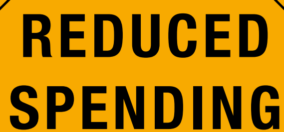

ZIPAR
Zambia Institute for Policy Analysis & Research

REDUCED DEBT ACCUMULATION

REDUCED SPENDING

INCREASED REVENUE

#ZIPARBudgetTalk

# TAKING THE ROAD LESS TRAVELLED: In Pursuit of Fiscal Consolidation

"Delivering Fiscal Consolidation for Sustainable and Inclusive Growth"

## Analysis of the 2019 National Budget

4th October 2018

Website: www.zipar.org.zm    www.facebook.com/OfficialZIPAR    Twitter: @ZiparInfo

# ZIPAR's Take in a Nutshell

For the fourth year in a row, Zambia's Budget in 2019 will focus on fiscal consolidation. Clearly, the country's approaches to fiscal management over the past few years did not deliver the desired fiscal outcomes. Most likely, this is because some worthwhile fiscal paths were not sufficiently understood or were not pursued. But, of these fiscal paths, which one should Zambia find and take in 2019? What should the authorities do in order to ensure that the 2019 Budget delivers fiscal consolidation? Taking the road less travelled will be a necessary precondition for eventually re-establishing robust, sustained and inclusive growth – but that road can be bumpy and Zambia is currently travelling over a rough section

Until relatively recently Zambia's macro-economic fundamentals were reasonably sound. Growth has been slower than expected but most macro-economic targets were being met, inflation - with a blip in August 2018 – has been within the 6-8% target and the kwacha has remained relatively stable. However, over the last few months something's changed – the fiscal position has worsened and this had fed through into a lack of investor confidence. Outturn growth has been lower than expected and since the beginning of September the kwacha has lost 20% of its value against the dollar.

Some of this can be put down to external factors, increases in Western central bank rates, a declining demand for copper and the contagion in emerging market confidence from the run on the Turkish Lira play a part. But, it also certain that high levels of debt, diminishing foreign exchange reserves and growing arrears have all contributed to the worsening macro-economic fundamentals and have left Zambia with less room to respond to external challenges.

Given this context if the macro-economic targets in the Budget can be achieved this will be a significant achievement. The key question is: are the right domestic and fiscal policy measures in place to support growth, and put Zambia on the road to recovery.

The biggest barrier on this road, and the elephant in the room, remains Zambia's debt. The 2019 Budget forecasts debt service costs for external and domestic debt to rise by K9.3 billion or 66%. This could rise further if the kwacha continues to lose value against the dollar. This represents 27.2% of all spending and 42% of domestic revenue. The Budget confirms the Government's intention to run a deficit of 6.5% of GDP, further adding to Zambia's debt burden.

In this context Zambia needs to find tax and spending policies that can deliver on the country's desire to support inclusive growth and reduce poverty, whilst delivering fiscal consolidation. This will be increasingly difficult given pressures on spending and will require a shift to private sector led growth and, despite continued investment in infrastructure (roads spending will remain over K6 billion), unfortunately the budget is largely silent on how this will be achieved. Whilst the budget contains some welcome measures on irrigation and energy that are supportive of growth, this is contrasted with a notable absence of an update on employment objectives or pro-private sector measures.

When we turn to tax and spending policy we can see clearly why private sector led growth is going to be vital. On the spending side the Government has talked of implementing austerity measures but Budget 2019 sees an increase in expenditure from K71.6 billion to K86.8 billion (28.9% of GDP).

Zambia's spending challenge flows from the cost of debt servicing. The 2019 Budget suggests this will be K1,357 per person, as much as spending per person on health, education and social protection combined. With debt servicing creating such a large cost it is easy to see why other spending gets crowded out. This becomes even clearer when you consider that the public sector wage bill accounts for over a quarter of spending, and little is being done to change this.

The large proportions of spending taken up by debt servicing and the wage bill leave little space for policies to support poverty reduction and growth- these two spending lines make up 85% of Zambia's tax revenue, so the vast majority of pro-poor and pro-growth spending is funded by debt. In spite of this, and "austerity measures", the Budget sees increases in spending on health, education and economic affairs but a small reduction in social protection spending.

The space for domestic spending is made more stark when considering the deficit. A deficit of 6.5% of GDP may sound modest but this represents new borrowing of K28.8 billion. This is despite a significant increase in the tax forecast from 17.7% to 18.7% of GDP. This increase is driven by significant forecast increases in VAT and income taxes and significant increase in mineral royalties (equivalent to 25% at current copper prices). The desire to increase revenue is welcome , but not without risks. The impact of increased taxes, at a time of declining demand, on the mining sector is uncertain and given questions around economic growth, rises in VAT and income tax are far from certain.

Fiscal consolidation needs to find the right balance between tax rises and reductions in spending, and these need to be reconciled with the need to promote. On the tax side for Zambia this may mean looking to broaden the tax base and ensure more business and labour is captured in the formal sector. In this sense the big surprise of the 2019 Budget – the move from VAT to a Sales Tax could be an interesting move, but more details are needed and it moves against

international trends toward VAT.

