

Literavia: A Case Study in Economic Reform and PPD

The country of Literavia had recently experienced its first democratic, multi-party election since the fall of the previous Movement for National Liberation (MNL) government which, led by the charismatic Dr Awazi Tonto, had been in power for 28 years. Over that time the economy declined dramatically, and the newly installed coalition government faced numerous challenges.

I The Politics

Until the rise of the MNL, Literavia had been led by a monarchy. Its economy had been a bustling mix of industry, trade and services and the country possessed significant natural beauty. Rumours of a mysterious 'Shangri-La' –type paradise in Literavia had sprung up among travellers at the time, and this, coupled with the country's exotic mix of religion, culture, artifacts and architecture, stoked its international reputation as a tourist mecca.

However, the monarchy's appalling record on human rights and stifling of the burgeoning civil society movement eventually led to protests and riots. The last straw was a major scandal between one of the King's children and a foreign diplomat, the result of which saw the monarchy overturned through revolution and replaced with a Parliamentary system of Government. This came at great cost to the nation, however, as long-simmering tribal animosities (largely contained during the years of the monarchy) led to 10 years of fractious civil war immediately following the monarchy's downfall. This destroyed the country's infrastructure and finances, and any trust between the country's main tribes evaporated. Recent major discoveries of mineral deposits stoked the violence further. Millions of people fled the country, and hundreds of thousands were killed or injured.

It took a major international peacekeeping team to restore order and organize multiparty elections. The elections themselves resulted in the victory of the MNL in a relatively free and fair election which was the first of its kind in the region. Its leader, Dr Awazi Tonto, had spent many years as a medical doctor and then football coach on the Isle of Man off the coast of the UK which gave him a unique vantage point in terms of understanding human nature and team chemistry, and it was hoped that this unique perspective would help unite the country. The newly elected MNL party promised to continue the solid economic progress which characterized most of the monarchy's final if not somewhat chaotic years in power. The IMF agreed a rescue package deal based on a return to microfinance discipline and a stabilization of the currency. Recognising the historic opportunity that this presented and each wanting to be first, dozens of donors flooded back to Literavia and announced bold new programmes of economic reform.

However, everything changed once the MNL assumed power. Slowly but surely the Government's grip on the economic and political landscape began to tighten. Much of heavy industry was nationalized; new Government agencies sprouted up and new and complicated rules governing business activity emerged. The Ministry of Finance enlarged its mandate and staffing, and the taxation system became more complex and more arbitrary. The recent large deposits of minerals – including iron ore, gold, diamonds and bauxite - rapidly fell into the hands of a privileged few. Cronyism replaced transparency as the basis for decision making.

The economic impact of these changes could be easily predicted. International investment declined dramatically, with many investors relocating to the neighbouring country of Tinseltin. All the leading economic indicators plunged. Industrial output and GDP declined,

inflation rose, and the complicated new rules governing business activity forced hundreds of thousands of businesses into the informal sector. Although donors acknowledged the difficulties that the country and its people were facing, for the most part they did not withdraw.

Overarching this economic transformation was an internal power struggle between the two dominant tribes within the ruling party. Multaphan Awazi, who was the son of Dr Awazi, wielded enormous power as Minister of Finance. He was pitted against his rival cousin, Madame Hillary Awazi-Hanor, whose rise thru the political ranks was even more impressive given the generally traditionalist views of the roles of men and women in Literavia society. Her husband was a rich industrialist but rumours persisted of his less than transparent business dealings and his allegiance with the Royal Family, which although ostracized, retained a special place in the hearts of the people given the brutal impact of the civil war. As the new millennium dawned and the MNL celebrated 20 years in power, Madame Awazi-Hanor was appointed Minister of Justice.

The situation became untenable; the economy was being ruined, and a tumultuous revolution again loomed. Then suddenly, President Awazi was forced from power in an internal (and bloodless) coup led by his son. Multaphan Awazi took over, promising fresh elections within 3 years. In the meantime, some encouraging reform efforts took place, including a revamping of the commercial law framework (although minus meaningful consultation), attempts to restore fiscal budget discipline, and steps to expand credit to the private sector despite political interference in many microlending programmes.

Wary investors began to return to Literavia albeit slowly. Multaphan delivered on his electoral promise and the elections were scheduled. His cousin, Madame Awazi-Hanor, formed a rival party called the Organisation for the Betterment and Meaningful Advancement of Literavia (OBAMAL). The election produced a mixed result; MNL carried much of the rural parts of the country while OBAMAL carried most of the urban areas. The third major party, called Literavia Economic Renewal (LER) and headed by the leader of a prominent economic think tank, held the balance of power based on its platform of economic reform. Over a lengthy (and often heated) family dinner discussion, it was agreed that a coalition Government would be formed, with Multaphan becoming Prime Minister, a long time political ally becoming Minister of Finance, while Madame Hillary became Deputy Prime Minister and kept her post of Minister of Justice.

