BOTSWANA

SELECTED ISSUES

September 2024

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BOTSWANA

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CONTENTS

DESIGNING A SOVEREIGN WEALTH FUND FOR BOTSWANA: ISSUES AND POLICY OPTIONS[1]

This chapter discusses the rationale for and design of a new Sovereign Wealth Fund (SWF) in Botswana. It reviews the causes of declining financial reserves and calculates fiscal targets that would be needed to achieve insurance and intergenerational equity objectives. Staff conclude that a SWF could provide a useful institutional framework to support rebuilding buffers, but achieving significant savings to meaningfully fund an SWF would require much tighter fiscal policy than has been observed in recent years (e.g., achieving a 1 percent of GDP fiscal surplus on a persistent basis, versus deficits of almost 4 percent of GDP over the past decade). The institutional framework would need to be reformed by adopting (1) a new fiscal rule (e.g., an expenditure ceiling) that would enshrine the government's commitment to generate fiscal surpluses in the medium term, and (2) a new SWF, where the savings would be invested and managed. Importantly, international experience shows that proper design is essential to ensure that the new framework supports fiscal discipline and does not undermine FX reserves. For instance, a fiscal rule targeting a fiscal surplus is superior to a rule saving a share of mineral revenues. And a "financing fund" model, where inflows and outflows are directly related to the budget position, is superior to more ad hoc models.

A.   Introduction: Current Setup and Authorities' Reform Plans

1.   Established in 1994, Botswana's Pula Fund, owned and managed by the Bank of Botswana (BoB), aims to save mineral revenues for future generations. FX reserves—above those needed for international transactions—are transferred to the Pula Fund and invested in stocks and bonds. At end-2023, total Pula Fund assets stood at 20 percent of GDP. The Pula Fund is sometimes described as a SWF, but there are critical differences: unlike typical SWFs, the government does not have direct access to these resources and there are no high-level operational rules for deposits and withdrawals. Government has an indirect claim on the SWF through its Government Investment Account (GIA)—a savings account in Pula at the BoB.[2] The value of the Pula Fund is driven by the overall balance of payments and returns on investment (including valuation gains). The GIA is primarily driven by the fiscal balance (see Box 1).

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[2] Although the government is the ultimate owner of the Pula Fund as shareholder of the BoB, it does not own the Fund in an economic sense (e.g., right to manage or dispose of assets to finance the deficit).

2.   Over time, the government has implemented several fiscal rules to preserve fiscal discipline and generate public savings out of mining revenues.[3] The existing rule is a debt ceiling at 40 percent of GDP, with foreign debt at no more than half of this amount. This rule has not been tested because the government has run a disciplined fiscal policy and could draw down on cash reserves to fill the financing gap when needed. More recently, the impact of the pandemic— and an ambitious planned fiscal expansion for FY2023–2024—is bringing the fiscal account closer to these limits.

3.   Despite the Pula Fund and fiscal rules, public financial wealth has declined over the past two decades, prompting the government to consider significant reforms of their resource management framework. FX reserves, which stood at 121 percent of GDP in 2001, had fallen to 24 percent by 2023, while government's cash balances declined from 43 to 4 percent of GDP between 2008 and 2023. These trends mainly reflect a structural reduction in domestic diamond production and elevated public spending to GDP ratio. To reverse this decline, the authorities are considering the introduction of a fiscal rule that would automatically save a share of mineral revenues in a new SWF.[4] The new SWF would be owned by the government, with its own deposit and withdrawal rules. Seed funding may come from transferring a portion of existing central bank FX reserves.

4.   To contribute to the policy discussion, this SIP considers international experiences with SWFs. The chapter is organized in line with the analytical steps to be followed in designing a SWF (Figure 1): Section B puts the long-term decline in fiscal and external reserves into historical perspective. Section C outlines expected benefits from introducing a new SWF, while section D estimates the fiscal targets that will be needed to generate sufficient buffers for the 'insurance' or 'intergenerational equity' objectives. Section E makes the case for a 'financing fund' model for Botswana and explains the link between the fiscal rule and the SWF. Section F explains the risks to fiscal and external sustainability from more ad hoc models. Section G concludes with a summary of other institutional design considerations, including governance and investment strategy.

Figure 1. Sequential Steps for Designing a SWF

Define rationale for savings → Calibrate level of savings depending on objective → Choose inflow/outflow model for SWF → Design other features (e.g., investment, governance)

Source: IMF Staff

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[3] Botswana's rules have typically been non-binding political commitments. In the mid–1990s, the government aimed to keep the ratio of recurrent spending (excluding development spending) to non-diamond revenue below 1. Adhering to this rule would leave diamond revenue to finance the accumulation of financial assets and development spending. Another indicative target was on the composition of spending: development spending ought to make up at least 30 percent of total spending. In 2003, the government set as an indicative target a non-negative fiscal balance. In 2005, a formal cap on debt (to be kept below 40 percent of GDP) was introduced.

[4] The National Development Plan 11 (2017) outlined a rule requiring the government to save 40 percent of mineral revenues in financial assets for future generations.

Box 1. Botswana's Pula Fund and the Government Investment Account

The **Bank of Botswana's FX reserves** are divided between two main accounts: the Liquidity Portfolio and the Pula Fund. The Liquidity Portfolio is a money market and fixed income fund that provides a buffer for short- and medium-term trade and capital account requirements and is typically less than a fifth the size of the Pula Fund. The Pula Fund is a long-term investment portfolio in foreign assets. Assets in excess of what is needed for reserves adequacy (i.e., the Liquidity Portfolio) are invested long-term in the Pula Fund, with investment decisions made in consultation with the Ministry of Finance. The Pula Fund and Liquidity Portfolio appear on the asset side of the BoB's balance sheet (see the complete balance sheet in Annex II).

The **Government Investment Account** (GIA) is one of the two government deposit accounts in Pula at the central bank (on the liability side). The government has a remittance account (like a current account for day-to-day transactions) which receives zero interest, while the GIA receives an estimated long-term SDR rate, plus revaluation gains/losses reflecting the revaluations arising from movements in the market value of the Pula fund assets (including from currency fluctuations). Through the GIA, the government has a notional claim on the Pula Fund, with the government's share of the capital of the Pula Fund roughly equal to the GIA balance. When the GIA increases, it affects the government's claim on the Pula Fund, but not the size of the Pula Fund. In general, the Pula Fund and GIA typically move in tandem because diamond exports drive both fiscal and BoP balances, but there is no mechanical relationship.

Box 1. Figure 1. Financial Flows – Pula Fund & GIA
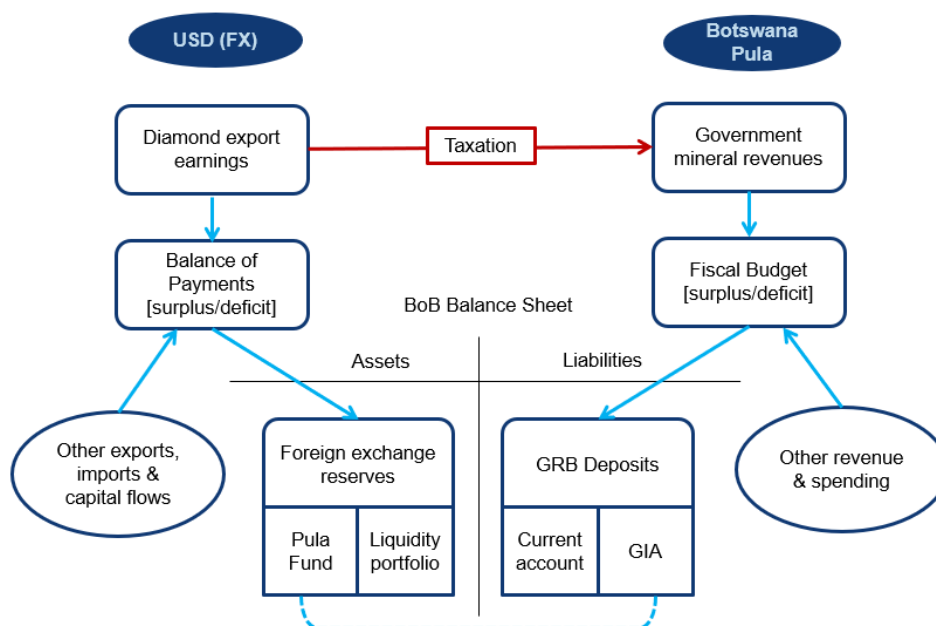
B. Context: Long-Term Depletion of Fiscal and External Buffers

5.   **Botswana's external and fiscal buffers have persistently declined over the past two decades.** The fiscal and BoP accounts exhibit similar trends, with revenues (inflows) declining and expenditures (outflows) remaining relatively stable (Figure 2). Botswana is very exposed to the international environment, and tends to draw down on its buffers when hit by global shocks. This was particularly noticeable during the 2008 Global Financial Crisis (GFC), the diamond market downturn in 2014 and the 2020 Covid-19 pandemic.

Figure 2. External and Fiscal Buffers 2000–23
(Percent of GDP)

Government Investment Account and Net Debt

Sources: Bank of Botswana, and IMF staff calculation.

Fiscal Balance

Sources: Ministry of Finance, and IMF staff calculation.

BoB Foreign Exchange Reserves

Sources: Bank of Botswana, and IMF staff calculation.

Diamond Trade Balance

Sources: Bank of Botswana, and IMF staff calculation.
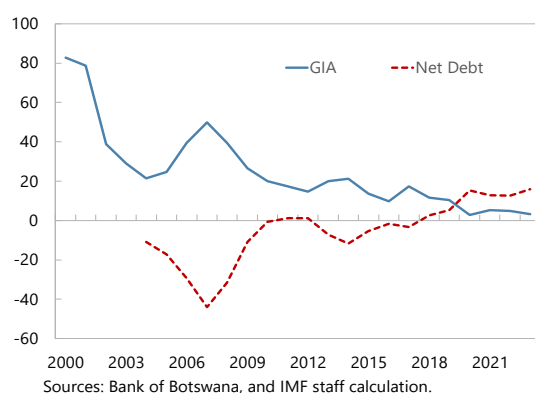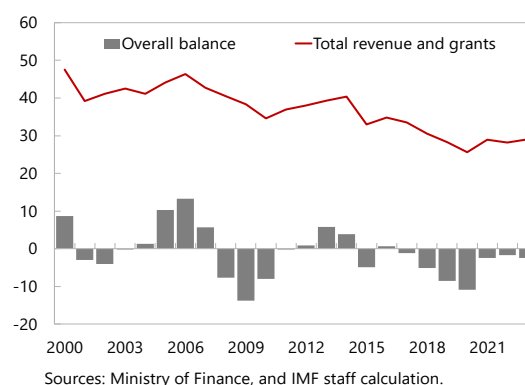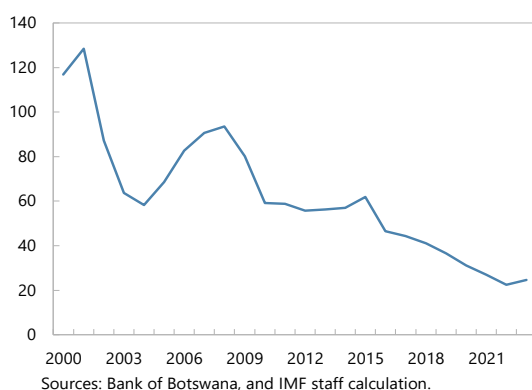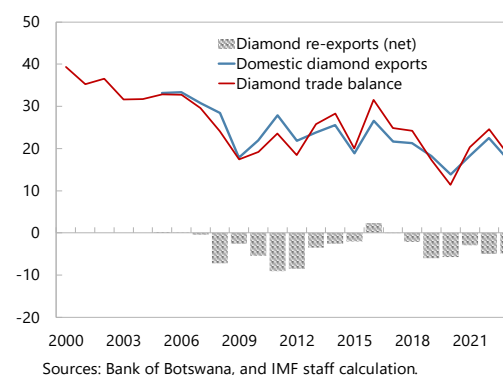
Note: For the top panel, the denominator of the ratios is the imputed fiscal year GDP. Diamond imports to Botswana began in 2005.

Fiscal Buffers

6.   Falling fiscal buffers reflect a declining revenue-to-GDP ratio and sustained expenditure. The budget balance has shifted from a surplus of more than 12 percent of GDP in FY2006/07 to deficits averaging 5 percent of GDP over the past five years. Indeed, total revenues have fallen from more than 40 percent of GDP in 2007 to 28 percent of GDP in 2023. Half of this decline reflects falling mineral revenues, but both non-mineral and South African Customs Union (SACU) revenues have also fallen. Government spending, however, has kept pace with GDP, averaging 34 percent of GDP over the past 10 years. The public sector wage bill is high by international standards, at 13 percent of GDP.

7.   While debt ratios have been steady, the government has financed these deficits by drawing down its assets. The government's net financial assets (NFA) have fallen by more than 40 percentage points of GDP, from 32 percent of GDP in FY2008 to minus 16 percent of GDP by

FY2023. Government deposits at the BoB—which is a proxy for the GIA[5]—fell from 40 percent of GDP in FY2008 to 4 percent of GDP in FY2023. The GIA would have declined more rapidly, were it not for returns on the Pula Fund and large exchange rate changes (i.e., accumulated revaluation gains).

