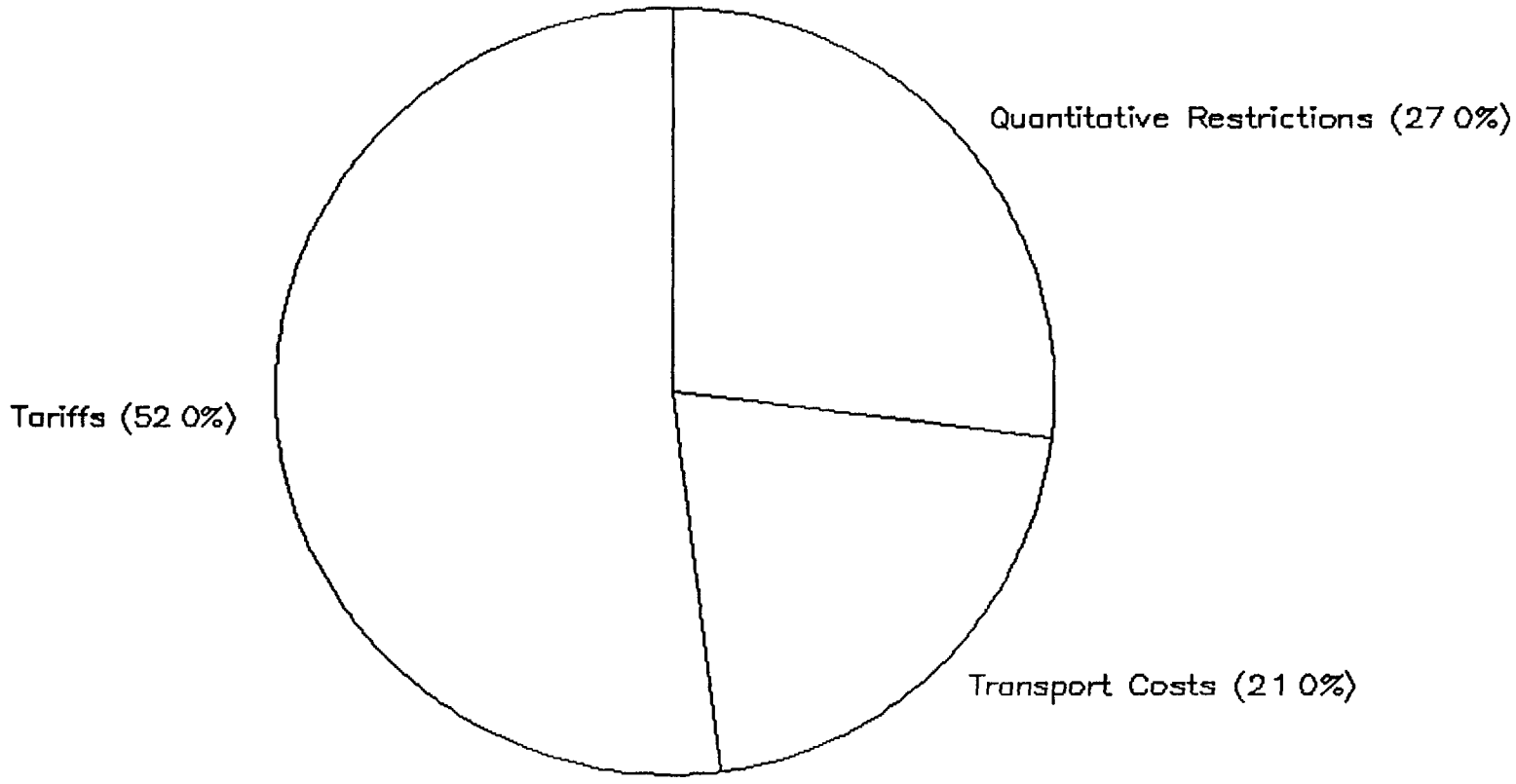


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TABLE 3

CENTRAL GOVERNMENT REVENUE
(Z$ million)

Income Catagory	1979/80	1980/81	1981/82	1982/83	1983/84	1984/85
Taxes on Income & Profits						
Income tax	172	239	329	400	458	542
Company tax	128	182	282	367	317	322
Other taxes	16	17	27	26	26	40
Taxes on Goods and Services						
Sales & Excise	213	263	411	536	627	648
Customs duties	22	60	140	228	291	316
Other	2	5	5	6	6	7
Miscellaneous taxes	9	12	14	16	18	17
Non-Tax Revenue						
From investment	48	62	54	77	95	96
Fees	16	13	13	17	26	36
Other	49	98	59	90	79	88
TOTAL REVENUE	675	951	1334	1763	1943	2112
Revenue as % of GDP						
Total Revenue	25	28	30	36	34	34
Direct Taxes	12	13	15	16	14	14
Indirect Taxes	9	10	13	16	16	16

CENTRAL GOVERNMENT RECURRENT EXPENDITURES
(Z$ million)

Expenditure Catagory	1979/80	1980/81	1981/82	1982/83	1983/84	1984/85
Goods & Services						
Wages & Salaries	316	375	473	559	622	682
Subsistance & Transport	37	33	41	51	65	75
Incidental Expenses	20	21	40	56	38	46
Other Recurrent	227	170	209	244	328	308
Total Goods & Services	600	599	763	910	1053	1111
Transfers						
Interest	70	100	143	200	271	368
Public Corporations	62	70	85	105	163	204
Pensions	48	72	75	75	74	82
Grants & Transfers	191	296	383	529	662	675
Total Transfers	371	538	686	909	1170	1329
TOTAL RECURRENT EXPEND	971	1137	1449	1819	2223	2440

