Creating and wasting fiscal space

Zambian fiscal performance, 2002–2011

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## Contents

Executive summary .................................................................................................................. 6

1 Introduction .......................................................................................................................... 7

2 Data ....................................................................................................................................... 9

3 Revenue, aid, expenditure and fiscal deficits ................................................................. 13
   3.1 Revenue ......................................................................................................................... 13
      3.1.1 Non-mining revenue ................................................................................................. 13
      3.1.2 Mining revenue ........................................................................................................ 14
   3.2 Aid ................................................................................................................................... 15
   3.3 Total expenditure and the fiscal deficit ........................................................................ 16

4 Debt and interest .................................................................................................................. 19
   4.1 Foreign debt ................................................................................................................... 19
   4.2 Domestic debt ................................................................................................................ 20

5 Breakdown of domestic expenditure ............................................................................. 23

6 How has fiscal space been used? ....................................................................................... 26
   6.1 Farmer Input Support Programme ................................................................................. 26
   6.2 Food Reserve Agency maize purchase .......................................................................... 27
   6.3 Paving roads ................................................................................................................... 27

7 Conclusions ......................................................................................................................... 29

References ............................................................................................................................... 31
Tables

Table 1. Zambian fiscal trends, 2002–2011

Table 2. Zambian debt trends, 2002–2011

Table 3. Growth in discretionary balance and selected expenditure programmes (% of GDP)

Figures

Figure 1. Revenue, expenditure & fiscal deficit (after grants) as % of GDP

Figure 2. Domestic and foreign interest as % of GDP

Figure 3. Government and private sector debt as % of GDP

Figure 4. Breakdown of domestic expenditure (%)

Figure 5. Breakdown of domestic expenditure as % of GDP
### Acronyms

<table>
<thead>
<tr>
<th>Acronym</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>FRA</td>
<td>Food Reserve Agency</td>
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<tr>
<td>GDP</td>
<td>Gross Domestic Product</td>
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<tr>
<td>GRZ</td>
<td>Government of the Republic of Zambia</td>
</tr>
<tr>
<td>HIPC</td>
<td>Highly Indebted Poor Country</td>
</tr>
<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
</tr>
<tr>
<td>MDRI</td>
<td>Multilateral Debt Relief Initiative</td>
</tr>
<tr>
<td>OECD</td>
<td>Organisation for Economic Cooperation and Development</td>
</tr>
<tr>
<td>SADC</td>
<td>Southern African Development Community</td>
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<tr>
<td>ZCCM</td>
<td>Zambia Consolidated Copper Mines</td>
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EXECUTIVE SUMMARY

Following three decades of economic mismanagement and decline, Zambia has experienced sustained economic growth since the turn of the century. The combination of rapid growth, reduced public expenditure, increased mining taxation and debt relief helped the Government establish fiscal discipline and reduce fiscal deficits and debt to sustainable levels. As a result, fiscal space has grown significantly and Zambia is no longer aid dependent. In addition, lower domestic public borrowing has helped cut inflation and interest rates and has reduced crowding out of private sector borrowing. These developments would normally be expected to lead to significant poverty reduction. However, by 2010 there had been little improvement in poverty. This is partly due to fiscal space being wasted on ill-designed agriculture policies and uneconomic road paving projects of little benefit to the poor.
1 INTRODUCTION

Between the 1970s and 1990s the Zambian economy was one of the most badly mismanaged in Africa, at both the macro- and micro-economic levels. At the macro level this is perhaps best illustrated by the scale of fiscal deficits, which averaged 12.3% of gross domestic product (GDP) during the 1970s, 13.8% in the 1980s and 6% in the 1990s (McPherson 2004).\(^1\) With fiscal deficits and debt at unsustainable levels and copper production and prices in decline, per capita income fell substantially. One of Africa’s richest countries – classified as ‘lower middle income’ at independence – had become a ‘least developed’ country by the 1990s.

The Zambian macro economy has been transformed since the turn of the century. Real GDP has grown every year since 1999, averaging 5.8% between 2002 and 2011. GDP per capita increased from $847 in 1998 to $1,221 in 2010 in constant 2010 prices (IMF 2012, 4). By 2011, with rapid growth, modest fiscal deficits, single digit inflation, low debt, healthy foreign exchange reserves and relative exchange rate stability, the macro economy had probably never been in better shape (IMF 2012). However, there are worrying signs that the potential benefits for poverty reduction of improved macro performance are being lost through poor micro-economic policies.

While numerous factors contributed to the macro turnaround, two predominate. The first and most obvious driver of growth was the privatisation of the copper mines in the late 1990s and early 2000s and the subsequent boom in copper prices. This both removed a major drain on public finances – in 2000 bailing out the mines cost the government 4.1% of GDP, roughly $1 million a day – and facilitated an investment boom in mining. Copper production increased from 256,000 tonnes in 1998 to 879,000 tonnes in 2011, surpassing the previous peak in 1969. With copper prices increasing from about $2,000 a tonne to about $8,000 a tonne over the period, copper export revenues increased from $497 million in 2000 to $6,660 million in 2011 (IMF 2012).\(^2\)

The other key factor in Zambia’s macro-economic transformation was the establishment of fiscal discipline. This reform, which was radical in the Zambian context but has attracted little public attention, is the main subject of this paper. It shows how the combination of reduced fiscal deficits since 2004 and economic growth enabled the Zambian government (GRZ) to bring down the domestic debt to GDP ratio. Along with debt relief on external debt under the Heavily Indebted Poor Countries (HIPC) and Multilateral Debt Relief (MDRI) initiatives and falling domestic interest rates, this facilitated a substantial reduction in the GRZ interest bill.

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1 An indication of “normal” fiscal deficit levels is provided by the rules of the European Union Stability and Growth Pact which, until the global financial crisis, limited deficits to 3% of GDP.

2 Growth in exports has enabled Zambia to increase gross official foreign exchange reserves from $180 million (1 month of prospective imports) in 2001 to $2.2 billion (3 months) in December 2011. This has greatly reduced exposure to balance of payments shocks.
This not only increased the fiscal space available to GRZ, but also facilitated increased private borrowing by reducing GRZ crowding out of the private sector in the domestic financial market.