External Buffers

8.   **From 2000 to the present, Botswana's FX reserves have declined sharply.** There have been persistent BoP deficits since 2009. The current account, which had exhibited large surpluses prior to the GFC, moved into deficit, mainly due to a weakening of the trade balance. Reserves have also declined due to net portfolio outflows (averaging 3.7 percent of GDP between 2000 and 2023) and net outflows from the income balance of the current account (averaging 5.8 percent of GDP). Portfolio outflows mostly reflect external investments by pension funds, while negative income balances reflect dividends and reinvested earnings paid to foreign investors (e.g., dividends paid by Debswana to De Beers). Over the past decade, additions to FX reserves have come almost exclusively from SACU transfers and valuation gains.

9.   **Over time, the trade balance has become a major contributor to the weaker external position.** From an average surplus of 13 percent of GDP between 2000 and 2007, the trade balance has typically been in deficit since 2008. The deterioration is mostly due to the decline in the diamond balance, which, itself, reflects falling exports of domestically-sourced diamonds, while net re-exports have remained small and broadly stable.[6] Non-diamond exports have also shrunk as a share of GDP, mainly reflecting a decline in textile exports.

C.   Main Benefits Expected from a New Sovereign Wealth Fund

10.   **Accumulating government savings would be particularly beneficial for Botswana:**

- *Financial savings is a powerful way of achieving intergenerational equity.* A new SWF could support the authorities' desire to preserve wealth for future generations and prepare for the depletion of diamonds by reining in spending pressures and ensuring that not all the mineral revenues are spent today. In fact, this was the original intent of the Pula fund, which was created in 1994 to preserve part of the income from diamond exports for future generations.

- *Intergenerational equity may be better served by creating financial assets, rather than through investment spending, although the two are not mutually exclusive.* Botswana has tended to allocate resource revenues primarily to physical and human investment (Jefferis 2016). Like many other resource-rich countries, however, Botswana struggles to spend its mineral

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[5] At end-2023, government deposits held at the BoB amounted to P10bn, while the GIA held P8bn. This difference mainly reflects the resources set aside for development funds and day-to-day government operations.

[6] Botswana is a global diamond hub. In addition to its own domestic production, the country imports diamonds for sales events, known as "sights," in which buyers from all around the world come to see the new diamond batches. Diamonds are later re-exported. In Figure 2, net re-exports are computed as diamond re-exports minus imports.

revenues efficiently. The 2023 IMF PIMA report noted a large gap in infrastructure spending efficiency between Botswana and the most efficient countries with comparable income levels and public capital stock. Similarly, despite generous public spending, the quality of education and the ability of social protection to reduce inequality remain low (World Bank 2023 and second Selected Issues Paper). This paper focuses mostly on intergenerational transfers achieved though the accumulation of financial assets, but recognizes the importance of finding the right balance between different forms of investment.

- *Creating buffers against shocks would strengthen the country's resilience.* Botswana is very vulnerable to shocks, given its dependence on one luxury good faced with erratic global demand and an artificial substitute. Thus, a SWF could be very helpful to build up an insurance cushion for the budget, helping smooth out public expenditure when diamond prices fluctuate.

11.   Given low public debt in Botswana, government savings should be primarily allocated to building financial assets. Many countries in Africa struggle with elevated debt vulnerabilities and any fiscal surplus should primarily be directed to debt reduction rather than creating a buffer of assets. But Botswana has a much stronger fiscal position and does not need to deleverage.[7] Thus, any fiscal surplus should primarily go to a SWF.

12.   The reform would also be an opportunity to separate government's savings across various functions. Both the Pula fund and the GIA are primarily *stabilization funds* used to respond to cyclical shocks (respectively, for Balance of Payments and the budget). Neither seems to prioritize the accumulation of longer-term savings. In fact, there is no pure *saving fund* owned by the government.

13.   Nonetheless, a SWF cannot, in itself, rebuild buffers. The function of a SWF is to manage balance of payment or fiscal surpluses, not to generate them. A SWF alone does not affect the fundamental causes of the accumulation of buffers (e.g., competitiveness, diamond prices, and fiscal prudence). Rigid accumulation rules can give the (false) impression that the country is building up savings in a fund, but if the government continues to borrow in parallel, this may not have much impact on government net wealth from a balance sheet perspective. In the end, accumulating buffers requires surpluses. We will discuss these issues further in the next sections.

D.   Calibrating Botswana's Medium-Term Fiscal Targets

14.   Before discussing SWF design, it is important to consider the level of savings that the government requires to achieve its policy objectives. There are many reasons why a government may want to generate savings and manage them in a SWF. In this section, we calibrate the medium-term fiscal targets based on two alternative objectives. The "insurance" objective is to build sufficient financial buffers to absorb revenue shortfalls and prevent large cuts to public expenditure when faced with a shock. The "intergenerational equity" objective is to transfer wealth across generations.

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[7] In fact, there may be a case for issuing more debt in Botswana for the purpose of financial sector development.

In the Permanent Income Hypothesis (PIH) framework, this is operationalized by estimating total net wealth (defined as net financial wealth plus resource wealth[8]) and computing the fiscal balance that would stabilize net wealth going forward—total wealth would remain constant, with growing financial assets offsetting falling resource wealth.

15.   This section updates the 2023 Article IV report's calculation of fiscal targets, considering the specific context of a SWF. Two changes are made to tailor the calibration to the proposed SWF reform. First, given that the aim is to accumulate savings, the net debt stabilization scenario is not considered. Second, we assume that asset returns differ from the interest rate on debt (these were equal in the 2023 Article IV report calculations). This seems a more reasonable assumption in the context of a SWF, where savings tend to be invested in a wide range of assets to achieve higher yield.

16.   The main conclusion of this exercise, summarized in Box 2, is that the authorities will need to generate fiscal surpluses in the medium term. The calibration of the fiscal targets varies significantly depending on the policy objective and the interest-growth differential. Achieving the insurance objective would require a surplus of 1 percent of GDP. The intergenerational equity objective is much more demanding, requiring a surplus of 2–4 percent of GDP to stabilize wealth in real terms, and even larger to stabilize wealth in percent of GDP. Although achieving a fiscal surplus is in line with the authorities' medium-term budget plans, this represents a significant tightening in the fiscal position relative to the past. Over the past five years (FY2020-FY2024), the fiscal deficit averaged 4.6 percent of GDP. In the five years before the pandemic (FY2015-FY2019), the deficit averaged 3.8 percent of GDP.

Box 2. Estimating Fiscal Balance Benchmarks to Build Up a SWF

Assumptions:

- Gross debt is 20 percent of GDP and assets represent 5 percent of GDP, with net debt equal to 15 percent of GDP at end FY2023. Gross interest bill is 1 percent of GDP. Mineral revenues are estimated at 10 percent of GDP. We assume that the debt ratio is constant in the future.

- Nominal GDP growth is 8.5 percent (equal to 4 percent real growth plus 4.5 percent midpoint inflation target). The ratio of non-resource GDP to total GDP is assumed to be 80 percent.

- A 5 percent effective interest rate on debt (1 percent of GDP of interest bill divided by 20 percent of GDP gross debt ratio) is a used as proxy for average debt costs.

- The return on financial assets depends on the investment strategy of the SWF. Under a "risky strategy," we assume for illustrative purposes that all investments are in rand (as an example of higher-risk and higher-return investment), with a return of long-term bonds of 10 percent, and no currency depreciation (since central bank inflation targets are identical in Botswana and South Africa); thus, the return in pula terms is 10 percent. Under a "prudent strategy", we assume that half of the investment is in South Africa and half in US/euro. For US/euro, we assume a neutral real rate of 1.5 percent plus inflation target of 2 percent plus a depreciation against the pula of 2.5 percent (reflecting the gap between the inflation targets of the central banks), meaning a 6 percent nominal return in pula. Under the prudent strategy, the weighted average South Arica-US/euro is therefore a return of 8 percent in pula terms.

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[8] Resource wealth is the net present value of future resource revenues until full depletion of resources.

Box 2. Estimating Fiscal Balance Benchmarks to Build Up a SWF (concluded)

Option 1. Maintaining an overall surplus of about 1 percent of GDP over the medium term would be sufficient to create a credible insurance buffer against shocks. The 2022 IMF TA report on "Strengthening the Fiscal Rule Framework" estimates that a buffer of 20 percent of non-resource GDP (equivalent to 16 percent of GDP) would be sufficient to protect the budget against major economic shocks over a full National Development Plan. To achieve this objective over 10 years, the authorities should maintain, on average, a fiscal surplus of 1.1 percent of GDP, which would improve the net debt ratio by 16 percent of GDP.[1]

Option 2. Transferring wealth to future generations requires much higher fiscal surpluses. The 2022 TA report estimates resource wealth at 225 percent of non-mining GDP at end-FY2021 (equivalent to 180 percent of GDP) using an 8 percent discount rate. Combined with net debt of 15 percent of GDP, this yields a total wealth estimate of 165 percent of GDP. The Permanent Income Hypothesis (PIH) model's formulas can be used to estimate the fiscal balance needed to stabilize total wealth either in real terms or in percent of GDP. Results are very sensitive to the underlying assumptions and the policy objective:

- *Stabilizing wealth in percent of GDP* in future years is the most demanding option, and probably an unrealistic policy objective (requiring very tight fiscal policy, possibly to the detriment of development spending—a traditional criticism against models based on the PIH, see Eyraud and others 2023). Under the **prudent strategy**, $i^A = 8\%$ and $i^D = 5\%$, stabilizing the wealth ratio would require a non-resource primary balance (very similar to the Norway model, assuming no return on the fund transferred to the budget since the fund is very small). Using today's interest bill and resource revenue ratios (1 percent of GDP and 10 percent of GDP), this would correspond to a **fiscal surplus of 9 percent of GDP.** Under the **risky strategy**, $i^A = 10\%$ and $i^D = 5\%$, resource wealth is now discounted at 10 percent and revised down to 190 percent of non-resource GDP, or 150 percent of GDP. Combined with financial wealth, this gives 155 percent of GDP for total net wealth, which, to be stabilized, requires a non-resource primary deficit of 3 percent of GDP. At today's interest bill and resource revenue ratios, this would correspond to a **fiscal surplus of 6 percent of GDP.**

- *Stabilizing wealth in real terms* (rather than in percent of GDP) requires less fiscal effort (although still significant). This scenario relies on the excel template of the TA report. Using a discount rate of 8 percent[2], the TA report shows that, although the non-resource primary deficit is constant in real terms, its GDP ratio would improve over time and remain around 7–9 percent of non-resource GDP in the medium term. In terms of overall balance, the target would translate into a **fiscal surplus of 2–4 percent of GDP** in the medium term.

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[1] See formula in Escolano (2010), equation (23).

[2] In this scenario, we use the excel template of the TA report and could not differentiate the interest rates on assets and debt or explore the impact of alternative investment strategies. They are all assumed to be 8 percent.

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17.   The fiscal surplus target could be supported by a fiscal rule. Fiscal rules can be used to enshrine the authorities' commitment to fiscal prudence, although their ability to constrain fiscal policy should not be overstated. This paper does not discuss the pros and cons of various rules, and there are many possibilities. A 1 percent of GDP surplus target, for example, could be achieved using an expenditure rule, a structural balance rule, or a non-resource balance rule (assuming that mineral revenues are around 10 percent of GDP, even targeting a non-resource deficit would be sufficient to generate an overall surplus). All these rules have countercyclical properties because they allow the nominal balance to fluctuate around the 1 percent surplus target over time. The key is to have a stable expenditure path.

18.   The fiscal surplus target should be re-estimated periodically. As shown in Box 2, the calibration exercise is very sensitive to the assumptions and policy objectives. Best practice is to recalibrate fiscal rules every 3–5 years, accounting for changes in the economic environment, including export prices, external demand, and the frequency of severe shocks. For instance, a fiscal target could be enshrined in a fiscal rule for the duration of the next NDP.

E.   Proposing a "Financing Fund" for Botswana

19.   When designing a SWF, the first step is to establish a policy and legal framework for transferring monies into and out of the fund. While the current Pula Fund has a legal basis in the Bank of Botswana Act, it is not legally separated from the foreign exchange reserves, and there are no legal provisions requiring monies to be paid into the Fund, nor legal restrictions on drawdowns from it. An Act of Parliament (either a new one, or an amendment to the BoB Act) may be needed to set out the rules for inflows and outflows. There are multiple ways of designing them: one is the financing fund approach (described in the section below); other ad hoc models are discussed in section F.

20.   Staff propose a type of design for inflows and outflows, described in the literature as a "financing fund" model (see, for instance, Villafuerte 2015, Ossowski 2016, and Delechat and others 2017). This model, followed in Chile and Norway, is generally considered best practice (see Annex I). In this design, the SWF is the mirror image of the budget and is usually accompanied by a fiscal rule constraining directly or indirectly the budget expenditure envelope.