TABLE 4

GOVERNMENT SUBSIDIES TO MAJOR PUBLIC ENTERPRISES
(Z$ million)

Public Enterprise	1986/87	1987/88	1988/89	1989/90
Ag. Marketing Boards	166.0	210.0	156.0	160.0
Grain Mktg Board	48.1	123.9	80 0	48.9
Dairy Mktg Board	65 0	43 3	40 0	56.1
Cold Storage Comm	49 5	31.2	11 1	37.5
Cotton Mktg Board	0.0	11.7	25.0	17.7
Ag Mktg Authority	3 4	0 0	0 0	0.0
National Railways	80 0	100.0	120.0	100.0
Air Zimbabwe	45.0	39 9	10.0	15.0
Affretair	15.0	3.0	0.0	0.0
Zimbabwe Steel	82.0	100.0	167.0	100.0
Ag Finance Corp	18 4	4 5	15.0	12.5
National Oil Company	0.0	0.0	0.0	0.0
TOTAL SUBSIDIES	406.4	457 5	468.1	387.7
Gov't Expenditures b/	3077 0	3783.0	4264.0	5016.0
Subsidies/Expenditures	13.2	12 1	11.0	7.7

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a/ 1990 Economic Reform Document, Gov't of Zimbabwe
b/ IFS, 1990

Attachment A

GOVERNMENT OF ZIMBABWE'S ECONOMIC REFORM PROGRAM
POLICY MATRIX

Policy	Action
Exchange Rate	Manage in support of trade liberalization and resource shift to export sectors
FX Allocation	Eliminate FX allocation system over 5 years by steadily expanding OGIL
	Rationalize tariffs to range of 10% - 30% Phase out surtax
	Phase out special export incentive schemes
Investment	Remove investment sanctions
	Liberalize remittance controls
	Reorganize investment corporation to assist in promoting foreign investment and technology transfer.
Labor	Replace wage controls with collective bargaining
	Permit retrenchment after setting up worker's compensation program
Price Controls	Eliminate price controls
	Establish commission on monopoly pricing
Domestic Regulations	Relax controls on informal and small scale enterprise
Money Supply	Manage to contain inflation
	Replace interest rate and credit controls with indirect controls
Interest Rates	Make the base lending rate dependent on the cost of foreign borrowing
Financial Sector	Modernize Banking Companies Act to permit emergence of new financial instruments
	Set up securities exchange commission

Inflation	Use monetary and fiscal policy to reduce to less than 16%
External Debt	Keep debt service payments at 20% of exports while borrowing concessional and non-concessional resources to finance structural adjustment
Fiscal Deficit	Reduce deficit by 2% of current level:GDP
Revenue	Reduce levels and rationalize structure (tariffs, company tax & marginal tax rate for individuals)
Expenditure	Eliminate redundant and non-essential civil service by 25%
	Increase cost recovery in health and education sectors
	Eliminate indirect subsidies
	Reduce direct subsidies
Parastatals	Develop public enterprise reform policy Determine privatization candidates Make public enterprises autonomous Change consumer and producer prices Change operating rules to promote efficiency
Agriculture	Reduce marketing board losses and permit private trading
	Redistribute land without decline in productivity
Environment	Broaden conservation policies
Energy	Charge economic price for petroleum imports
	Pursue energy efficient strategies, rehabilitate thermal power stations and increase electricity tariffs
Education	Reduce spending on education by amount collected in cost recovery program
Health	Maintain expenditure in health, recover costs from private patients, improve efficiency, strengthen rural services

VULNERABLE GROUP ASSESSMENT

Urban Formal Sector: Skilled and Semi-Skilled

Least likely to be adversely affected Some frictional unemployment for those workers employed in uncompetitive industries. Minor negative impacts from removal of food price subsidies and minor gains from decrease in market price of consumer durables. Cost recovery in social services will impact this group the most.

Urban Formal Sector: Unskilled/Domestic Workers

Mixed impact likely. If laid off from jobs would face severe competition in finding new positions. Women are likely to suffer more. Real wages will be eroded by inflation and approximately 10% of this group may fall below poverty line. Exemptions from social service cost recovery will be designed for this group Relaxation of limitations on informal sector activity will positively impact this group.

Small-Scale and Informal Sector

Will benefit from liberalization of business regulations Will benefit from linkages with an increasingly efficient formal sector, although transitional unemployment in formal sector may create competition for informals. Increase in efficiency of formal sector may decrease market share of informal sector

Urban Unemployed

Until a quantity of new jobs arises from trade liberalization, this group will face most severe difficulties as inflation erodes what little purchasing power they have.

Communal Areas

Given the preponderance of low income households in rural areas, social service cost recovery programs and removal of food subsidies to be carefully targeted to avoid adverse impacts. Erosion of urban sector real wages will negatively impact remittances to rural areas.

Workers on Commercial Farms

An increase in employment on commercial farms is expected. However farm labors have little bargaining power and may face wage erosion due to inflation.

Attachment C

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"Zimbabwe The Capital Goods Sector: Investment and Industrial Issues" World Bank, January, 1990

"Zimbabwe A Framework For Economic Reform" Government of Zimbabwe, November, 1990