This paper is organised as follows. Section 2 discusses the sources and types of data presented. Sections 3 to 5 provide an interpretation of the key trends revealed by the data looking at revenue, expenditure and fiscal deficits (3), debt and interest (4) and the breakdown of expenditure (5) respectively. Section 6 looks at what use GRZ has made of additional fiscal space. Section 7 presents the main conclusions.
2 DATA

The paper reviews trends in Zambian fiscal and debt data since 2002. The main source of fiscal data is the International Monetary Fund (IMF). Figures for 2010 and 2011 are published in the IMF 2012 Article IV Report of May 2012 (IMF 2012). Data for earlier years was provided by IMF staff and not all of it has been published. Data on GRZ domestic credit and credit to the private sector was provided by the Bank of Zambia. Road expenditure data is taken from Raballand and Whitworth (2012) and was originally supplied by the National Road Fund Agency.

The data is presented in two tables. Table 1 shows the main features of Zambia’s fiscal framework between 2002 and 2011, divided into revenue & grants, expenditure and the fiscal balance. 2011 data is only preliminary at the time of writing. Table 1 has three sections:

- **Actual figures in billions of Zambian Kwacha.** This is the input section, which generates the other two sections. Since figures have been input in actual, current prices it is not possible to directly compare one year with another (because of inflation).
- **Shares of total domestic expenditure.** Figures are expressed as percentages of GRZ domestic expenditure, i.e. total expenditure minus donor capital expenditure. Since they abstract from inflation, figures for different years are directly comparable.
- **Shares of GDP.** Figures are expressed as percentages of GDP. Again, figures are comparable between years.³

Table 2 presents key trends in Zambian debt, distinguishing between Government debt – both external and domestic – and credit to the private sector. It has two sections:

1. Actual data in billions of Zambian Kwacha
2. Shares of GDP

Five charts have been generated from Tables 1 and 2:

- Figure 1: Revenue, expenditure & fiscal deficit (after grants) as shares of GDP.
- Figure 2: Domestic and foreign interest as shares of GDP
- Figure 3: Government and private sector domestic debt as shares of GDP
- Figure 4: Breakdown of domestic expenditure (%) between wages, interest, arrears and ‘discretionary’ balance
- Figure 5: Breakdown of domestic expenditure as shares of GDP

The bulk of the paper is an interpretation of the time series data from Tables 1 and 2, by reference to Figures 1 to 5. To ensure comparability over time it looks at trends expressed

³The accuracy of Central Statistical Office estimates of Zambian GDP is questionable – with forestry alone having almost as large a share as mining, agriculture and manufacturing combined. However, since this changes little from year to year, time series figures presented as shares of GDP are reasonably comparable.
either as shares of GDP (Figures 1, 2, 3 and 5) or as shares of GRZ domestic expenditure (Figure 4).

In interpreting the charts it is important to remember that Zambia experienced rapid economic growth throughout the period under review. Real GDP grew at an average annual rate of 5.8% between 2002 and 2011 (see Table 2). This means that GDP was 75% larger at the end of 2011 than at the start of 2002. Since GDP is the denominator for most of the ratios presented here, most ratios show a declining trend even when the numerator has increased – unless the increase exceeded 75% in real terms.
### Table 1. Zambian fiscal trends, 2002–2011