Funding and Withdrawal Mechanisms under a "Financing Fund"

21.   Under the "financing fund" model, the inflows and outflows are dictated by the budget position rather than by ad hoc transfer rules. The SWF is fully integrated into the budget, and, in its purest design, is simply the mirror image of the budget: the fund receives any budget surplus, and any budget deficit is financed by withdrawing from the SWF.[9] For instance, a 10 pula fiscal surplus in the budget, would lead to 10 pula of inflows to the SWF; conversely, a 10 pula deficit would require 10 pula of outflows from the fund. There is no ad hoc funding/withdrawal rule that is disconnected from the budget position (as in other models described in Section F).

22.   In practice, there is not always an exact identity between net inflows to the financing fund and the fiscal balance. For instance, fiscal surpluses could sometimes be used to reduce government debt, especially when a country faces high borrowing costs. Even when running a budget deficit, a government may choose to continue funding the SWF, provided that the deficit could be cheaply financed (e.g., through long-term, multilateral project financing) or because the country issues large amounts of debt to build a yield curve and develop their domestic financial

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[9] This statement assumes that there is no change in net financial liabilities (in percent of GDP). Then, overall balance = change in net financial assets – change in net financial liabilities = change in net financial assets. The underlying assumption is that debt is rolled over to maintain the debt ratio constant. The next paragraph explains how this model can be tailored to more complicated cases.

markets. For all these reasons, the fiscal balance is not always equal to the change in financial assets at the SWF.

Link to the New Fiscal Rule

23.   To be effective, a financing fund must be accompanied by a fiscal rule applying to the budget. Without a binding budget rule and a clear political commitment to fiscal prudence, it is unlikely that the budget will generate sufficient savings to fund the SWF. And if there is no fiscal surplus, there will be no transfer to the SWF, at least under the financing fund model.[10] A budget's fiscal rule is therefore essential to constrain the government to accumulate savings (and, in the case of stabilization funds, allow dissaving in bad times).

24.   Except in the case of a stabilization fund, the fiscal rule should generate persistent fiscal surpluses to build up assets in the SWF. For instance, Chile used to target a structural fiscal surplus of 1 percent of GDP in the 2000s. A non-oil balance rule like Norway would also typically generate a surplus for the overall balance, since oil revenues (excluded from the rule) tend to be large in oil producers. By comparison, a stabilization fund does not require a structural budget surplus; in this case, the fiscal rule could achieve a nominal surplus in good times, offset by nominal deficit in bad times (with a balanced budget on average).

25.   In a setup with multiple funds, an additional rule is needed to allocate the budget savings across funds depending on their function. A single SWF can play multiple roles simultaneously: both stabilization and longer-term saving (like in the Norwegian model). But a country may prefer to separate these functions across various funds (e.g., Chilean model). In this case, an additional rule should dictate the split of the budget surplus between them, as discussed in Annex I. In general, the saving fund would be served first, up to a threshold (cap or target), and the residual would go to the stabilization fund, which would then fluctuate over the cycle.

26.   If the authorities wish to achieve very high savings through a tight fiscal rule, it is possible that there is no need for withdrawals, except in exceptional circumstances allowed under an escape clause. To illustrate this point, let's assume that the authorities wish to pursue a structural fiscal surplus of 1 percent of GDP like in the original version of the Chilean rule. Assuming an expenditure ratio of 30 percent of GDP, and an output gap oscillating between -4 to 4 percent, the (nominal) overall balance would likely fluctuate in the range of 0–2 percent of GDP. Thus, during a normal business cycle, the budget would remain balanced at a minimum, and there would not be any financing need (unless some debt needs to be repaid from the SWF, which is an unlikely scenario in Botswana). During more severe downturns, a deficit may, of course, materialize under the rule, but the advice would be that the government resorts to debt to finance it, rather than by drawing from the SWF—given the low level of debt in Botswana. Only in exceptional circumstances

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[10] As discussed below, there are alternative ("ad hoc") models for SWF inflows and outflows. Under such models, recurrent budget deficits may lead to a situation where the SWF is funded from borrowing, but this is not optimal from an asset-liability perspective. See section F.

(very large or persistent drop in diamond prices) would withdrawals from the fund be allowed, possibly under well-defined escape clauses.

One or Several Funds?

27. **Given that the funding and withdrawal flows mirror the budget position**, **a financing fund can achieve both stabilization and long-term saving objectives simultaneously** (as in Norway, for instance). As long as the fiscal rule has counter-cyclical properties, meaning that it allows the expenditure envelope to be stable across the business cycle, the SWF would stabilize the budget, even if its main function is to accumulate savings for future generations.

28. **Allocating savings across two separate funds is also possible**. In the above proposal, the budget surpluses are transferred to a single fund and any deficit is financed from the fund (and possibly debt). There would be nothing left going to the GIA. An alternative setup is to separate the policy objectives across two SWFs—e.g., one for long-term saving (new SWF) and the other one for stabilization (GIA), like in Chile. To do so, it is necessary to fix or cap the value of transfers going to the new SWF, with any residual savings going to the GIA. The ceiling/target should be calibrated to ensure that the new SWF can achieve its long-term intergenerational saving objective. Following the Chilean example: transfers to the saving fund are capped at 0.5 percent of GDP, whereas the structural surplus target is 1 percent of GDP. This means that, on average over the cycle, the stabilization fund receives 0.5 percent of GDP (when the output gap is closed, the budget records a nominal surplus of 0.5 percent of GDP, pays 0.5 percent of GDP to the saving fund, leaving 0.5 percent of GDP to the stabilization fund). All this would need to be simulated, depending on the specific calibration of the rules.

F.   Risks Associated with More Ad Hoc Inflow-Outflow Models

29. **Although "financing funds," as described in the previous section, seem preferable and have been successfully implemented in several countries, many governments opt for more ad hoc models.** In these ad hoc models, the SWF operational rules (for accumulation and withdrawal) are set independently from the budget position, and there is often no fiscal rule applying to the budget. "The SWF is conceived as an independent instrument of fiscal policy rather than simply as a medium to manage part of the government's net worth" (Shields and Villafuerte 2010). Transfers from and to the SWF are achieved through rigid and often arbitrary operational rules, such as:

- *Funding rules:* Deposit rules can be price- or revenue-contingent. For instance, many oil stabilization funds specify a threshold price for oil revenue (e.g., $80 per barrel), with any excess (shortfall) above (below) the threshold being transferred to (from) the fund. Revenue-share rules are formulated as a predetermined share of revenue going to the fund (e.g., 10 percent of oil revenue).

- *Withdrawal rules*: Similarly, withdrawals can be dictated by ad hoc rules with strict conditions that are disconnected from the budget position—for instance, price or revenue contingent rules.

30.   A first problem with ad hoc operational rules is that they do not tend to discipline the budget. The introduction of SWFs with ad hoc rules is often motivated by the expectation that removing "high" commodity revenues from the budget would help moderate or stabilize expenditure and reduce policy discretion. In practice, the opposite tends to happen, because ad hoc rules do not directly constrain government spending or borrowing. Limiting the ability of the government to use its deposits, through seemingly tight withdrawal rules, is not an effective disciplining device if the government is allowed to borrow without restriction as a substitute. In fact, this may eventually contribute to deteriorating the fiscal position, since borrowing is generally more expensive than depleting deposits (i.e., the forgone return on assets is lower than the interest paid on debt).

31.   As a result, a situation of "leveraged deposits" may emerge, reflecting poor asset-liability management. Since the SWF can receive funds even when the budget is in deficit, the deposits accumulated in the SWF can be generated from government borrowing. This is a common problem in many resource-rich countries:[11]

- This tends to generate large *budgetary costs*, since government borrowing is generally more expensive than the SWF asset returns. For example, in the early 2010s, inflows into Ghana's petroleum-based SWF (the Ghana Stabilization Fund) increased substantially due to high oil prices. At the same time, however, the government ran large deficits, resulting in a rising debt-to-GDP ratio. Between 2014 and 2018, withdrawals from the GSF were mainly used for debt repayments, rather than the primary object of sustaining public expenditure capacity during periods of unanticipated petroleum revenue shortfalls (Gyeyir 2019).

- This is a *risky strategy* (Villafuerte 2015). Since access to financing is procyclical for commodity producers, debt rollover becomes very costly or even impossible in bad times (reflecting partial of full loss of market access). Then, either the SWF assets are sold (possibly at discount if they must be liquidated quickly) to offset sharp fiscal revenue drops and are not available anymore to offset rising borrowing costs; or the SWF assets are sold to cover debt costs and are not available to support spending in bad times. This illustrates the fundamental problem that borrowed deposits are not "true" savings, since there is no accumulation of financial assets in net terms.

- *Transparency problems* may also arise, since the SWF wealth does not represent the outcome of fiscal policy and the overall wealth of the government (e.g., when the SWF is accumulating assets, but the central government has large debt).

32.   Another problem is that poorly calibrated rules may be too ambitious and lead to systematic underfunding of the budget, which would undermine the credibility of the SWF. If

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[11] In general, the IMF has cautioned against borrowing to accumulate deposits both for cost and risk management reasons. That said, in Botswana, there is perhaps a stronger case for accumulating both debt and financial assets, since debt costs are relatively moderate (an effective interest of around 4.5 percent at the time of writing this paper) and rollover risks are limited (no Eurobond).

funding/withdrawal rules are inconsistent with the budget (for instance, by creating funding shortages, cash management problems, or additional budget costs), then they are likely to be bypassed. The SWF itself could eventually be closed, as illustrated by numerous country examples (see Ossowski and others 2008). In the context of Botswana, a funding rule transferring 40 percent of mineral revenues to the SWF every year, as initially considered by the authorities, would represent 4–5 percent of GDP of forgone revenues for the budget, which seems too high. By comparison, our previous analysis finds that targeting a surplus of 1 percent of GDP—meaning transferring 1 percent of GDP every year to the SWF—would be sufficient to create an adequate safety buffer against shocks.

33.   Finally, ad hoc rules could reduce the central bank's FX reserves and threaten the sustainability of the exchange rate regime. While a SWF is sometimes presented as a way of ringfencing reserves, some rigid designs may achieve the exact opposite and contribute to depleting reserves. This is because ad hoc rules allocate a share of FX to the government (rather than to the central bank), but do not force the government to generate savings in the budget. Therefore, the central bank's reserves' accumulation is reduced by the annual transfers to the fund; but there is no offsetting factor reducing the drain on reserves (e.g., lower government imports or lower external debt service) since the budget position does not improve. Box 3 discusses this issue.

<center>Box 3. Impact of the SWF on FX Reserves</center>

While a new SWF should strengthen the government's financial position, it may paradoxically lead to a decline in FX reserves. If government deposits (in pula) are initially transferred to the SWF and then converted into forex to be invested abroad, this will reduce the level of FX reserves available for the central bank to support the peg. Indeed, government's foreign assets in a SWF are not treated as central bank reserves by international statistics standards, which only consider as reserves the assets meeting the following criteria: (a) invested in external assets in foreign financial markets and in high-quality financial instruments traded in highly liquid and deep global markets; (b) controlled by monetary authority (in the books of the central bank); and (c) can be used toward balance-of-payments purposes (IMF 2009).

Not only the level but also the pace of reserve accumulation could be affected. If some reserves are initially re-allocated to the new SWF when it is created, there will be a one-off downward shift in the *level* of reserves of the BoB. But the new setup may also affect future reserve *growth*. This is because FX inflows come mostly from the public sector in Botswana—SACU and mineral revenues. Thus, if these FX are partly retained by the government rather than remitted to the central bank, this could entail a much slower pace of reserve accumulation. Given that reserves have already declined sharply in the past decade, this may be problematic for the sustainability of the exchange rate regime.[1]

This effect could be mitigated if the government exerts greater fiscal prudence, supported by a fiscal rule. Indeed, a higher fiscal balance would translate into lower public imports and lower external debt service, hence less pressures on reserves.

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[1] A tighter monetary policy and competitiveness reforms or beneficiation (to increase the share of higher-priced polished diamond exports) could offset the decline in reserves.

Box 3. Impact of the SWF on FX Reserves (concluded)

The impact on reserves will ultimately depend on the design of the SWF operational rules and the existence of a fiscal rule applying to the budget. Although detailed simulations would be necessary to estimate the precise impact of a particular design proposal, simple examples illustrate the critical effect of the fiscal framework on FX reserve dynamics. To simplify, we assume that the SWF's assets are entirely invested abroad, so that any transfer to the SWF (owned by the government) entails a loss of reserves for the central bank, all else being equal.

- *Scenario 1—"ad hoc model" with 40% funding rule and no fiscal rule.* Every year, the government transfers 40 percent of mineral revenues to the Fund, which translates into 5 percent of GDP of forgone reserves for the central bank. Assuming that the government is not subject to a fiscal rule and does not change the fiscal deficit path, it continues to tap reserves at the same pace (for imports and debt service). Given that FX reserves account today for about 25 percent of GDP, this could be an unsustainable reform from the perspective of the sustainability of the peg.

- *Scenario 2—"financing fund model" with 1 percent of GDP fiscal surplus rule.* The government transfers to the fund 1 percent of GDP every year, which reduces the central bank's reserves by the same amount, all else equal. On the other hand, the budget's position would now be much stronger, with an improvement of 5 percent of GDP compared to the average deficit ratio of 4 percent of GDP observed over the past decade. Assuming an import content of 50 percent, this means that the import drain on reserves would be reduced by 2.5 percent of GDP every year (without even considering the possible reduction in external debt service). Thus, the net effect on reserves would be positive for the central bank.