The Head of the Central Bank is an ally of Madame Hillary although the Central Bank's capacity is limited. The Ministry of Commerce and Industry (led by a Minister who is also leader of third political party) has recently undergone an internal reorganization which includes the establishment of a Private Sector Development Directorate. Government-wide reform efforts include the establishment of policy analysis units in each Ministry and ambitious plans for broader civil service reform.

II The Economics

- As of the year 2008 the country had a total population of 16 million with an annual growth rate of 1.9%.
- GDP per capita = \$400
- As of 2008 20.4% of GDP came from the agricultural sector, 26.6% came from the industrial sector, while 53.0% of GDP was contributed by the services sector. Growth rates in industry had been the highest in the years since Multaphan took power.

- Major agricultural products of the country are wheat, rice, maize, coffee, tea, sorghum, cattle, sheep and goats, cotton, vegetables, milk, beef, sugarcane, mutton, and fruits.
- Important industries in the country are textiles, paper products, mining, agricultural machines, food processing, fertilizer, chemicals, and pharmaceuticals.
- Tourism and financial services are the major contributors within the services sector.
- Total investment in 2008 was \$1.2 billion, or 9% of GDP. Investment is concentrated in heavy industry and manufacturing; a large majority of investment is in the form of Foreign Direct Investment (FDI) but the rate of growth of domestic investment over the last five years has been much higher.
- Formal unemployment stood at 21% while inflation reached 11% in 2008, the third year in a row in which inflation was in double digits. Reducing unemployment is considered a major Government priority given that many people, including skilled workers, are now returning to the country. Youth unemployment is particularly high at over 50%.
- The size of the informal economy is estimated at 50% of the total economy and includes 80% of all small businesses.
- Fiscal 2008 foreign exchange and gold reserves amounted to \$9.104 billion. Literavia had external debt worth \$13.23 billion at the same time.

III The Enabling Environment

- Literavia ranked poorly on the World Bank's list of Doing Business Indicators, placing among the bottom 10% in the overall Ease of Doing Business ranking. For the Paying Taxes indicator, it is second-worst for total tax (278.7 % of profit) the time needed to pay taxes (1,400 hours) is over three times the regional average.
- For the Dealing with Licenses indicator, Literavia's cost (as a percent of income per capita) is greater than three times the regional average. The long time to start a business (202 days) is more than three times the income group average.
- The credit to GDP ratio is the smallest in the region and one of the smallest in the world.
- Over the last 3 years, two out of three rankings (Control of Corruption and Index of Economic Freedom) declined, while the Country Credit Rating stayed steady.
- According to the World Economic Forum's Global Competitiveness Report, the four most problematic factors for doing business are access to financing, corruption, tax rates, and tax regulations.
- Over 40% of firms rate tax rates as the greatest obstacle to firm investment, according to the 2008 Enterprise Survey.

Ease of...	2008 rank	2007 rank	Change in rank
Doing Business	164	158	-6
Starting a Business	171	162	-9

Dealing with Construction Permits	154	153	-1
Employing Workers	124	124	0
Registering Property	138	136	-2
Getting Credit	131	126	-5
Protecting Investors	113	110	-3
Paying Taxes	171	170	-1
Trading Across Borders	137	135	-2
Enforcing Contracts	172	172	0
Closing a Business	95	95	0

A recent report launched by the World Bank, IFC and PricewaterhouseCoopers shows that tax authorities worldwide are overhauling tax systems by reducing taxes, streamlining administrative processes and modernizing payment systems. The report finds that: (i) 36 economies made it easier to pay taxes; (ii) the most popular reforms were reducing corporate income tax rates (in 21 economies) and improving electronic filing and payments systems efficiency (in 12 economies); (iii) 8 economies reduced the number of taxes paid by business; (iv) on average, corporate income tax accounts for only 13 percent of tax payments, 26 percent of compliance time, and 37 percent of the total tax rate (tax cost to the case study company); (v) employment taxes account for 34 percent of the total tax rate, taking into account only amounts borne by the employer; (vi) on average, 36 percent of the overall time to comply with tax systems and 48 percent of the number of tax payments are spent on consumption taxes.

The Literavia Association of Small Businesses (LASB) has recently emerged as a leading private sector business association. It joins the Literavia Chamber of Commerce and Industry as well as numerous sector-based associations as players and potential sources of influence in policy reform. Civil society and women's groups are especially well organized in Literavia, and the proportion of women in the economy is by far the highest in the region. Advocacy capacity, however, is weak; few business associations can point to having significantly influenced recent Government reform efforts, and there have been few collaborative efforts among business associations in support of reform. International investors have traditionally been more trusted partners of Government.

While the IMF, World Bank, USAID, GTZ and DFID provide the majority of assistance in support of private sector development, the IMF has wielded the greatest influence to date on the Government although this has not often sat well with the population. There have been few attempts among donors to cooperate in support of specific initiatives, however, and the degree of information exchange among donors is limited. Conflict between USAID and GTZ has recently flared over the issue of developing a more effective Chamber of Commerce system in the country. The Government's Poverty Reduction Strategy Paper was developed with little private sector input, and Literavia cannot boast of any legacy of meaningful public-private dialogue.