<table>
<thead>
<tr>
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<th>Actual (ZMK billion)</th>
<th>As % of Total Domestic Expenditure</th>
<th>As % of GDP</th>
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</table>
| **Total Revenue & Grants**
(excluding HIPC Debt Reduction)|
<p>| Total Revenue | 4,256 | 5,104 | 6,173 | 7,467 | 8,415 | 10,626 | 12,606 | 12,182 | 15,198 | 20,969 | 78.2 | 81.6 | 90.5 | 84.9 | 82.2 | 81.6 | 83.3 | 77.4 | 80.0 | 89.5 |
| Income taxes   | 1,241 | 1,610 | 2,032 | 2,416 | 2,901 | 3,765 | 4,673 | 4,838 | 6,914 | 10,655 | 7.6  | 7.8  | 7.8  | 7.5  | 7.5  | 8.1  | 8.5  | 7.5  | 8.9  | 11.4 |
| VAT            | 812    | 1,034 | 1,362 | 1,633 | 1,792 | 2,231 | 2,215 | 2,475 | 3,160 | 3,973  | 5.0  | 5.0  | 5.2  | 5.1  | 4.6  | 4.8  | 4.0  | 3.8  | 4.1  | 4.3  |
| Excise taxes   | 423    | 482    | 607   | 768   | 821   | 1,205 | 1,418 | 1,024 | 1,377 | 1,665  | 2.6  | 2.3  | 2.3  | 2.4  | 2.1  | 2.6  | 2.6  | 1.6  | 1.8  | 1.8  |
| Customs duties | 367    | 409    | 544   | 656   | 744   | 916   | 1,324 | 1,089 | 1,250 | 1,725  | 2.2  | 2.0  | 2.1  | 2.0  | 1.9  | 2.0  | 2.4  | 1.7  | 1.6  | 1.8  |
| Total Tax Revenue | 2,843 | 3,535 | 4,546 | 5,473 | 6,258 | 8,116 | 9,630 | 9,426 | 12,700 | 18,018 | 17.4 | 17.2 | 17.5 | 17.1 | 16.2 | 17.6 | 17.5 | 14.6 | 16.4 | 19.3 |
| Non-tax revenue | 63     | 145    | 194   | 169   | 360   | 406   | 728   | 889   | 1,109 | 1,501  | 1.8  | 3.2  | 3.7  | 2.5  | 4.5  | 3.9  | 5.9  | 6.7  | 6.4  | 6.9  | 0.4  |
| Tax revenue (excl. mining) | 2,843 | 3,535 | 4,546 | 5,348 | 6,039 | 7,465 | 8,854 | 9,025 | 11,612 | 13,792 | 79.5 | 78.4 | 86.8 | 80.5 | 75.0 | 71.4 | 67.7 | 67.3 | 63.2 | 17.4 |
| Non-tax revenue (excl. royalties) | 60   | 122    | 194   | 130   | 301   | 338   | 443   | 654   | 697   | 633   | 1.7  | 2.9  | 3.7  | 2.0  | 3.7  | 3.2  | 3.6  | 4.9  | 4.0  | 2.9  | 0.4  |
| Mining Taxes    | na     | na     | na    | 125   | 219   | 650   | 776   | 401   | 1,088 | 4,226  | na   | na   | na   | 1.9  | 2.7  | 6.2  | 6.2  | 3.0  | 63.2  | na   | na   | na   | 0.4  | 0.6  | 0.7  | 0.8  | 0.7  | 1.0  | 0.9  | 0.7  | 0.4  |
| Mining Royalties | 3    | 13     | na    | 39    | 59    | 68    | 285   | 235   | 412   | 868   | 0.1  | 0.3  | 0.6  | 0.7  | 0.6  | 2.3  | 1.8  | 2.4  | 4.0  | 0.0  | 0.1  | 0.1  | 0.2  | 0.1  | 0.5  | 0.4  | 0.5  | 0.9  |
| Total Mining Revenue | na  | na     | na    | 164   | 278   | 717   | 1,061 | 636   | 1,500 | 5,095  | na   | na   | na   | 2.5  | 3.4  | 6.9  | 8.5  | 4.8  | 8.7  | 23.4  | na   | na   | na   | 0.5  | 0.7  | 1.6  | 1.9  | 1.0  | 1.9  | 5.5  |
| Grants | 1,350 | 1,424 | 1,433 | 1,825 | 1,797 | 2,104 | 2,248 | 1,867 | 1,389 | 1,450  | 37.7 | 31.6 | 27.4 | 27.5 | 22.3 | 20.1 | 18.1 | 14.0 | 8.0  | 6.6  | 8.3  | 6.9  | 5.5  | 5.7  | 4.7  | 4.6  | 4.1  | 2.9  | 1.8  |
| Budget Support | 314    | 229    | 258    | 543   | 423   | 582   | 660   | 879   | 912   | 602   | 9.1  | 5.1  | 4.9  | 8.2  | 5.3  | 5.6  | 5.3  | 6.6  | 5.3  | 2.8  | 2.0  | 1.1  | 1.0  | 1.7  | 1.1  | 1.3  | 1.2  | 1.4  | 1.2  | 0.6  |
| Project | 1,026 | 1,195 | 1,175 | 1,282 | 1,374 | 1,522 | 1,587 | 988   | 477   | 847   | 28.7 | 26.5 | 22.4 | 19.3 | 17.1 | 14.6 | 12.8 | 7.4  | 2.8  | 3.9  | 6.3  | 5.8  | 4.5  | 4.0  | 3.6  | 3.3  | 2.9  | 1.5  | 0.6  | 0.9  |
| HIPC / MDRI Debt Reduction* | 8,410 | 8,410 | 8,410 | 8,410 | 8,410 | 8,410 | 8,410 | 8,410 | 8,410 | 8,410 | 104.5 | 22.8  |</p>
<table>
<thead>
<tr>
<th></th>
<th>Actual (ZMK billion)</th>
<th>As % of Total Domestic Expenditure</th>
<th>As % of GDP</th>
</tr>
</thead>
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<tr>
<td>Wages</td>
<td>1,301</td>
<td>1,278</td>
<td>2,012</td>
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<td>Arrears Repayment</td>
<td>147</td>
<td>52</td>
<td>84</td>
</tr>
<tr>
<td>Total Non-Discretionary (incl. wages)</td>
<td>2,108</td>
<td>2,573</td>
<td>2,994</td>
</tr>
<tr>
<td>Discretionary Balance (excl. wages)</td>
<td>1,469</td>
<td>1,936</td>
<td>2,244</td>
</tr>
<tr>
<td>Of which:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fertiliser Support</td>
<td>na</td>
<td>na</td>
<td>na</td>
</tr>
<tr>
<td>FRA Maize Purchase</td>
<td>na</td>
<td>na</td>
<td>na</td>
</tr>
<tr>
<td>Road upgrading</td>
<td>43</td>
<td>55</td>
<td>23</td>
</tr>
<tr>
<td>Overall Fiscal Balance (deficit) (incl. grants, excl. HIPC debt reduction)</td>
<td>-830</td>
<td>-1,233</td>
<td>-746</td>
</tr>
<tr>
<td>Nominal GDP (Kwacha billion)</td>
<td>16,324</td>
<td>20,551</td>
<td>25,993</td>
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<tr>
<td>Nominal GDP (US$ million)</td>
<td>3,711</td>
<td>4,342</td>
<td>5,439</td>
</tr>
<tr>
<td>ODA Net, all donors (US$ million), includes HIPC</td>
<td>811</td>
<td>775</td>
<td>1,130</td>
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3 REVENUE, AID, EXPENDITURE AND FISCAL DEFICITS

This section looks at aggregate fiscal trends – revenue (plus aid), expenditure and fiscal deficits – as illustrated in Figure 1.

Figure 1. Revenue, expenditure & fiscal deficit (after grants) as % of GDP

3.1 Revenue

Table 1 and Figure 1 reveal striking trends in GRZ revenue. The third line from the top in Figure 1 shows total revenue, comprising non-mining tax revenue, non-tax revenue (excluding mineral royalties) and mining taxes (plus royalties). Total revenue was fairly stable (at around 17–18% of GDP) between 2002 and 2008. It then dropped sharply from 18.8% of GDP in 2008 to 16.0% in 2009 following the global financial crisis, before rebounding to 20.9% in 2011. To understand this pattern it is useful to examine the contrasting trends in non-mining and mining revenue. We start with the former.

3.1.1 Non-mining revenue

Non-mining revenue comprises tax and non-tax revenue. Non-mining tax revenue declined gradually from 17.4% of GDP in 2002 to 16.1% in 2008. It then dropped sharply to 14.0% in 2009 and had only recovered slightly to 14.8% by 2011. The drop in 2009 was largely attributable to the global financial crisis. The sudden depreciation of the kwacha which
followed the fall in copper prices in 2008\textsuperscript{4} led to reduced imports, particularly of motor vehicles, contributing to the reduction in excise taxes and customs duties in Table 1. However, the deterioration in non-mining tax revenue started well before the crisis.

Some of the deterioration is a result of Zambia honouring its commitments to reduce import taxes under regional trading agreements such as the SADC Trade Protocol. However, while it is not possible here to quantify the impact of different factors, much of the deterioration results from the increased use of tax exemptions to attract investment (e.g. Multi Facility Economic Zones) or to meet short-term political objectives. An example of the latter was the cut in September 2008 of excise duties on petrol and diesel from 60% and 30% to 36% and 7% respectively to offset the impact of rising world prices. Even though world prices fell sharply soon after duties were not revised until January 2010, when diesel excise duty (but not petrol) was raised from 7% to 10%. Tax revenue from oil products (customs, excise and VAT) fell from 2.8% of GDP in 2008 to 1.6% in 2009 (Whitworth 2011).