G.   Other Design Considerations

34.   Beyond the financing mechanisms discussed in the previous sections, there are other important design features that should be considered for the SWF. These relate to the institutional setup, investment management, governance safeguards, and the impact of the SWF on budget procedures—all key elements of the legal framework for the SWF (see also IWG 2008; Hammer and others 2008; Das and others 2009).

Institutional Setup

35.   The structure and ownership of the SWF will have to be carefully considered. One option would be to create an arrangement like the existing GIA. The BoB could host the SWF, but with government having ultimate ownership of the fund (similar to Norway's SWF). In this instance, the fund would be a pool of assets, rather than having its own legal personality. Assets would be managed by the BoB, given its accumulated expertise and institutional relationships in the field of asset management. Hosting the SWF at the BoB would also limit administrative costs.

36.   Another option would be to have a legally independent SWF, either as a statutory or corporate entity. A legally separate SWF owned by government and with its own investment management structure is the model followed by the main Singapore SWF (the Government Investment Corporation, or GIC, which is an SOE). Another example is the Nigeria Sovereign Investment Authority, which manages three different funds and is not subject to any company law. A distinct variation model is also possible, such as that recently proposed by Namibia for its new SWF

to assist in the management of projected oil revenues. The Namibian SWF will be an independent statutory entity but managed by the Bank of Namibia.

37. **Regarding the process of creating the SWF, it is advisable to start early given that establishing the institutional and financing infrastructure will take time**. The authorities could consider 'starting small' and taking initial steps to set up the fund. This would entail selecting an overall design, establishing inflow/outflow rules, defining legal and institutional requirements, identifying a team, and setting aside a small amount of seed funding. This would help quick start the SWF activities on a small scale to test the functioning of the fund. It would then be ready to be scaled up when the budget generates persistent fiscal surpluses. The initial seed capital should not substitute for regular transfers from the budget and the SWF should only become fully operational after significant fiscal effort has been made to return to fiscal surpluses from the current deficit position.

SWF Investment Strategy

38. **The new SWF will require clear and transparent investment policy and guidelines in the legal framework**. These guidelines determine the parameters against which the activities of external managers of funds are monitored. Investment policies, and associated risk management, depend on the economic objectives established for a SWF. For instance, short-term stabilization implies a focus on liquid and low-risk investments that can be sold relatively quickly, whereas intertemporal equity calls for longer-term assets and more risk-taking, which requires expertise to properly oversee transactions and protect the SWF integrity.

39. **Proper risk management calls for diversification of assets**. SWFs may hold assets with negative correlation of the country's major exports (e.g., diamonds) or offset the price risk of future imports. SWFs without identified liabilities allow for a more exclusive focus on a return objective and acceptable level of risk (IMF 2007).[12]

40. **Domestic investments are generally ruled out by SWFs, which tend to focus on external financial investments.** Investing domestically can run counter to the objective of isolating the whole economy from the volatility and uncertainty of those revenue sources. Furthermore, large domestic investments (e.g., loans or equity participations in companies) by SWFs could be seen as hidden quasi-fiscal or extrabudgetary operations that should instead take place within the budget (if these operations are not conducted on a commercial basis); or could overlap with the remit of developments banks (in the case of promotion of commercial domestic investments) (Ossowski 2016, Villafuerte 2016). In the case of Botswana, institutions, such as Botswana Development Corporation, are better suited to undertake domestic projects. Finally, domestic investments have important macroeconomic implications. To invest domestically, SWFs would typically need to convert part of their accumulated assets back into domestic currency, which creates pressures on

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[12] For instance, pension funds, which are sometimes treated as a type of SWF, have identified pension liabilities.

the domestic currency. Investing domestically could also stimulate domestic demand with inflationary consequences.

Governance: Transparency, Independence, and Accountability

41.   A good internal governance structure is essential to ensure that resource revenues are managed in a sound and transparent manner. Some of the safeguards include:

- The legal basis and institutional set-up and structure of a SWF should be based on *clear roles and responsibilities* for the owner of the resources (the government) and the fund managers to enhance its legitimacy, performance, and accountability.

- SWF managers should have the *capacity to administer its financial assets at arm's length* from the government on the basis of strategic asset allocations and accountability principles provided by the government.

- *Proper oversight and transparent operations* are essential in setting SWFs. This includes oversight carried by several agencies and operational units (internal auditors, private independent auditing firms, external custodians), production and publication of annual reports and accompanying financial statements on the SWF operations and performance as well as of annual audits in line with international standards or equivalent national auditing standards.

Risk to Public Financial Management (PFM)

42.   International experiences show that SWFs should respect the integrity of the budget process. Good PFM requires that the budget process constitutes the central mechanism to allocate resources. This has important implications for SWFs – in particular, they should not have authority to spend, and their outflows should go through the budget. Furthermore, designs where the SWF is set up as an extrabudgetary entity should be avoided.

43.   The lack of integration between the SWF operations and the budget process tends to create a range of expenditure management problems (Ossowski and others 2008):

- Spending pressures in the budget lead to liquidity problems that can translate into *government arrears* (if the government loses part of the revenues going to the SWF and is short on cash).

- When the SWF is allowed to do extra budgetary spending (that is, the SWF has legal authority to spend) or SWF outflows are earmarked for specific purposes, this leads to a *fragmentation of policymaking*, which results in a loss of control over expenditure and reduces the efficiency of resource allocation (e.g., duplication of budget activities, spending pressures re-channeled to the SWF etc.). This fragmentation undermines the budget process as the main vehicle to allocate resources.

- Allowing SWFs to pursue domestic investment makes them the target for *rent-seeking capture*, a latent risk in many resource-rich countries.

- Scarce resources are diverted away from developing *national PFM systems*—a common problem associated with the "islands of excellence" argument.[13]

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[13] When PFM systems are perceived to be weak in some countries, it is sometimes argued that the creation of a SWF with separate procedures and controls might yield better results than the budget (e.g., enhanced selection, evaluation, and procurement for investment projects). There is little tangible evidence, however, to support the creation of such "islands of excellence" (Ossowski 2016). Moreover, this can negatively impact the development of national PFM systems, as scarce resources may be diverted to the fund's management and there also might be less scrutiny of core budget systems as the focus shifts to a single large resource.

Annex I. Consistency of the SWF and the Budget in the Chilean and Norwegian Frameworks

Norway's Fiscal Rule

1.   Under the fiscal rule, the annual nominal expenditure envelope is capped by the sum of non-resource revenues (cyclically adjusted) plus the return coming from the SWF. In more technical terms, the fiscal rule states that the non-oil structural deficit of the central government should not exceed the expected real return of the SWF—the Government Pension Fund (GPF). Initially estimated at 4 percent, the long-run rate of return on GPF assets was lowered to 3 percent in 2017.

2.   By isolating spending from volatile commodity revenues, a non-resource budget balance rule has stabilizing properties similar to those of a structural balance rule (even in the absence of any cyclical correction for non-resource revenues). For instance, if the non-resource deficit NRD = α (where α is the deficit target), then the *overall* deficit is D = NRD – RR (where RR = resource revenues) = α – RR. This means that when RR < α, the budget can record a deficit in compliance with the rule. When RR > α, compliance with the rule results in an overall surplus. In practice, given the size of oil revenues, the overall balance has recorded a surplus in most years, but the size of the surplus varies greatly over the cycle.

Norway's SWF

3.   In Norway, the GPF receives every year the full amount of oil revenues (transferred from the budget) and the GPF transfers an amount covering the budget's non-oil deficit. In other words, the funding rule of the GPF is simply to transfer annual oil revenues. And the withdrawal rule is automatic, consisting in financing the non-oil deficit of the budget, which is, by virtue of the fiscal rule, capped at 3 percent of the GPF assets. Sometimes, the setup is described (improperly) as the GPF sending its returns to the budget, which is not the case (the returns are kept in the GPF); the GPF covers the budget non-oil deficit, which happens to be constrained by the fiscal rule.

4.   Although the design may look different at first glance, the GFP functions like a "financing fund." The overall budget balance = oil revenues + NOB = oil revenues – r.SWF, since NOD = r.SWF under the rule. Thus, the mechanism described in the previous paragraph is equivalent to a standard "financing fund" model, where the fiscal rule generates a budget overall surplus (amounting to oil revenues net of SWF returns), which is sent to the SWF. Sending oil revenues net of returns is equivalent to sending the oil revenues and receiving the financing of the non-oil deficit, which corresponds to the return.

5.   An additional complexity comes from the fact that the rule is expressed in structural terms. Using the same equation as above, overall balance = oil revenues + NOB, with NOB = - NOD = - NOSD + (nonoil revenues – structural nonoil revenues) and NOSD = r.SWF. Thus, what is

transferred to the fund in net terms is the sum of three components: NOB = oil revenues – r.SWF + (actual nonoil revenues – structural nonoil revenues). The third component can be interpreted as follows: if there is a nonoil revenue cyclical shortfall, the budget would receive a compensation from the fund, whereas if there is a nonoil revenue windfall, it would go to the fund (but on average, over the cycle, these symmetric transfers cancel out, and the last component is zero).

6.   **The fact that the government transfers all oil revenues to the fund may not be reproducible in other countries**. This is possible in Norway because the government has large non-oil revenues (in fact, larger than oil revenues) and the budget also receives the returns of the GPF (with assets above 300 percent of GDP in 2023). Thus, removing all oil revenues from the budget does not lead to severe resource shortfalls. For instance, the loose fiscal stance in 2020–21 was consistent with the fiscal rule.

7.   **The GPF only finances the non-oil deficit; it does not finance the amortization of debt**. Given that debt in Norway is relatively small by international standards and can easily be rolled over, the GPF's withdrawal rules do not provide for possible debt redemptions. Thus, the accounting identity between overall budget balance and net accumulation of assets in the GPF still holds.

Chile's Fiscal Rule

8.   **The Chilean fiscal rule sets a limit on the structural budget balance**, **with an independent body providing key inputs.** Government expenditures are budgeted ex ante in line with structural revenues, i.e., revenues that would be achieved if: (i) the economy were operating at full potential; and (ii) the prices of copper and molybdenum were at their long-term levels.

9.   **The fiscal surplus target has been revised over time**. The target is set by the incoming administration at a level consistent with its objective of fiscal sustainability (Fuentes and others 2021). From 2001-07, the constant target for the structural balance was a 1 percent of GDP surplus. In 2008-09, a new constant target was specified (surplus of 0.5 percent of GDP). The downward drift of the CAB target continued in 2010 and 2011. From 2011 to 2019, the CAB target has remained in the range between -1.0 and -1.8 percent of GDP.

Chile's SWFs

10.   **Chile maintains two separate SWFs:** a stabilization fund to insulate the budget from volatile commodity prices (ESSF) and a saving fund to accumulate resources over a longer time horizon (PRF). Any fiscal surpluses generated by the fiscal rule are transferred first to the PRF (with a minimum of 0.2 percent of GDP per year but could go up to 0.5 percent of GDP if there are large fiscal surpluses), then the residual surplus (if any) goes to the stabilization fund.

11.   **In contrast with the Norwegian model, withdrawals from the ESSF are not automatic and decided annually by the minister of finance**. This allows the authorities to have a more flexible approach that incorporates some asset-liability management considerations. For instance, the ESSF can be used to finance fiscal deficits (or part of them) but can also be used to repay debt.

This is a desirable feature: if debt is considered too expensive, it is possible to repay it by selling some assets of the SWF. In this case, the ESSF could potentially cover up to the gross financing needs (rather than just the deficit, as in the vanilla financing fund model). In other cases, the minister may decide that the ESSF will *not* be used to cover the deficit in a particular year (in which case, the deficit would be financed solely through additional borrowing).

12.   If the fiscal surplus target is sufficiently high, there may be no need to withdraw from the stabilization SWF, even during a downturn. A few simple examples illustrate this point:

- Let's start with a 1 percent of GDP surplus target, which was the target set over 2001–07. Then, during the business cycle, the nominal balance oscillates around this structural surplus target of 1 percent of GDP. The balance would fluctuate between 0 and 2 percent of GDP assuming an expenditure ratio of 25 percent of GDP and an OG between -4 percent and +4 percent (as estimated by Medina and Magud 2011).[1] This means that, under the 1 percent surplus rule, the budget is unlikely to require transfers from the ESSF. Indeed, even in severe downturns, the fiscal balance is likely to record a small surplus; thus, even after transferring the minimum amount of 0.2 percent of GDP to the PRF, the budget is unlikely to be in deficit.[2] In other words, in bad times, the budget would simply reduce its transfers to the two funds, but these transfers would not turn negative. This is a feature of countries targeting a significant surplus (rather than a balance): on average, they tend to always send money to the SWF, reducing them in bad times and raising them in good times. This still achieve stabilization, although not by withdrawing from the fund.

- If the structural target is smaller (like in the revised version of the Chilean rule: 0.5 percent of GDP in 2008-09), then the nominal balance would oscillate between -0.5 percent and +1.5 percent of GDP, under the same assumptions. Given the mandatory transfer to the PRF, the budget would draw 0.7% of GDP from the ESSF at the trough of the business cycle, and it would transfer 1 percent of GDP at its peak (given that the transfer to PRF is capped at 0.5 percent of GDP). This means that, over the cycle, the budget transfers to the ESSF a maximum of 1 percent of GDP, which declines gradually when the economy slows down until becoming a withdrawal of 0.7 percent of GDP; when the output gap is closed, the nominal balance is 0.5 percent of GDP and there is no transfer/withdrawal to the ESSF.

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[1] Indeed, SB ≈ OB − α.OG with α being the expenditure ratio.

[2] The budget does not draw from a fund when it records a balance or surplus.

Annex II. Bank of Botswana's Balance Sheet

BANK OF BOTSWANA
STATEMENT OF FINANCIAL POSITION
As at December 31, 2023

	2023 P'000	2022 P'000
ASSETS		
Foreign Assets		
Liquidity Portfolio	6 301 900	5 960 397
Cash and cash equivalents	6 301 900	5 960 397
Pula Fund	51 829 427	43 342 303
Investment in equities	27 411 329	21 696 865
Investment in bonds	23 255 563	18 923 931
Short-term deposits	1 162 535	2 721 507
International Monetary Fund (IMF)		
Reserve Tranche	1 002 248	966 136
Holdings of Special Drawing Rights (SDR)	4 526 840	4 239 750
General Subsidy Account	27 367	25 888
Total Foreign Assets	63 687 782	54 534 474
Domestic Assets		
Standing Credit Facility	-	248 965
Receivables and Other Assets	585 499	376 574
Property, Plant and Equipment	1 414 191	1 162 285
Total Domestic Assets	1 999 690	1 787 824
TOTAL ASSETS	65 687 472	56 322 298
LIABILITIES AND SHAREHOLDER'S FUNDS		
Foreign Liabilities		
Allocation of IMF Special Drawing Rights	4 433 919	4 194 350
Liabilities to Government (IMF Reserve Tranche)	503 200	467 089
Total Foreign Liabilities	4 937 119	4 661 439
Domestic Liabilities		
Bank Notes and Coin in Circulation	4 360 102	4 085 884
Deposits	5 621 384	3 782 814
Standing Deposit Facility	3 487 185	341 077
Bank of Botswana Certificates	5 998 068	3 273 810
Dividend to Government	238 758	273 205
Payables and Other Liabilities	509 728	287 109
Total Domestic Liabilities	20 215 225	12 043 899
Total Liabilities	25 152 344	16 705 338
Shareholder's Funds		
Paid-up Capital	150 000	25 000
Government Investment Account		
Pula Fund and Liquidity Portfolio	8 577 425	14 816 612
Currency Revaluation Reserve	15 557 760	26 759 120
Fair Value Revaluation Reserve	1 249 943	(3 598 772)
General Reserve	15 000 000	1 600 000
Unappropriated Net Income for the period	-	15 000
Total Shareholder's Funds	40 535 128	39 616 960
TOTAL LIABILITIES AND SHAREHOLDER'S FUNDS	65 687 472	56 322 298
FOREIGN ASSETS IN US DOLLARS (000)[1]	4 757 477	4 280 956
FOREIGN ASSETS IN SDR (000)[2]	3 541 041	3 206 627

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[1] United States dollar/Pula – 0.0747 (2022: 0.0785)
[2] SDR/Pula – 0.0556 (2022: 0.0588)

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REFORMING BOTSWANA'S SOCIAL SECURITY SYSTEM[1]

Despite its strong economic performance and sound policy management, Botswana remains one of the most unequal countries globally. The country's complex social protection system lacks efficiency, with funds often allocated towards regressive programs and burdened by high administrative costs. To make growth more inclusive, there is a pressing need for more targeted fiscal interventions and a comprehensive overhaul of the system. This includes simplifying the framework, improving its adaptability, modernizing delivery and targeting methods, reallocating funds away from regressive programs, and relying more on progressive financing sources.

A. Introduction

1.   Several decades of growth have substantially boosted average income and alleviated poverty in Botswana. The discovery of diamonds in late 1960s sparked an unparalleled economic expansion over the subsequent five decades. As a result, real per capita income increased by a factor of 17 between 1960 and 2022, ranking as the fourth highest growth rate globally (Figure 1, Panel A).[2] The share of people living below the international poverty line[3] declined from over 40 percent to 14 percent in 2022 (Figure 1, Panel B).

2.   Despite this strong economic performance, Botswana's income inequality was one of the highest in the world in 2015. In 1985, Botswana's income inequality, as measured by the Gini coefficient, was just below the median of upper-middle income countries (based on today's sample). Over the following two decades, inequality in Botswana increased, in contrast to a decline among its peers (Figure 1 Panel C). The 2000s saw some improvement, with inequality levels returning to 1980s levels. Yet, by 2015 (latest year with available data), Botswana was one of the most unequal countries in the world.[4] Within sub-Saharan Africa (SSA), Botswana is the 4th most unequal country, according to World Bank Gini index. The level of inequality is particularly notable given the country's current income per capita level (Figure 1, Panel D).

3.   Although recent data is lacking, there are reasons to think that the situation has not improved and may even have deteriorated in the past decade. The unemployment rate, one of the leading causes of poverty and inequality in Botswana, increased from 17.6 to 25.9 percent between 2015 and 2023 (and is as high as one third among the youth), while labor force participation declined from 61.5 to 59.7 percent of the working-age population. The public sector

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[2] Real income per capita is measured in 2017 US$ using purchasing power parity (PPP) rates.

[3] The share international poverty line is defined as $2.15 per day in terms of 2017 PPP rates.

[4] The last household survey that can be used to measure Gini coefficient was conducted in 2015-16. Income and consumption inequality may have further deteriorated during the Covid-19 pandemic (UNDP, 2021).

wage bill has remained elevated at nearly 13 percent of GDP (as of FY2023), perpetuating the income gap with the private sector and the unemployed. A series of large shocks, including the Covid-19 pandemic and droughts in 2018/19 and 2023/24, have negatively impacted the livelihood of the most vulnerable, potentially aggravating further inequalities (UNEDP 2021).

Figure 1. Real Income per Capita, Poverty, and Inequality

Source: World Development Indicators and IMF staff calculations.
Note: Panel A: Real income per capita defined as aggregate real income in constant 2017 PPP US$ divided by population.
Panel B: Poverty headcount is defined as the share of population living on less than $2.15 a day at 2017 US$ PPP rates.
Panel C: Gini coefficient measures income inequality, data for upper-middle-income countries is a 5-year moving average.
Panel D: Real income per capita definition similar to Panel A; Gini coefficient and real income measured in the same year.

4.   High and persistent inequality in Botswana is primarily explained by structural factors related to economy and geography:[5]

- *Mining production has a low labor content*. The country's economy is largely driven by the diamond sector, which is very capital-intensive. While the mining industry accounts for close

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[5] Gender inequality does not seem to be one of the main drivers of inequality in Botswana, which fares better than sub-Saharan African countries' average along various indicators (e.g., Gender Development Index (UNDP), Gender Inequality Index (UNDP), Global Gender Gap Index (World Economic Forum), secondary and tertiary education enrollment rates, maternal mortality rate). However, there is still room for improvement, as Botswana is among the countries with the highest gender-based violence incidence.

to a quarter of GDP, it accounts for less than 2 percent of total employment (Statistics Botswana, 2023).

- *Private sector development remains limited*. High mineral revenues have supported the expansion of the public sector (central government and SOEs), where wages tend to display an elevated premium relative to the private sector (see IMF 2023a, and IMF 2023b).[6] Such disparity has led to the concentration of wealth and opportunities within a relatively small segment of the society. Furthermore, the dominance of SOEs in several sectors of the economy has further contributed to sluggish private sector growth (IFC 2022, and World Bank 2023).

- *Inequality is further aggravated by the urban-rural divide and disparities in land ownership*. Botswana is a large country similar in landmass to Ukraine but with a small population equivalent to Moldova, with a large share of people scattered in sparsely-populated rural areas. Urban centers are hubs of resources, infrastructure, and economic opportunities, contrasting with rural and remote areas, where limited access to productive land and essential services perpetuates poverty and hinders development (UNDP 2021). This divide is further widened by uneven land distribution, with a minority of individuals controlling vast tracts of land, leaving many rural dwellers without the means to secure their livelihoods or invest in agricultural productivity. Finally low population density in some areas of the country makes it difficult to supply all the necessary services (health, education, finance, connectivity), further aggravating the disparity in opportunities.

5.   **Beyond these structural factors, the education system tends to perpetuate existing inequalities.** Although universal primary education enrollment was achieved in the late 1990s, the secondary education system faces challenges including shortages of learning materials and classrooms, alongside limited teachers' training. Additionally, the vocational education system is fragmented and suffers from limited organizational capacity (World Bank, 2023). Skill mismatches drive unemployment and create significant barriers to private sector development (Stepanyan and others 2013; and IMF 2017b). Moreover, while obtaining a tertiary education degree usually results in a significant wage premium, tertiary education is disproportionately accessed by wealthier individuals, thereby exacerbating social inequities.

6.   **In most countries in the world, fiscal policy is a powerful tool to affect income distribution.** There is extensive literature showing that fiscal policy instruments (both taxation and expenditure programs) have significant distributional effects and can either mitigate or aggravate preexisting trends.[7] On the revenue side, progressive income and consumption taxes can be used to mitigate income disparities. On the spending side, social protection systems offer a bulwark against inequality, extending a lifeline at the lower levels of the income pyramid through cash disbursement

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[6] Cust and others (2022) document this pattern for many countries: resource revenues windfalls often lead to elevated public wage bill.

[7] See IMF (2014), Clements and others (2015), and IMF (2017a) for a discussion on how fiscal policy can reduce inequality.

and in-kind benefits. Health and education spending exert a subtler influence on income distribution by influencing the incentive to work. Empirical analysis suggests that, in advanced economies, taxation paired with transfers reduces income inequality by approximately one third (see Gaspar and García-Escribano, 2017).

7.   The Botswanan authorities have launched important initiatives to reduce inequality and reform their social protection system. Botswana Vision 2036, unveiled in 2016, aims to "promote equal opportunities for all, and ensure that prosperity is widely shared," partly by enhancing the social protection system. In 2020, the Cabinet approved a new National Social Protection Framework (NSPF), accompanied by an implementation plan (MoLGRD 2020a and 2020b). Since then, the authorities have collaborated with development partners and external consultants to chart out a roadmap of actionable measures aimed at improving social protection (see, for example, MoLGRD 2022). The NSPF includes proposals to consolidate and integrate programs for individuals at different life stages. It also envisages the creation of a Single Social Registry, efficiency-enhancing measures like more accurate targeting, and transitioning away from in-kind to cash transfers. Nonetheless, despite the anticipated improvements that the new framework is expected to bring, its implementation has progressed very slowly (UNICEF 2022).

8.   This chapter analyzes Botswana's social protection system, estimates its impact on poverty and inequality, and discusses reform options to strengthen its effectiveness. The chapter primarily examines the programs that fall under the umbrella of the NSPF (see Box 1).[8] Section B evaluates existing policies, covering the level of spending, impact on inequality, and significant barriers that limit the framework's effectiveness. Section C discusses the financing of social protection and how it impacts inequality, focusing more specifically on the personal income tax (PIT) and value added tax (VAT). Section D discusses international experience and best practices, while suggesting policy reform options for Botswana. Section E concludes.

Box 1. Botswana Social Protection System

Botswana social protection system encompasses nearly 30 distinct social assistance, labor market, and social insurance programs, all supervised by an array of 10 ministries and government bodies (Text Table 1). Social assistance programs deliver non-contributory support to beneficiaries through both cash and in-kind transfers. Labor market programs include a range of interventions aimed at fostering relevant job skills. The Public Officers Pension Fund stands as the only public social insurance scheme. Text Table 2 presents a comprehensive breakdown of key programs across these categories, detailing eligibility criteria and the nature of benefits.

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[8] Other types of public spending and policy interventions that may have direct effects on poverty and inequality, such as health, education, infrastructure, and regulated utility prices, are outside the scope of this chapter, which focuses, more narrowly, on social protection programs.

Box 1. Botswana Social Protection System (continued)

Box 1. Table 1. Botswana: Social Protection Programs by Type and Supervising Ministry (as of 2023)

	Social Assistance	Labor Market	Social insurance
MLGRD	Orphan care Destitute persons Old age pensions Ipelegeng Vulnerable groups feeding program Drought relief WWII veterans pensions Community home-based care Primary school feeding Early childhood development	Remote area development program (RADP) Community driven development livelihoods Skills training	
MYESCD		National internship program National youth service Youth development fund Youth volunteer program	
MOHW	Early childhood development		
MOBE	Secondary school feeding	Second chance education	
MOTE	Tertiary education sponsorhips/scholarships		
MELSD		Apprenticeship program Job search assistance Non-formal skills training	
MNIG		Gender development fund	
MADFS		Integrated support program for arable agriculture development (ISPAAD) Livestock management and infrastructure development program (LIMID)	
MSP		Poverty eradication program	
MOF			Public officers pension fund
NBFIRA			Public officers pension fund

Source: National Social Protection Framework (2018).