The decline in non-mining tax revenue was offset somewhat by increases in non-tax revenue (excluding royalties, see below) from 0.4% of GDP in 2002 to 0.7% in 2011.

### 3.1.2 Mining revenue

Despite Zambia’s considerable mineral resources, the mining sector contributed little to GRZ revenue following nationalisation in 1972.\textsuperscript{5} Following privatisation of the mines at the turn of the century, there was much public frustration when the subsequent boom in copper prices did not immediately lead to greatly increased GRZ revenue. There are a number of reasons for this. First, because the mines were privatised at a time when copper prices were at historic lows GRZ was forced to offer generous tax concessions when negotiating the Development Agreements. Second, the new owners had to invest large amounts to clear the backlog of maintenance and investment inherited from Zambia Consolidated Copper Mines (ZCCM). As in most tax regimes, they were able to use accelerated depreciation of this investment and to carry forward losses to offset taxable income in subsequent years. It has also been suggested that some mines used transfer pricing and hedging to evade tax, though no hard evidence has been made public.

Responding to public pressure, the 2008 Budget Address announced a number of new revenue measures designed to increase GRZ’s share of mining profits\textsuperscript{6} – see Manley (2012) for details. However, some mines refused to pay the new taxes (citing the fiscal stability clause in their Development Agreements), particularly the ‘windfall’ tax. Following the global financial crisis

\textsuperscript{4}The exchange rate to the US Dollar dropped from an average of ZMK 3,747 in 2008 to ZMK 5,045 in 2009, before strengthening somewhat to ZMK 4,797 in 2010.

\textsuperscript{5}Mining had a substantial negative fiscal impact prior to privatisation, as GRZ bailed out ZCCM’s losses. This peaked at -4.1% of GDP in 2000.

\textsuperscript{6}With high copper prices, the IMF (2008a) anticipated mining revenues increasing substantially to 4.6% of GDP in 2009.
and a sharp (though short-lived) fall in copper prices, some marginal mines stopped production. Fearing further job losses on the Copperbelt, GRZ reversed some of the 2008 revenue measures in the 2009 Budget.

Mining revenue is divided into two categories – tax and royalties – in Table 1, though they are combined in Figure 1. Mining taxes were insignificant until 2005, when they represented 0.4% of GDP. They increased to 1.4% of GDP in 2007 and 2008, as profits grew and tax depreciation allowances and carried forward losses started to taper off. Following the dispute over the 2008 tax regime, mining taxes fell to 0.6% of GDP in 2009. Agreement was eventually reached between GRZ and most mines on the revised (2009) tax regime and, as part of the deal, tax arrears from 2008 were cleared during 2010 and 2011. Payments were equivalent to 0.5% and 1.9% of GDP respectively; the 'one-off' arrears payment in 2011 comfortably exceeded the total amount of normal tax paid in any previous year. Along with the rebound in world copper prices since 2008 and growing production volumes, this helped increase mining tax to 4.5% of GDP in 2011 – easily the highest level since privatisation.

Mining royalties are not based on profits, but are levied as a fixed percentage of the value of a firm’s sales of a particular mineral. They are classified as non-tax revenue by the IMF but are highlighted separately in Table 1, which shows a significant increase in royalties since 2005. The most significant revenue measure in the 2008 Budget not to be reversed in 2009 was the increase in the royalty rate on copper from 0.6% of gross sales value in the Development Agreements to 3%. As a result, revenue from royalties increased from 0.1% of GDP in 2007 to 0.9% in 2011.

Table 1 and Figure 1 show that the combined value of mining tax and royalties jumped sharply from 1.9% of GDP in 2010 to 5.5% in 2011. As a result, total revenue (the third line from the top of Figure 1) jumped from 17.8% of GDP in 2010 to 20.9% – the highest level this century. Although the 2011 figure is distorted by the ‘one-off’ payment of arrears (1.9% of GDP), the doubling of the royalty rate on base metals to 6% in the 2012 Budget means that Total Mining Revenue (tax plus royalties) is unlikely to return to previous levels. While there is still controversy over the appropriate mineral tax regime for Zambia, a decade after privatisation the mining sector has finally become a significant source of GRZ revenue.

### 3.2 Aid

For much of its history Zambia has been dependent on foreign aid to supplement GRZ revenue. During the 1980s and 1990s it was one of the most aid dependent countries in the world. However, aid’s fiscal significance has greatly diminished in recent years.

The collection of historic aid data by the Ministry of Finance and National Planning is erratic and its quality inconsistent. While the Development Cooperation Report 2009 (GRZ 2010b) represents a serious attempt to compile consistent time series of aid data, it only covers the

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7 Company income taxes are paid in the year following the year in which profits are earned.
period 2006 to 2009. As a result, the sharp drops between 2002 and 2011 in project grants (from 6.3% of GDP to 0.9%) and donor-funded capital expenditure (from 9.2% of GDP to 2.1%) should be treated with caution.

Though much less detailed than locally collected data, the most consistent aid data available for the period 2002–2011 is that published by the Organisation for Economic Cooperation and Development (OECD 2012). The last row of Table 1 shows total net aid to Zambia, as reported to the OECD by donor headquarters, in US dollar terms.\(^8\) In 2002 aid was equivalent to 21.9% of GDP and 97.6% of Total Domestic Expenditure. OECD data shows total aid increasing from $811 million in 2002 to $1,267 million in 2009, before falling to $1,046 million in 2011.\(^9\) Despite the nominal increase, aid’s share of GDP declined sharply from 21.9% in 2002 to 5.4% in 2011.\(^10\) This largely reflects the rapid growth in GDP since the turn of the century and is exaggerated by the sharp appreciation of the kwacha–US dollar exchange rate in 2006.\(^11\) With GDP expected to continue growing faster than aid over the medium term, the ratio is likely to continue to fall. Zambia is no longer aid dependent.

Note that the ‘one off’ HIPC/MDRI debt reduction grants in 2006 (discussed below), equivalent to 21.8% of GDP, are omitted from Figure 1 so as to avoid distorting the underlying trend.

### 3.3 Total expenditure and the fiscal deficit

The top line of Figure 1 shows trends in total expenditure. This fell sharply from 31.2% of GDP in 2002 to 23.5% in 2006, before stabilising. However, this should be interpreted with caution because it mainly reflects estimates of donor-funded capital expenditure (i.e. project aid), the reliability of which is doubtful. Fortunately, this does not affect data on the deficit. The difference between “total revenue and grants”, on the one hand, and “total expenditure” on the other is the “overall fiscal deficit (after grants)”. This is shown in red in Figure 1. The deficit was 7.9%, 5.1% and 6.0% of GDP in 2001, 2002 and 2003 respectively – a continuation of the unsustainable levels of the 1990s.

The year 2004 was a watershed in Zambian fiscal performance. Expenditure was cut significantly and the deficit was halved. This is best seen by looking at total domestic expenditure in Table 1 and Figure 5. Trends in domestic expenditure are a better indicator of GRZ fiscal performance than total expenditure because they exclude donor-funded capital expenditure and represent resources controlled by GRZ. From 21.9% of GDP in both 2002 and

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8 Development Cooperation Report estimates of aid received between 2006 and 2009 are significantly lower than the OECD estimates (averaging $743 million per annum), primarily because they exclude debt relief and aid which is not channelled through GRZ (GRZ 2010b).

9 Aid increased substantially between 2003 and 2004. If HIPC/MDRI debt relief in (mainly) 2006 is excluded, aid was essentially flat at a bit over $1 billion per year between 2004 and 2009.

10 According to the Development Cooperation Report, aid to government in 2009 was equivalent to 6.7% of GDP and 28.7% of central government expenditure (GRZ 2010b, 3).

2003, domestic expenditure fell to 20.2% in 2004. This appears to reflect a serious effort to reduce expenditure and the deficit, which dropped from 6.0% of GDP in 2003 to 2.9% in 2004. The deficit continued to decline, reaching a healthy 1.6% of GDP in 2006. This level of expenditure was sustained until 2007, when it jumped to 22.6% of GDP. By then the fiscal deficit had been brought under control.

So, by reducing expenditure – and assisted by rapid growth in GDP (the denominator) – it took just three years for the GRZ to bring an end to decades of unsustainable deficits. It is unclear how much this reflected a conscious policy decision to establish fiscal discipline (perhaps motivated by the prospect of debt relief) and how much simply reflected the fact that fiscal management is easier when GDP is growing.

Since reaching an exceptionally low level of 0.9% of GDP in 2008\textsuperscript{12} the fiscal deficit has increased, while remaining within manageable limits. GRZ responded (appropriately for macro-economic stability) to the sharp fall in revenue in 2009 following the global financial crisis by both cutting domestic expenditure by 2.0% of GDP and increasing the deficit to 2.5% in 2009. The deficit jumped further to 3.1% and 3.0% in 2010 and 2011 respectively, largely because of unbudgeted expenditure (1.2% and 1.1% of GDP respectively) to finance the Food Reserve Agency’s purchase of maize from smallholder farmers at above-market prices following two successive record maize harvests. This is discussed below.

\textsuperscript{12} The deficit outturns between 2006 and 2008 were smaller than budgeted, reflecting the inability of ministries to spend increased appropriations – particularly on capital projects.
## Table 2. Zambian debt trends, 2002–2011

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<th>Actual (ZMK billions)</th>
<th>As % of GDP</th>
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<tbody>
<tr>
<td>GRZ external debt</td>
<td></td>
<td></td>
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<tr>
<td>Debt stock</td>
<td>29,053</td>
<td>32,108</td>
</tr>
<tr>
<td>Interest bill (external)</td>
<td>210</td>
<td>229</td>
</tr>
<tr>
<td>GRZ domestic debt</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net Claims on Govt (Securities less Deposits)</td>
<td>1,744</td>
<td>2,709</td>
</tr>
<tr>
<td>Credit to Parastatals</td>
<td>94</td>
<td>116</td>
</tr>
<tr>
<td>Non-bank public holdings of Govt Securities</td>
<td>591</td>
<td>787</td>
</tr>
<tr>
<td>Total GRZ Domestic Credit</td>
<td>1,838</td>
<td>3,416</td>
</tr>
<tr>
<td>Treasury Bill Yield (weighted average), Interest bill (domestic)</td>
<td>35.8</td>
<td>31.9</td>
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<tr>
<td>Credit to the private sector</td>
<td>1,019</td>
<td>1,390</td>
</tr>
<tr>
<td>Nominal GDP</td>
<td>16,324</td>
<td>20,551</td>
</tr>
<tr>
<td>GDP Growth, % (constant prices)</td>
<td>3.3</td>
<td>5.1</td>
</tr>
<tr>
<td>Consumer price inflation %</td>
<td>26.7</td>
<td>17.2</td>
</tr>
</tbody>
</table>
4 DEBT AND INTEREST

This section shows how trends in public debt both benefitted from and contributed to the improvement in fiscal performance, and how this helped reduce crowding out of private sector borrowing. Key trends from Table 2 are illustrated in Figures 2 and 3.

Table 2 and Figure 2 show the trend in the GRZ interest bill, broken down between interest on domestic and foreign public debt. While public attention has focused on the reduction in foreign debt as a result of Zambia reaching HIPC Completion Point, Figure 2 shows that: (a) domestic interest has been much larger than foreign interest throughout the period; and (b) reductions in domestic debt have been more important in cutting the GRZ interest bill. Foreign interest fell from 1.3% of GDP in 2002 to 0.1% in 2011. Domestic interest fell even more, from 2.8% of GDP in 2002 to 1.1% in 2011. The reductions in the two categories of interest have quite different explanations. Each will be examined in turn, beginning with foreign debt.

Figure 2. Domestic and foreign interest as % of GDP

4.1 Foreign debt

Table 2 shows trends in the stocks of both external and domestic debt. The cumulative result of the persistent fiscal deficits from the 1970s onwards was that, prior to debt relief, Zambia had the highest foreign public debt per capita in the world. It can be seen that the stock of external debt in 2002 (at ZMK 29.1 trillion, or 178% of GDP) dwarfed the domestic debt stock (ZMK 1.8 trillion, or 11% of GDP). However, when Zambia reached HIPC Completion Point in 2005 most of its external debt was forgiven and the debt stock dropped dramatically from ZMK 27.9
trillion (87% of GDP) in 2005 to just ZMK 3.5 trillion (9%) in 2006. As a result, Zambia now has one of the lowest levels of external debt in Africa and is in a strong position to increase its borrowing. At current levels, foreign debt has negligible fiscal significance.