Notes: MLRGD -- Ministry of Local Government and Rural Development; MYESCD -- Ministry of Youth Empowerment, Sport, and Culture Development; MOHW -- Ministry of Health and Wellness, MOBE -- Ministry of Basic Education, MOTE -- Ministry of Tertiary Education, MELSD -- Ministry of Employment, Labor Productivity and Skills Development, MNIG -- Ministry of Nationality, Immigration, and Gender Affairs, MOA -- Ministry of Agricultural Development and Food Security, MSP -- Ministry for State President, MOF -- Ministry of Finance, NBFIRA -- Non-Bank Financial Institutions Regulatory Authority

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Box 1. Botswana Social Protection System (concluded)

Box 1. Table 2. Botswana: Select Social Protection Programs: Eligibility and Benefits (as of 2023)

	Eligibility	Benefits
Social assistance:		
Tertiary scholarships	Students who score above a threshold at a secondary education test	Scholarships and allowances
Old age pensions	Citizens 65 years and older	Cash
Community home-based care	Terminally or chronically ill referred by Government Medical Officer, eligibility is means tested	Electronic food card, social care
Destitute Persons Program	Permanently destitute: persons having a disability or chronically ill Temporary destitute: incapable to support themselves (e.g. due to floods, injuries, etc), posessing less than 5 livestock animals and having income less than 120 pula per month	Cash, in-kind, electronic food card
Ipelegeng	Unemployed citizens who are at least 18 years old	Employment (public works)
School feeding (secondary)	All children aged 5 to 14 attending government-owned public schools	Mid-day meal
Orphan Care Program	Children younger than 18 years who have lost a parent (single parent) or both parents (married) through death	Food basket, clothing, transport and psychological support
Labor market programs:		
ISPAAD	All farmers with national identity card	Potable water, fencing, seeds and fertilizers, access to credit among other things
Youth development fund	Unemployed and under-employed out-of-school citizens between the ages of 18 and 35	Grants
Poverty eradication program	Citizens aged 18 years and above living under extreme poverty (earning less than P300 per month)	Training, project funding
National internship program	A citizen graduate (degree holders) from a recognized institution, below the age of 35 years	Internship placement
LIMID	Certain requirements on the ownership and type of livestock	Smallstock, cash, infrastructure development
RADP	Destitute persons residing in remote area settlements	Housing, cash covering living expenses, transportation
Social Insurance		
Public officers pension fund	Public officers	Cash

Source: MoLGRD, WB, 2022

B. Botswana's Social Protection System: Generous but Lacking Effectiveness

9.   In this section, we evaluate the main features of the social protection system, focusing more specifically on its distributional effects and implementation challenges. To assess the effect on income distribution, we use data provided by the Ministry of Local Government and Rural Development as well as the 2015–16 Multi-Topic Household Survey (MTHSS).[9] Data from the

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[9] The 2015–16 MTHHS contains responses from more than 7,000 households that constitute a representative sample of the Botswanan population. The survey has information on household consumption and income, with detailed breakdown of social protection benefits across various programs. This is the main source of information to conduct

(continued)

Ministry allows us to construct aggregate measures of social protection spending across different programs, while tracking the number of beneficiaries of each program. Using survey data, we estimate program coverage and transfer amounts received by individuals at different consumption levels. We then infer the distribution of *pre-transfer* consumption, which allows us to estimate the impact of each program on inequality.[10] Combining this analysis with aggregate measures of spending enables us to determine whether social protection spending is used efficiently to reduce inequality.

A Generous Social Assistance System

10.   Botswana's *social assistance* budget is relatively large by international standards. Botswana's allocation of 2 percent of GDP to social assistance programs in FY2022[11] positions it in the upper quartile among SSA countries and beyond the median for upper-middle income peers (Figure 2, Panel A). In contrast to many SSA countries, the funding for Botswana's social safety nets comes predominantly from domestic sources, underscoring its self-reliant approach to social welfare (World Bank 2015, and UNICEF 2019).

11.   The bulk of social assistance spending is concentrated in a few key initiatives. Above 90 percent of the budget dedicated to social assistance is absorbed by only 5 programs: tertiary education scholarships and sponsorships, which alone consume over 45 percent of the FY2022 social assistance budget or 1 percent of GDP, followed by old age pensions (20 percent of the budget, equivalent to 0.4 percent of GDP), Ipelegeng (public works), the Secondary School Feeding Program, and the Destitute Persons Program (Figure 2, Panel B and Table 1).

12.   There has been a discernible decline in social assistance spending in recent years. Since FY2019, the allocation of social assistance (as a share of GDP) has been on a downward trend (Figure 2, Panel C). The allocation fell sharply from 3.7 percent of GDP in FY2019 to just above 2 percent in FY2022, with a decline of 20 percent in nominal terms, as the government prioritized other types of spending.

13.   Compared to social assistance, spending on *labor market programs* and *social insurance* is more limited. Between FY2018 and FY2022, the nation earmarked, on average, merely 0.5 percent of its GDP to labor market programs. This allocation is modest when compared to the

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an analysis of programs' incidence and effects on inequality. It has, for instance, been used to construct the indicators underlying the World Bank Atlas of Social Protection Indicators of the Resilience and Equity (ASPIRE) cross-country database. The survey was also used in the recent Social Protection Review by the World Bank (2022). This recent study differs from the previous one as it analyzes the joint effects on inequality of social protection *and* tax systems and uses more complete information on spending across different programs.

[10] To calculate pre-transfer consumption, we subtract the value of transfers from total consumption. Pre-transfer consumption is a measure of welfare commonly used in the social protection literature (see, e.g., WB (2022) and the World Bank Aspire Dataset).

[11] The fiscal year in Botswana runs from April 1 to March 31.

OECD median of 1.7 percent of GDP,[12] a gap that becomes even more apparent given Botswana's unemployment rate of 26 percent (as of September 2023) and the pressing need for skill enhancement across the workforce. Moreover, the country's social insurance spending, at about 1 percent of GDP, is half the level of neighboring countries like Namibia and South Africa (World Bank ASPIRE Database).

Figure 2. Botswana Social Protection Spending and Coverage
(Percent of GDP)

Panel A: Social Assistance Spending, FY2022
(Percent of GDP)

Panel B: Spending Across Main Programs, FY2022
(Percent of GDP)

Sources: MoLGRD, WB ASPIRE Database, WEO

Sources: MoLGRD, WEO, and IMF staff calculations.

Panel C: Social Protection Spending, FY2018-FY2022
(Percent of GDP)

Panel D: Coverage of Social Protection Programs, 2016
(Percent of Population)

Sources: MoLGRD, WEO, BPOPF annual report, and IMF staff calculations.

Sources: WB ASPIRE Database and IMF staff calculations.

Note: Panel A: data for Botswana covers FY2022. Data for other countries is latest available from the World Bank ASPIRE Database. Botswana Social Assistance programs are defined in Box 1. Panel B: spending across programs in FY 2022/23. Panel C: coverage is defined as the share of total population who are direct or indirect beneficiaries of the program. Direct beneficiaries are those who receive the benefit; indirect beneficiaries are those who reside in the same household as program direct beneficiaries.

A Broad Safety Net Covering a Large Part of the Population....

14.   The coverage of *social assistance* and *labor market* programs is extensive. More than half of the total population are beneficiaries, directly or through household association, [13] of at least

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[12] OECD countries implement *active* and *passive* labor market policies. The second type does not exist in Botswana. Spending on passive labor market policies represents, on average, 0.6 percent of GDP in OECD countries.

[13] Beneficiaries include recipients (direct beneficiaries) and those who reside in the same household with the recipients (indirect beneficiaries).

one social assistance scheme—a figure that is double the SSA average and much higher than in upper-middle income countries (Figure 2, Panel C and Table 2). In terms of reach, the main programs are old age pensions, Ipelegeng program, and the universal secondary school feeding program, collectively casting a wide net over the nation's recipients and beneficiaries (Tables 1 and 2). However, tertiary scholarships and sponsorships, despite being the most generously funded, benefit only 2½ percent of the population. Overall, the combination of all social assistance programs manages to cover nearly four-fifths of Botswana's poor population. Furthermore, labor market programs cover 6 percent of total population, which is comparable to the average of upper-middle income countries.[14]

15.   **On the other hand, *social insurance* covers a much smaller segment of the population.** Approximately 10,000 pensioners receive benefits from the Public Officers Pension Fund, representing only 15 percent of those over the age of 65 (Table 1). There are 150,000 active contributors– representing 30 percent of formal employment and 18 percent of total (formal and informal) employment. When combined with non-public pension funds, slightly below 60 percent of formal sector employees are enrolled in a pension plan, thereby excluding a considerable portion of the formal and the majority of informal sector workers from contributory pension schemes (IOPS 2017).

Table 1. Botswana: Social Protection Programs: Spending and Number of Recipients

	FY2022 spending		FY2023 recipients	
	mn pula	percent of GDP	Number of recipients	Percent of population
All social protection	8,940	3.5		
All social assistance	5,360	2.08		
Tertiary scholarships	2,504	0.97	35,000	1.3
Old age pensions	1,046	0.41	137,773	5.2
Community home-based care	30	0.01	907	0.0
Destitute Persons Program	626	0.24	68,712	2.6
Ipelegeng	529	0.20	83,814	3.2
School feeding (secondary)	479	0.19	182,017	6.9
Orphan Care Program	45	0.02	18,337	0.7
Other	100	0.04		
All labor market programs	1,145	0.44		
ISPAAD	729	0.28	124,028	4.7
Youth development fund	100	0.04	20,064	0.8
Poverty eradication program	42	0.02	41,721	1.6
National internship program	48	0.02	3,587	0.1
LIMID	72	0.03	24,106	0.9
RADP	35	0.01	1,364	0.1
All social insurance	2,434	0.94	10,401	0.4
Public officers pension fund	2,434	0.94	10,401	0.4

Source: MoLGRD, WB, 2022, and BPOPF annual report

Note: The number of recipients is equal to the number of direct beneficiaries, and hence does not necessarily correspond to the number of direct and indirect beneficiaries that define the coverage of the programs in Table 2. Hence, the shares may differ between the two tables.

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[14] This is a conservative estimate of the coverage of labor market programs, since our analysis does not include ISPAAD due to insufficient data.

Table 2. Botswana: Social Protection Programs Coverage (2016)

		Deciles of Consumption						
	Total	Q1	Q2	Q3	Q4	Q5	Poor	Non-poor
All social protection	55.8	79.2	72.0	59.4	41.1	27.2	78.3	48.8
All social assistance programs	52.8	76.7	70.6	56.0	38.2	22.7	76.1	45.7
Tertiary scholarships	2.4	1.8	1.4	2.2	3.0	3.4	1.7	2.6
Old age pensions	19.9	37.8	29.6	17.9	9.7	4.6	36.9	14.7
Community home-based care	0.2	0.5	0.2	0.3	0.2	0.1	0.5	0.2
Destitute persons Program	5.1	12.8	8.3	3.1	1.1	0.2	12.3	2.9
Ipelegeng	15.1	29.2	23.2	15.3	6.5	1.1	28.4	11.0
School feeding (secondary)	12.4	14.3	16.7	14.8	9.9	6.3	15.0	11.6
Orphan care program	4.5	7.6	4.9	6.0	2.4	1.3	7.6	3.5
All labor market programs	6.2	12.3	6.4	6.9	3.4	2.1	11.4	4.6
ISPAAD	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Youth development fund	0.4	1.1	0.3	0.3	0.0	0.2	1.0	0.2
Poverty eradication program	2.0	5.5	2.0	1.3	0.8	0.3	5.2	1.0
National internship program	2.3	2.4	3.1	3.2	1.7	0.9	2.4	2.2
LIMID	1.5	2.5	1.6	2.0	0.9	0.6	2.5	1.2
RADP	0.3	1.0	0.1	0.4	0.0	0.1	0.8	0.2
All social insurance	3.8	3.0	1.6	4.3	4.0	5.9	2.8	4.1
Public officers pension fund	3.8	3.0	1.6	4.3	4.0	5.9	2.8	4.1

Source: WB ASPIRE Database based on the 2015/16 multi-topic household survey

Note: Coverage is defined as the share of population (total, within each decile of consumption, or by poverty status) receiving the transfer directly or indirectly (residing in the same household as the transfer recipient). Poverty is defined using the international poverty line of $2.15 2017 US$ PPP per day.

....Including Rich Households.

16.   A significant share of *social assistance* benefits is not poverty-targeted.[15] A large portion of social assistance funds benefits non-poor people, defined as those above the lowest quintile consumption bracket.[16] In fact, more than 70 percent of beneficiaries are from the upper four quintiles of consumption (Table 2).[17] Nonetheless, there is some heterogeneity across programs when it comes to benefit distribution: old age pensions and school feeding schemes display more progressivity compared to the allocation for tertiary scholarships.[18]

17.   Compared to social assistance, *labor market programs* tend to better direct aid towards those most in need. Almost 40 percent of the individuals served by these initiatives fall within the poorest quintile of the population (Table 2). It is important to highlight, however, that, due to data limitations, the current analysis excludes the ISPAAD program, which represents the largest financial commitment among all labor market programs.

18.   Finally, Botswana's *social insurance scheme* tend to benefit a more narrow and wealthier segment of the population. The recipients predominantly hail from higher income

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[15] The 2022 *Bank of Botswana Annual Report* (Chapter 2) reaches similar conclusions.

[16] Using the 2015–16 MTHHS, households are ranked based on per-capita consumption. Consumption is defined in pre-transfer terms by subtracting from total consumption the amount of all identified social protection transfers that the household receives. The analysis omits some social protection programs, notably social insurance and some labor market programs due to survey questionnaire limitations.

[17] Some social protection programs (e.g., tertiary education scholarships and sponsorships) are not poverty-targeted with eligibility criteria that are not means-tested.

[18] As shown in Table 2, the share of beneficiaries receiving old age pensions declines with the level of consumption, from almost 38 percent in the poorest quintile to less than 5 percent in the richest. On the other hand, the share of beneficiaries receiving tertiary education increases from 1.8 percent (poorest quintile) to 3.4 percent (richest quintile).

quintiles (Table 2), reflecting the comparatively generous remuneration of public sector employees, as noted by IMF (2023b).

Complex Design and Costly Administration

19.   The large number of programs and oversight structures complicates the operation of the social protection system. As shown in Text Table 2, social protection encompasses 30 programs. These programs fall under the jurisdiction of 10 different ministries and government entities. Moreover, there is currently no single fully operational electronic registry of beneficiaries or joint information management system across programs to ensure that benefits are provided in a consistent manner and without duplication or omission. As a result, the targeting and selection of beneficiaries can be time-consuming, frequently requiring extensive paperwork. Beneficiaries may need to repeatedly submit the same information when they apply for different programs. Social protection programs are usually implemented by local authorities (e.g., city/town/district councils or district commissioners' offices), but coordination with the relevant supervising ministry is often weak (MoLGRD, 2020). The implementation of these programs exhibits significant variation across districts (World Bank, 2022). Finally, the large number of delivery methods (Text Table 2), coupled with the absence of single social registry, limits the ability of the system to be rapidly expanded in times of shocks.

20.   The social assistance budget, in particular, is burdened by high administrative costs. The lack of a unified registry of beneficiaries, coupled with the diversity of benefits, complex eligibility criteria, and labor-intensive registration processes, complicate the profiling of beneficiaries and the general management of the programs. This complexity results in substantial overhead costs, as highlighted by World Bank (2022). Specifically, administrative expenses constitute approximately 12 to 14 percent of the social assistance budget. In comparison, average administrative costs associated with social protection programs in the European Union amount to about 2½ percent of total spending.

21.   The lack of coordination between programs also leads to considerable redundancy. For instance, two thirds of the destitute persons program beneficiaries also benefit from the old age pension (World Bank, 2022). While this overlap can sometimes provide necessary additional support, duplication more frequently creates the possibility that beneficiaries receive multiple forms of assistance, potentially beyond what they are eligible for (World Bank 2022). This leads to financial leakages and makes the system less efficient.

Limited Effects on Poverty and Inequality

22.   Overall, the poor targeting and complexity described in previous paragraphs reduce the ability of social protection to markedly reduce poverty and inequality. In particular:

- *A large share of financing for social protection is allocated to regressive programs.* Expenditures on tertiary education yield limited benefits in terms of poverty alleviation and

inequality reduction,[19] primarily due to their coverage that predominantly benefits individuals in the higher income quintiles. In a hypothetical scenario where all tertiary sponsorships and scholarships were discontinued, the impact on the poverty gap would be limited.[20] However, such a measure would result in a 50 percent reduction in spending on social assistance, which could increase the benefit-cost ratio[21] by more than a third without adversely affecting the Gini inequality coefficient.

- *At the same time, progressive social assistance programs receive significantly lower allocations.* Old age pensions, destitute persons, and secondary school feeding collectively reach more than half of the poor population. But, the average spending per recipient of such programs is 9-11 times lower than the average spending per recipient of tertiary education scholarships and sponsorships, considerably limiting the distributional impact.

- *Administrative costs inflate total social assistance spending without providing benefits to the poor.* By reducing administrative costs to levels observed in the European Union, the benefit-cost ratio could improve by 10 percent. This improvement is observed even without considering the possible benefits from reallocating spending towards programs that have greater impact.
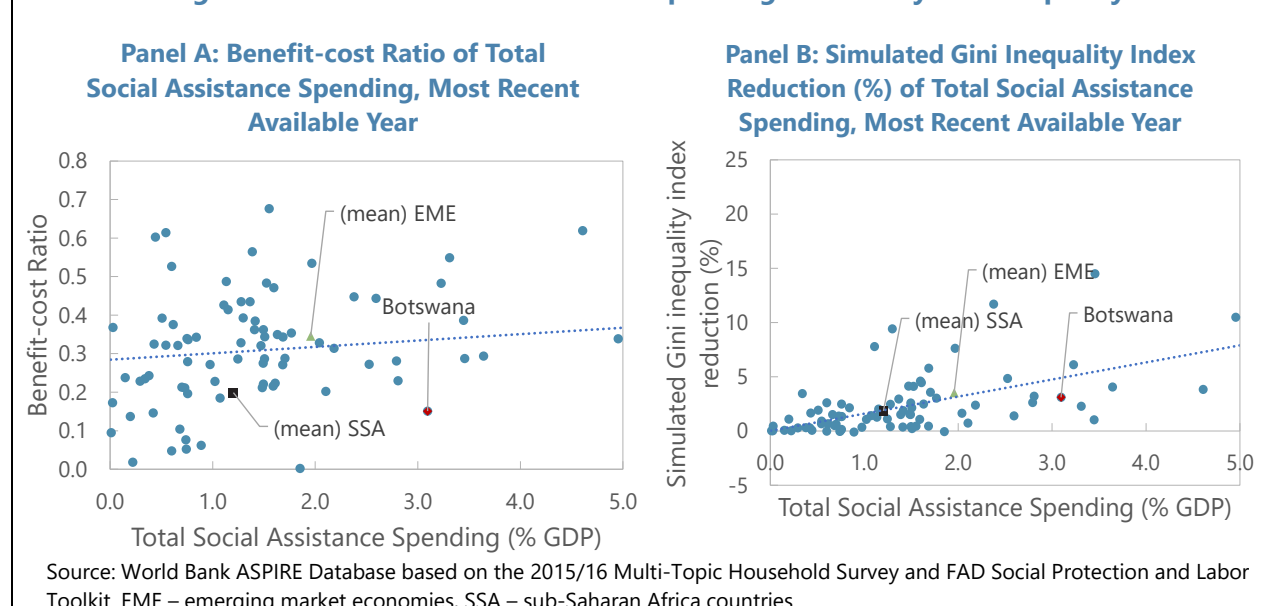
23.   The limited effect on poverty and inequality is confirmed by an empirical analysis focused on social assistance.[22] Based on the 2015–16 Multi-Topic Household Survey, the World Bank ASPIRE database provides various estimates of the effects of social assistance on different poverty and inequality metrics. The results are presented in Figure 3. Panel A plots the benefit-cost ratio and social assistance spending as a share of GDP. For Botswana, the benefit-cost ratio is 0.15, meaning that for every 100 pula spent on social assistance, only 15 accrue to the individuals below the poverty line. This outcome is significantly lower than the *average* benefit-cost ratio of approximately 0.3 and much lower than the *frontier* ratio of 0.5 for countries with comparable levels of spending. As discussed above, even though social assistance programs reach most of the poor population, actual spending is tilted towards richer individuals through regressive programs. Consequently, this leads to only modest improvements in the Gini coefficient (Figure 3, Panel B).

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[19] While poverty eradication is not an explicit goal of tertiary education subsidies and scholarships, these programs fall under the umbrella of the NSPF, whose purpose is "to prevent, address, and reduce the risks of poverty and vulnerability for Batswana throughout their lives."

[20] Tertiary education subsidies may have positive effects on human capital accumulation in the long run. This chapter focuses on distributional impacts. It does not take into account the effects of tertiary education subsidies on human capital accumulation and future earnings of the recipients. As access to tertiary education is skewed towards wealthier individuals, these earnings effects may only lift a limited number of people out of poverty, while aggravating inequalities.

[21] The benefit-cost ratio is calculated as the reduction in poverty gap for every unit of local currency spent. Poverty gap is defined as the difference between the poverty line and actual income, or zero, if income is above the poverty line. Hence, a benefit-cost ratio of 1 implies that every dollar spent goes to individuals with incomes below the poverty line, while a benefit-cost ratio of 0.5 implies that only 50 cents per dollar spent reach poor individuals.

[22] Due to data limitations, it is not possible to conduct the same analysis for labor market and social insurance programs.

Figure 3. Effects of Social Assistance Spending on Poverty and Inequality

Panel A: Benefit-cost Ratio of Total Social Assistance Spending, Most Recent Available Year

Panel B: Simulated Gini Inequality Index Reduction (%) of Total Social Assistance Spending, Most Recent Available Year

Source: World Bank ASPIRE Database based on the 2015/16 Multi-Topic Household Survey and FAD Social Protection and Labor Toolkit. EME – emerging market economies, SSA – sub-Saharan Africa countries.

C. Financing Social Protection: The Other Side of the Coin

24.   To have a more complete picture of its distributional effects, it is important to also consider the financing side of social protection. A progressive social protection system could, for instance, be funded through regressive taxes, which might negate its beneficial effects on inequality. Conversely, a broadly neutral system of transfers could still have beneficial effects if it is financed through highly progressive taxation.

25.   This section focuses on the effects of the PIT and VAT, which have the most direct effects on income and consumption inequality.[23] An in-depth examination of the entire budget, encompassing both expenditures and revenues, is out of the scope of this paper. The objective of this short section is not to provide a comprehensive analysis, but rather to offer a preliminary assessment of the consolidated effects of social protection and its financing.

26.   PIT and VAT taxes have limited impact on inequality in Botswana. Regarding PIT, Botswana has five income tax brackets with progressive rates varying from 0 to 25 percent for top earners. The highest marginal tax rate is low by international standards and is the lowest in the SACU region.[24] Consequently, PIT has limited effect on inequality, reducing Gini coefficient by 3.5 percentage points, a figure that is lower than simulated for other countries in the region (Figure 4). Regarding VAT, Botswana applies a uniform rate of 14 percent, albeit with some exceptions. Most

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[23] Social assistance and labor market programs are financed directly from the budget. VAT, personal income, or other taxes are not specifically earmarked for spending on social assistance and labor market programs.

[24] Based on the most recent PWC Worldwide Tax Summaries.

notably, some staple food items[25] and fuel are taxed at a zero rate. The VAT impact on the Gini coefficient is assessed by analyzing consumption shares across the income distribution using data from the 2015-16 Multi-Topic Household Survey.[26] Given that wealthier households tend to consume more fuel and transport services, while poorer households consume more food, the overall effect of VAT on inequality metrics is marginally negative, with an estimated reduction in the Gini coefficient by approximately 1 percentage point.

27.   The limited evidence presented in this section suggests that the tax system is insufficiently progressive to markedly add to the effect of social protection on income inequality. With the relatively flat PIT rate schedule, individuals with higher earnings do not contribute enough towards a more equitable distribution of income. Furthermore, although consumption taxes represent a smaller share of total taxes in Botswana than in other African countries,[27] VAT exemptions for certain goods may benefit richer consumers more than poorer consumers, aggravating income disparities. For social protection to have a more pronounced effect on income equality, there is a clear need for a more progressive taxation approach, ensuring that the tax system complements rather than undermines the goals of social protection.

Figure 4. Redistributive Capacity of the PIT, 2023
(Percent)
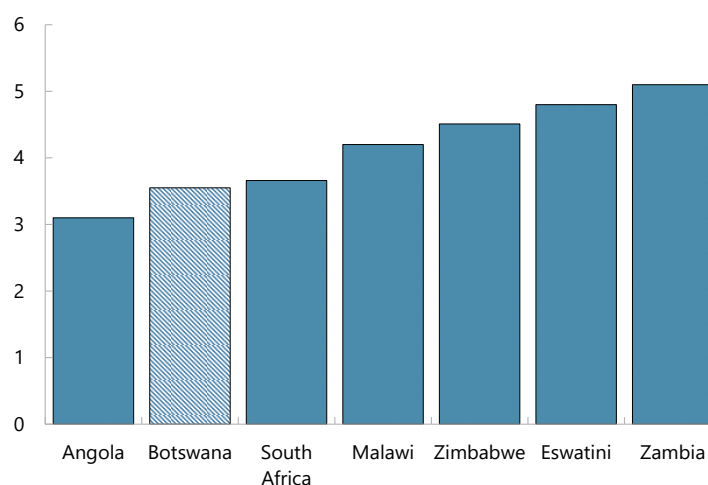
Sources: World Inequality Database, IBFD, IMF-staff computations

Note: The results are based on the IMF FAD Personal Income Tax tool based on the survey microdata and simulations. Redistributive capacity is calculated as the difference between pre-tax and post-tax Gini coefficients in percentage points.