However, even before Completion Point the cost of foreign debt was much lower than for domestic debt because interest rates were much lower. Nearly all the foreign debt was highly concessional, with interest rates of the order of 1%–2%, whereas domestic interest rates were (and remain) essentially market determined (see Treasury Bill yields in Table 2).

The reduction in foreign interest following Completion Point was much less dramatic than that of the debt stock. This was because Zambia started benefitting from ‘interim’ debt relief as soon as it joined the HIPC scheme (termed ‘Decision Point’) in 2000 (IMF 2008b). Much of the reduction in interest occurred then.\textsuperscript{13} The main significance of Completion Point was that interim debt relief became irrevocable and most foreign debt was formally forgiven.

\section*{4.2 Domestic debt}

While the reduction in foreign interest is almost entirely attributable to debt relief (by foreigners), domestic interest savings are due to three distinct factors: (1) lower borrowing resulting from improved fiscal management from 2004,\textsuperscript{14} (2) GDP growth, and (3) falling interest rates.

The reduction in the fiscal deficit since 2004 enabled GRZ to reduce its level of domestic borrowing. Table 2 shows that total GRZ Domestic Credit\textsuperscript{15} increased in nominal terms from ZMK 3,416 billion to ZMK 5,292 billion between 2003 and 2008. However, in real terms (after adjusting for inflation), this represented a decline of about 17% over the period.

The impact of lower borrowing was magnified by economic growth. As noted, GDP growth averaged 5.8% a year between 2002 and 2011. The combined effect of a real reduction in the debt stock (numerator) and relatively rapid growth (denominator) was a reduction in the domestic debt to GDP ratio from 16.6% in 2003 to 9.7% in 2008.\textsuperscript{16} There was a temporary reversal in the trend in 2009 and 2010 following the global financial crisis. The increase in the fiscal deficit and unbudgeted maize purchases meant that GRZ domestic credit increased to 10.8% and 11.8% of GDP respectively. The downward trend resumed in 2011, reaching 9.1% – its lowest level this century.

\textit{Ceteris paribus}, lower government expenditure and borrowing reduces inflationary pressure. The reduction in GRZ borrowing undoubtedly contributed to the substantial reduction in

\textsuperscript{13} Foreign interest due fell from 5% of GDP in 1998 (Hill and McPherson 2004, 85) to 1.3% in 2002.

\textsuperscript{14} This also contributed to foreign debt relief because successful implementation of an IMF programme for at least a year was a condition for reaching Completion Point.

\textsuperscript{15} This is defined as Net Claims on Government (securities less deposits) plus Credit to Parastatals plus Non-bank public holdings of Government Securities.

\textsuperscript{16} Growth also magnified the reduction in the foreign debt to GDP ratio.
inflation from 26.7% in 2002 to 7.2% in 2011 (Table 2). Along with the general improvement in macro-economic stability, this facilitated a reduction in interest rates. Government borrowing takes a number of forms and there is no single interest rate applicable to all domestic debt. Table 2 presents time series data for the weighted average Treasury Bill yield, probably the best indicator of trends in domestic interest rates. It can be seen that yields dropped from 35.8% in 2002 to 16.0% in 2008, though the trend was highly erratic. There was a further sharp fall to 9.4% in 2009 and 8.0% in 2010 as a result of the contraction in credit to the private sector following the global financial crisis and increased demand for Treasury Bills by commercial banks. Private sector credit rebounded in 2011 and yields increased to 10%. Falling yields offset the impact on the domestic interest bill of the (temporary) increase in domestic credit in 2009 and 2010.

The significant reduction in the domestic interest bill since 2004 reflects the combined effects, therefore, of both a lower debt stock and falling interest rates. Zambia has experienced a ‘virtuous circle’ of lower borrowing facilitating lower interest rates, leading to a reduction in the interest bill which in turn facilitates further reductions in borrowing, inflation and interest rates, and so on.

Another important benefit of reduced GRZ borrowing is the impact on “crowding out” of the private sector. When governments borrow domestically to finance fiscal deficits they both reduce the supply of finance available to the private sector and increase its cost – the interest rate. This discourages private investment and growth. Conversely, when government borrowing is reduced interest rates are likely to fall and private sector borrowing increase.

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17 Interest rates changes are not always reflected in the interest bill for the year in which they occur because payment for Treasury Bills is only made upon maturity.
Figures for credit to the private sector in Table 2 are consistent with the thesis that crowding out has decreased since 2003. Interestingly, Treasury Bill yields started falling (from 35.8% in 2002 to 31.9% in 2003) and credit to the private sector started increasing before GRZ domestic borrowing started to decrease in 2004. This is not surprising since government borrowing is not the only factor influencing yields and private borrowing; factors such as inflation and growth in the mining sector are also important. Nevertheless, the fact that credit to the private sector increased from 6.8% of GDP in 2003 to 14.7% in 2008 while total GRZ domestic credit declined from 16.6% to 9.7% over the same period strongly suggests that improved fiscal management has helped reduce crowding out of the private sector. Figure 3 shows that credit to the private sector overtook GRZ domestic debt in 2007. While both trends were temporarily reversed in 2009 and 2010, this reflected commercial banks’ risk aversion to private sector lending in the wake of the global financial crisis rather than crowding out by GRZ. Private sector credit resumed its upward path in 2011.
5 BREAKDOWN OF DOMESTIC EXPENDITURE

This section looks at the breakdown of total domestic expenditure, illustrated in Figures 4 and 5, and shows how lower interest costs in particular have increased GRZ fiscal space.

Figure 4. Breakdown of domestic expenditure (%)

Figure 4 shows trends in certain expenditure categories expressed as percentages of GRZ domestic expenditure, i.e. total expenditure minus donor-funded capital expenditure. In particular, it illustrates the increase in the GRZ “discretionary balance” over the period – i.e. that part of the budget over which GRZ can exercise real control. This is more meaningful than changes in total expenditure.

The term “discretionary balance” is used here rather than the more commonly used term “fiscal space”,18 to which it is virtually equivalent. To understand the concept it is easiest to look at what is “non-discretionary”. Certain categories of expenditure, such as interest, elections and the salaries of constitutional office holders, are “constitutional”; they have to be paid under the Constitution and are not subject to the normal budget process. Where legislation provides that a proportion of fuel taxes shall be earmarked for road maintenance, this is also non-discretionary.