D.   Reforms: International Experiences and Options for Botswana

28.   This section explores international best practices in the management of social protection systems and proposes reform options for Botswana. It examines four key areas: (1) overall design, (2) choice of programs, (3) delivery, and targeting technologies, and (4) financing. General principles are discussed in IMF (2014), Clements and others (2015), World Bank (2022b), and

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[25] Zero-rated food items include, among others, some sorghum, rice, and maize products, brown breads, as well as fresh vegetables and fruits.

[26] We estimate the amount of VAT paid by each individual in the survey. To do so, we first compute τ_g, the average VAT rates for 12 categories of consumption goods and services, denoted by g, like food or transportation (by aggregating individual VAT rates for the items within each category). Then, the VAT paid by individual i is computed as $VAT_i = \sum_g \tau_g C_{ig}$ where C_{ig} is consumption by individual i of consumption category g.

[27] See comparative analysis in OECD (2023). Consumption taxes, levied at a flat rate, are generally regressive.

ILO (2023). Country experiences are discussed in greater details in Soares and others (2010), World Bank (2014), ILO (2016), and World Bank (2019). Some policy options discussed below are priority areas of the authorities' NSPF.

Simplifying the Social Protection System

29.   Best practice 1: Several developing and emerging countries have rethought their social protection system towards more simplicity and adaptability. Examples include Brazil, Indonesia, and China (World Bank, 2019). This process has been achieved by:

*   **Consolidating programs.** The consolidation of numerous fragmented programs into fewer programs with broader coverage enables countries to achieve enhanced coherence in policy objectives, aligning social protection initiatives more closely with broader national development goals. Additionally, a more unified and streamlined system improves accessibility for beneficiaries, simplified the process to obtain assistance, and minimized bureaucratic barriers.

*   **Introducing a single social registry.** A single social registry centralizes the collection, management, and use of data regarding potential beneficiaries. This enhances data collection and analysis capability, thereby improving the targeting of programs. It also supports the continuous evaluation and adaptation of programs to address the evolving needs of the population effectively.

*   **Making the system more "adaptive."**[28] Adaptive social protection systems are designed to be flexible, allowing for rapid adjustments—both vertical (the level of benefits) or horizontal (the number of beneficiaries)—in response to economic shocks, natural disasters, or demographic shifts. This responsiveness not only provides immediate relief to those affected by adverse events in the near term, but also contributes to long-term poverty reduction and social equity by preventing the deepening of existing vulnerabilities.

30.   The Bolsa Familia Program in Brazil is a good example of effective streamlining of the social protection system. This program, which was introduced in 2003, has integrated multiple pre-existing cash transfer initiatives into a unified conditional cash transfer program, supported by a new single social registry. Thanks to its flexible design and solid underlying infrastructure, the Bolsa Familia program can expand or adjust its coverage to align with socio-economic developments and adapt its structure and conditions to address new challenges, such as those encountered during the COVID-19 pandemic (World Bank, 2020).

31.   Application to Botswana: The authorities could consider the following measures to streamline their social protection system:

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[28] For the purpose of this paper, we define "adaptive" social protection systems as those capable of rapidly scaling up coverage or benefits in response to shocks.

- **Reducing the number of programs.** The current landscape, featuring nearly 30 programs, results in a fragmented and operationally expensive system. There is potential to enhance efficiency by merging smaller, lower-coverage programs into broader ones with wider eligibility criteria.

- **Accelerating the rollout of the digital Single Social Registry (SSR)**. Initiated in 2016, the creation of the SSR has encountered delays due to the pandemic and various technical hurdles.[29] Nonetheless, the SSR remains vital for improving the precision of targeting, reducing administrative expenses, fostering program coordination, and enabling more effective monitoring and evaluation. Furthermore, it would support the adaptability of the social protection framework.

- **Improving program adaptability.** Given Botswana's reliance on mining activities and vulnerability to climate-related challenges like droughts, the economy is particularly prone to shocks. Thus, social protection programs that can be swiftly scaled up in response to economic or environmental crises are essential. Such programs should be capable of adjusting their benefits and beneficiaries to meet the specific needs arising from the materialization of risks, thereby delivering more targeted and efficient aid.[30]

Introducing More Effective Programs

32. **Best practice 2:** Two types of social protection programs have proven to be very effective in reducing inequality and boosting employment:

- **Conditional cash transfers (CCT).** CCT provide financial assistance directly to families, often the poorest, under the condition that they meet certain criteria, such as ensuring that their children attend school or receive regular health check-ups. This approach not only helps to alleviate immediate financial hardship for the most vulnerable, but also encourages behaviors that can break the cycle of poverty in the long term (hence, facilitating timely graduation from means-tested programs). For example, the *Prospera* program in Mexico (previously known as *Opportunidades*) has played a key role in reducing poverty in some regions and resulted in significant improvements in education, consumption, and labor market outcomes in the medium and long term (Parker and Todd 2017, Parker and Todd 2020, World Bank 2014).

- **Comprehensive active labor market programs that enhance broad-based skills and address other labor market bottlenecks.** On the labor supply side, programs focused on workforce development, technical and vocational education, and training have been effectively implemented in various emerging economies (e.g., Ghana, Uruguay, India). ILO

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[29] In the past decade, the World Bank has provided substantial support to Botswana in developing and operationalizing the SSR, including during its pilot phase in 4 districts.

[30] Adaptive programs should be able to scale down benefits to normal levels and allow beneficiaries to graduate when the shock is over.

(2023) offers a review of successful initiatives. These programs aim to enhance employability by equipping individuals with skills in demand by the private sector. Such strategies are known to address employment barriers and promote social mobility. The effectiveness of these policies in low- and middle-income settings is well documented, with outcomes heavily dependent on the design and execution of the programs (Kluve and others, 2019). In addition to supply-side programs, other policies can be used to facilitate the functioning of the job market and foster entrepreneurship. These include employment incentives, public employment services, and start-up incentives, among others. Ample evidence shows that comprehensive approaches (not just focused on boosting supply) are more effective in tackling the multifaceted nature of unemployment, particularly for the youth (ILO 2022).

33.   Application to Botswana: The authorities might contemplate improvements to certain social protection programs by:

- **Moving from in-kind delivery to means-tested conditional cash transfers**.[31] Transitioning to this approach for some programs could eliminate inefficiencies associated with procurement and delivery and enhance targeting accuracy. Implementing such a change necessitates sufficient administrative capacity to conduct means-testing and design and monitor the conditionality of transfers.[32] Additionally, the success of this transition is dependent on the effective operation of the SSR.

- **Reforming labor-market programs with greater focus on skills development and market functioning.** To achieve a meaningful reduction in inequality and poverty, Botswana authorities need to foster conditions for job creation, especially among the youth. In this regard, there is scope to consolidate and reform the multiple labor-market programs. A primary objective should be to enhance life-long learning and the acquisition of both technical and soft skills, which could significantly enhance employability and adaptability among the workforce.[33] In this context, cooperation with the private sector will be pivotal, as such collaboration can ensure that training programs are aligned with industry needs. Furthermore, complementary policies can include job-search assistance, career guidance, and intermediation services allowing young workers to signal their skills. Entrepreneurship promotion can also facilitate youth-owned businesses.[34]

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[31] The introduction of conditional cash transfers should be based on a rigorous analysis to determine which social sector services (education, health, nutrition, etc.) should be incentivized. Moreover, given the level of poverty in Botswana, some segments of the society should still receive direct income support through unconditional cash transfers.

[32] In the 2010s, the Government of Botswana started to reform the targeting system through a proxy means test (PMT) mechanism, aimed at objectively identifying a household's poverty status based on empirically derived poverty scoring coefficients. This system was pilot-tested to assess its performance in 2015/16, and then fine-tuned for nationwide use. However, it was never scaled to full implementation.

[33] The launch of the *Ipelegeng Skills Development Component* in 2022 is a positive development in this regard.

[34] The newly established *Chema Chema Fund* is another step in the right direction. It aims to provide credit to young people, stimulate entrepreneurship, and offer access to credit and business development services for the youth.

Exploiting New Technologies for Targeting and Delivery

34.   Best practice 3: Digital technology can be leveraged to improve the efficiency of social protection.[35] Governments in some emerging countries (Turkey, Chile) have developed sophisticated electronic social registries that allow them to exchange data across various databases (such as land, vehicle, and health registries, among others). Such integration can be used to proactively target potential beneficiaries. Additionally, the application of modern machine-learning techniques to analyze registry data allows for the construction of need-based indicators, as seen in Colombia and Togo, and can be supplemented with non-traditional 'big data' sources in contexts where government data are sparse. Furthermore, the adoption of modern payment methods, like mobile money, has proven to significantly reduce the delivery costs of social assistance and insurance programs—a strategy employed by Ghana, Kenya, Rwanda, and Uganda.

35.   Application to Botswana: The authorities could build capacity to harness the potential of modern technology, with a view to improving the efficiency of their social programs. This includes enhancing the digitization of beneficiary data, and regularly updating the dataset. By integrating information from this registry with other data sources, such as satellite imagery or mobile phone usage, the authorities can identify opportunities for expanding social protection programs. For example, satellite data on crop performance in drought conditions may be utilized to scale up the programs in the most affected areas, as done in Kenya, Uganda, or Niger (World Bank, 2022b). Moreover, Botswana can capitalize on innovative delivery mechanisms, like digital or mobile payments, supported by the nation's comprehensive identity card system.

Ensuring Sufficient and Progressive Financing

36.   Best practice 4: Optimizing the financing of social programs is crucial to strengthen the progressivity of fiscal policy and ensure that scarce resources are used in the most efficient way, given limited fiscal space. Insights from global practices highlight two key strategies:

- **Redirecting funds away from less effective programs.** This approach, which could be implemented in a budget-neutral way, ensures that limited resources are directed to interventions that yield the highest impact, particularly in improving the lives of the most vulnerable. By prioritizing funding for programs with proven outcomes, governments can achieve greater poverty reduction, enhanced social equity, and improved human capital development. Such reallocation often involves rigorous evaluation of existing programs to identify areas where funds may be underutilized or not delivering the desired results. This approach, for example, was successfully implemented in Indonesia in the early 2000s, when costly and regressive fuel subsidies were cut to finance a scheme supporting low-income families (ILO, 2016).

- **Improving the progressivity of income taxation and minimizing the use of reduced VAT rates.** PIT, when designed with progressive rate structures (higher income brackets

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[35] The examples provided in this paragraph are based on Lowe and others (2023).

taxed at higher rates) directly targets income disparities by redistributing wealth from richer segments of society to fund public services and social protection programs that benefit the poor. Consumption taxes, such as VAT are, in general, a less preferable tool to combat inequality. Exemptions or reduced VAT rates are blunt redistributive instruments, as the poor usually consume less than the rich in absolute terms.[36]

37.   Application to Botswana: On the financing side, the priority is to maintain or increase the budget allocated to social protection, while enhancing progressivity. The authorities could consider:

- **Reallocating existing funding across programs.** Introducing means-tested eligibility criteria for tertiary education scholarships and sponsorships could reduce the number of beneficiaries (excluding the richest ones) and generate savings. Alternatively, the government could evaluate replacing most of the scholarships and sponsorships with a student loan program. The funds saved from such reforms could be redirected to more targeted programs that better address the needs of economically disadvantaged groups, including school feeding schemes, old age pensions, and the destitute persons program.

- **Enhancing tax system progressivity.** While the social protection system plays a key role in mitigating inequality, there is room for refining the tax framework to make it more progressive. This could involve increasing the top marginal PIT rates, which are currently among the lowest in SSA. Furthermore, reconsidering the application of zero-rated VAT on items that disproportionately benefit higher-income groups, such as petrol and diesel, could also be considered (see IMF 2017b).

E. Conclusions

38.   Botswana stands as one of the most unequal countries globally. The primary driver is the economic structure, which heavily relies on capital-intensive mining industries. Additionally, geographic characteristics (with the country being both vast and sparsely populated) further exacerbate the situation. These elements create a challenging environment for addressing economic disparities and fostering a more inclusive growth pattern. In this context, targeted fiscal interventions can play a key role to mitigate these trends.

39.   The social protection system, despite being designed to support the neediest, suffers from some inefficiency. While the country has a wide array of programs aimed at reaching its poor population, the allocation of funds is tilted towards regressive programs. Furthermore, the system is characterized by fragmentation and incurs high administrative costs, compounding its inefficiency.

40.   Improvements in Botswana's social protection system are both necessary and achievable. Simplifying the existing framework, making it more adaptive, and introducing a single social registry, could significantly enhance the system's efficiency and effectiveness. By

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[36] As discussed in Warwick and others (2022) while reduced VAT rates and exemptions may reduce poverty, they are usually quite expensive in terms of forgone tax revenues, and rich households benefit more in nominal terms.

strengthening the role of conditional transfers and active labor market policies, the system could be better aligned with the needs of the population it aims to serve. Modernizing delivery and targeting methods is another critical step towards ensuring that administrative costs are reduced, and assistance reaches those who need it most. Finally, securing sufficient and progressively-sourced financing is paramount to sustaining improvements over time.

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