18 The term refers to the flexibility of a government in its spending choices, or “room in a government's budget that allows it to provide resources for a desired purpose without jeopardizing the sustainability of its financial position or the stability of the economy” (Heller 2005).
Arguably, the public service wage bill can also be considered non-discretionary. While governments have a degree of control over the number of public servants and wage rates over the long term, in the short term it is very difficult to cut the wage bill.

There is no single internationally accepted definition of discretionary expenditure. However, precision is not required here. As long as the chosen definition is applied consistently it can be used to highlight key trends. For present purposes, the following expenditure categories are treated as non-discretionary: wages, interest and repayment of arrears.

The public service wage bill is much the largest single category of GRZ expenditure. While this is true for most governments, the Zambian wage bill share is high by regional standards. Figure 4 shows it declining from 38.3% of domestic expenditure in 2003 to 33.8% in 2007; it then rebounded to 39.4% in 2009 before falling back to 33.9% in 2011.\(^{19}\)

Domestic and foreign interest declined from 12.6% and 5.9% of domestic expenditure in 2002 to 4.6% and 0.3% respectively in 2011. This represents a substantial release of resources from debt service which is available for more productive purposes.

As well as large fiscal deficits, fiscal indiscipline is frequently associated with the accumulation of arrears. Repayment of arrears represented between 1.2% and 5.2% of total expenditure between 2002 and 2011.

Deducting the above expenditure categories from the total leaves the “discretionary balance”, the top segment in Figure 4. This is an \textit{indicator}, not a measure, of fiscal space. It can be seen that the balance increased from 41.1% of domestic expenditure in 2002 to 59.4% in 2011. While the measure of discretionary balance adopted here should not be taken too literally, Figure 4 shows that GRZ had control over a much larger proportion of its expenditure in 2011 than in 2002.

Figure 5 shows trends in total domestic expenditure as a \textit{share of GDP}, broken down as in the previous figure. A number of features stand out. First, as noted above, total expenditure fell from 21.9% of GDP in 2003 to 20.2% in 2004 as GRZ took measures to cut the fiscal deficit.\(^{20}\) Second, following three years of suppressed expenditure during which the deficit was brought under control, total domestic expenditure returned to the level of the early 2000s between 2007 and 2010. Third, substantial pre-election spending on road upgrading and agriculture subsidies (discussed below) pushed expenditure to 23.4% of GDP in 2011 – its highest level this century.

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\(^{19}\) The (unweighted) average share of the wage bill in a recent informal IMF survey of 13 African countries was 25.7% of total expenditure (personal communication).

\(^{20}\) The expenditure reduction was about 1% in \textit{real} terms. Much of the reduction in the ratio reflected GDP growth.
Figure 5 also highlights the importance of the public service wage bill in recent fiscal trends. After interest, the wage bill was the main factor accounting for the reduction in total expenditure from 2004 (dropping from 8.4% of GDP in 2003 to 7.3% in 2006). It represented about 8.0% of GDP between 2008 and 2011.
6 HOW HAS FISCAL SPACE BEEN USED?

Taking the discretionary balance as an approximation of fiscal space, Table 1 and Figure 5 show that fiscal space increased by 4.9% of GDP between 2002 and 2011. Given that real GDP itself grew by 75% over the period, this represents a substantial increase in resources available to GRZ. Following some 30 years during which it had negligible control over its own expenditure, GRZ finally has significant fiscal space at its disposal. Now it is in a position to make real decisions on resources how has it chosen to allocate them?

As noted above, one factor contributing to the increase in fiscal space was debt relief. Zambia was one of the largest beneficiaries per capita of the HIPC and MDRI debt relief initiatives. The principal argument underpinning both initiatives was that debt relief would release resources being used unproductively for debt service in poor countries (i.e. create fiscal space) and allow it to be used instead for poverty reducing public expenditure. Is GRZ using its extra resources to reduce poverty? Or have those who wrote off Zambia’s debts been double-crossed? As a backdrop, it should be noted that Zambia’s impressive growth performance in recent years has had relatively little impact on poverty. “The proportion of the population falling below the poverty line reduced from 62.8% in 2006 to 60.5% in 2010” while the “percentage of the extremely poor marginally declined from 42.7% to 42.3%” (GRZ 2012).

Like the concept itself, assessing how fiscal space is used is an imprecise science. The findings can vary depending on the periods compared and additional public expenditure cannot be attributed to growing fiscal space with certainty. Nevertheless, while the figures below should be treated with caution, they suggest that most of the fiscal space created in recent years has been spent on three programmes, each of which represents an inefficient use of resources with little impact on poverty reduction: (1) fertiliser subsidies, (2) maize purchase, and (3) paving roads. Since the focus of this paper is on macro/fiscal performance, only a brief introduction to the three programmes is given here; references are provided to detailed sources.

6.1 Farmer Input Support Programme

Since 2002 the Farmer Input Support Programme (FISP, formerly known as the Fertiliser Support Programme) has received the majority of the agricultural budget aimed at poverty reduction. GRZ procures fertiliser and seed and sells it to smallholder farmers at subsidised rates. However, the scheme has been plagued by a number of problems. First, the delivery of FISP inputs to farmers is frequently delayed. Second, FISP inputs are targeted at and disproportionately captured by a small minority of larger, wealthier farmers. Third, the standardised FISP input pack is not appropriate for many of Zambia’s diverse soil and agro-ecological systems. Subsidising inappropriate inputs leads to maize mono-cropping and low yields. Fourth, GRZ direct procurement of fertiliser has crowded out private agro-dealers in some regions.
Despite the lack of any evidence that it has helped reduce rural poverty,\textsuperscript{21} Table 1 shows that expenditure on FISP increased from 0.5% of GDP (2.4% of domestic expenditure) in 2005 to 1.0% of GDP (4.1% of expenditure) in 2011.\textsuperscript{22}

### 6.2 Food Reserve Agency maize purchase

The Food Reserve Agency (FRA) is mandated to maintain strategic food reserves to ensure food security in the event of poor harvests. It also purchases surplus maize at guaranteed prices from smallholder farmers. Until 2010 these operations cost between 0.1% and 0.4% of GDP (1%–2% of domestic expenditure, see Table 1). Following good rains, the maize harvest increased by 48% to 2.8 million tonnes in 2010 – a record – and the marketed surplus increased substantially. Critically, lobbying by the Zambia National Farmers Union had resulted in a guaranteed price well above most farmers’ production costs and some 50% above market prices. As a result, private traders were crowded out and FRA ended up purchasing most of the marketed surplus. The bill ballooned to 1.6% of GDP in 2010 and, since the budget was only 0.4% of GDP, FRA maize purchases were largely responsible for the 2010 fiscal deficit target being overshot.

Although the rains were less good, Zambia had a second successive record maize harvest in 2011 – partly because farmers switched from other crops into maize in response to guaranteed above-market prices (Mason et al. 2011). Although by now FRA stocks exceeded storage capacity (causing much maize to rot), with an election due in September 2011, the government was reluctant to reduce the guaranteed price or restrict FRA purchases. As a result, FRA’s maize purchase bill increased still further to 1.8% of GDP in 2011 – again (with a budget of 0.7% of GDP) causing the deficit target to be missed.

If these subsidies to maize producers were clearly benefitting the poor they might be justified despite the damage to GRZ finances and private traders. However, “the benefits of the FRA maize support prices are disproportionately enjoyed by the relatively large farmers over 5 hectares, even though they constitute only 3.8% of the smallholder farm population”, while most Zambians who are net maize purchasers lose through paying higher prices (Jayne et al. 2011).

### 6.3 Paving roads

The third area to experience substantially increased expenditure in recent years is road upgrading. Following decades of neglect, Zambia has a large backlog of maintenance and rehabilitation, mainly on the unpaved road network. While funding for maintenance has increased somewhat, most additional GRZ funding has been addressed not at the backlog but at...
upgrading a small proportion of the unpaved network to fully engineered paved standard; upgrading expenditure increased from 0.1% of GDP in 2005 to 1.6% in 2011 (Table 1). As shown elsewhere, few of these projects have sufficient traffic potential to be economically viable (Raballand and Whitworth 2012). Decisions were taken at the political level with little, if any, technical/economic appraisal. Paving roads is of little benefit to the poor and is crowding out funding for maintenance and rehabilitation of the unpaved network – activities with much better economics and benefitting far more poor people.

Table 3 compares the growth in expenditure on the above three programmes (as shares of GDP) with growth in the discretionary balance for the periods 2005 to 2010 and 2005 to 2011. Over the former period their combined growth in expenditure accounted for 2.2% out of the 2.5% of GDP increase in the discretionary balance, while in the latter period they accounted for 3.6% out of 4.4%. This suggests that instead of utilising the fiscal space created in recent years to reduce poverty, GRZ has wasted most of it on programmes of little benefit to the poor.

Table 3. Growth in discretionary balance and selected expenditure programmes (% of GDP)

<table>
<thead>
<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td><strong>Discretionary balance</strong></td>
<td>2.5%</td>
<td>4.4%</td>
</tr>
<tr>
<td>of which:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>FISP</td>
<td>0.3%</td>
<td>0.5%</td>
</tr>
<tr>
<td>FRA</td>
<td>1.4%</td>
<td>1.6%</td>
</tr>
<tr>
<td>Road paving</td>
<td>0.5%</td>
<td>1.5%</td>
</tr>
<tr>
<td><strong>Sub-total</strong></td>
<td>2.2%</td>
<td>3.6%</td>
</tr>
</tbody>
</table>

Source: Table 1

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23 Total (GRZ and donor financed) expenditure on the roads sector, both capital and maintenance, increased from $97.4 million (0.9% of GDP) to $648.2 million (3.4%) over the same period (Raballand and Whitworth 2012).

24 Expenditure data on FISP and FRA is only available from 2005.
7 CONCLUSIONS

The time series presented here demonstrate that the Zambian macro economy has been transformed since the turn of the century, as the economic reforms of the 1990s (Hill and McPherson 2004) started to bear fruit. By far the most significant was the privatisation of the mines; boosted by booming copper prices, mining investment and production rebounded strongly, driving growth and turning the sector from a drain on fiscal resources into an increasingly important contributor. GRZ’s fiscal performance has been transformed since 2004, as it both took advantage of and reinforced economic growth. The fiscal deficit fell from 5.1% of GDP in 2002 (and 7.9% in 2001!) to a comfortable 3.0% in 2011. Remarkably, following decades as a macro-economic “pariah state”, Zambia has become a model of fiscal management.

The fiscal transformation is largely explained by three distinct developments. First, the mining recovery meant that mining revenues increased from negative or negligible amounts to 5.5% of GDP in 2011. Second, by increasing the value of the denominator, rapid economic growth reduced the “pain” required to bring down the debt-to-GDP and deficit-to-GDP ratios. Third, improved expenditure management enabled GRZ to reduce its domestic borrowing; assisted by HIPC/MDRI relief on foreign debt, this led to a reduction in interest by 2.9% of GDP over the period.

The combined effect of these developments was that GRZ’s “discretionary balance” (fiscal space) increased by 4.9% of GDP between 2002 and 2011. With real GDP growing by 75% over the period, this represents a substantial increase in resources. Zambia’s dependence on aid has fallen sharply and GRZ is funding significant levels of capital investment (particularly roads) from its own resources for the first time in decades.

This paper has focused mainly on fiscal trends. However, the above developments have also contributed to Zambia’s economic recovery in other ways. In particular, the reduction in GRZ domestic debt and interest rates has helped reduce both inflation, which fell from 26.7% in 2002 to 7.2% in 2011, and the crowding out of private borrowing, which increased from 6.2% of GDP to 12.2% over the same period.

In a context of sustained growth and macro-economic stability, the creation of substantial fiscal space means that GRZ has an unprecedented opportunity to use public expenditure to make inroads into poverty. Having had negligible fiscal space for decades, GRZ has little experience or expertise in the efficient allocation of public resources. It is perhaps not surprising, therefore, that recently created fiscal space appears so far to have been largely wasted on inefficient agriculture subsidies and uneconomic road paving projects which – while notionally aimed at poverty reduction – are of little benefit to the poor. Having finally mastered macro-

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25 The improvement is exaggerated by the payment of tax arrears from 2008 worth 1.9% of GDP.
economic management, if the rewards are not to be dissipated, GRZ needs to turn its attention to micro-economic policy and expenditure management.
REFERENCES