Borrowing the Minister's word from the 2019 Budget Speech: "We all have a legitimate and rightful stake in this country and we must all work together as a united people to make our Vision 2030 a reality". The Budget takes steps towards the Vision if the objectives and aspirations can be realised in full. However, we must be mindful of the considerable risks and challenges along the road, and 2019 Budget faces significant external and domestic risks. Importantly we must be firmly aware that we have viable solutions and pathways that would navigate the country away from the risks and challenges, and towards robust, sustained and inclusive growth, and ZIPAR's report highlights some of these solutions. Collectively we must have the presence of mind and will to find the road less travelled and the fortitude to persistently walk along that road. Stray but a little and our developmental future will fall into uncertainty.

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# 1. Introduction

The 2019 Budget Speech was read to the National Assembly on 28th September 2018. It carried the theme of "delivering fiscal consolidation for sustainable and inclusive growth", a somewhat modest variant of the 2018 Budget theme focusing on "accelerating fiscal fitness for sustained inclusive growth, without leaving anyone behind". Against the 2018 theme, ZIPAR's analysis of the 2018 Budget identified key ingredients for *staying the course of fiscal fitness*. However, it would appear that, much like a golf course, the course of fiscal fitness was perhaps too wide and unwieldy for fiscal management to readily find the right pathways to fiscal consolidation.

Meanwhile, the downside risks that emerged during 2015-2017 escalated in 2018, keeping the country at high risk of debt distress and increasing the incidence of various family, firm, and macroeconomic hardships and challenges. Fiscal restraint or austerity has now become a resounding necessity for Zambia. If the country is to eventually re-establish robust, sustained and inclusive growth, the authorities must find and take the road less travelled.

The ZIPAR Analysis of the 2019 Budget focuses on offering insights into what Zambia should do to ensure that the 2019 Budget delivers fiscal consolidation. It is premised on Dr M. Scott Peck's view that "confronting and solving problems is a painful process which most of us attempt to avoid. And [yet] the very avoidance results in greater pain and an inability to grow..." The Analysis therefore identifies the road less travelled for Zambia, pitching this as a necessary precondition for achieving fiscal consolidation and eventually, inclusive growth.

# 2. Managing Downside Risks to Macroeconomic Health

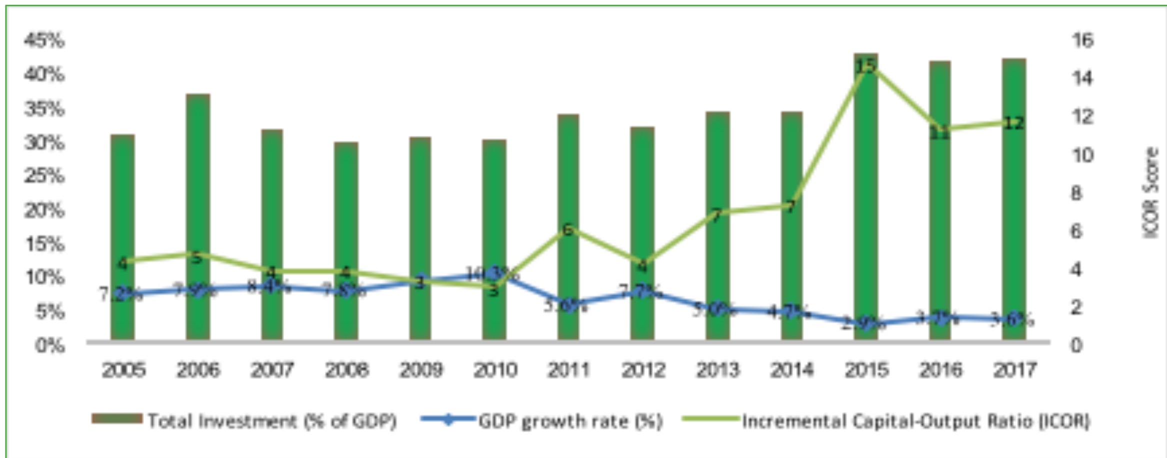
## 2.1 The Macroeconomic Case History

A short historic perspective of the recent macroeconomic health of Zambia is instructive in explaining the prospects for macroeconomic stability in 2019. Since 2014, GDP growth has fluctuated around 3.7% per year on average. In per capita terms, Zambia is making limited progress in accelerating the income growth rate beyond the rate of population growth. One of the aspirations of the Government in 2019 is therefore to promote broad-based, sustainable and inclusive growth. However, broad-based GDP growth requires the right public and private investments in building productive capacities.

One basic gauge of how GDP is being generated is the Incremental Capital-Output Ratio (ICOR). Formally, the ICOR measures and assesses the extra investment capital amount required to generate one more unit of growth. It is calculated by dividing investment as a percentage of GDP, over the GDP growth rate. The higher the ICOR value the lower the productivity of capital, or the higher the inefficiency in production.

During 2005-2010, Zambia's annual ICOR value averaged 4, implying that the country needed K4 worth of capital investment to generate an extra K1 of GDP. The country made efficiency gains in generating its GDP as shown in a declining ICOR value over the sub-period (Figure 2.1). This is corroborated by a high GDP growth rate averaging over 7% over the period. In a reversal of fortunes, from 2011, the ICOR increased markedly until 2017 (except in 2012); it averaged 9 during this latter period, implying that Zambia now needed K9 of capital investment to generate an extra K1 of GDP. One of the reasons for this maybe that investments of the recent past delivered relatively less growth-enhancing capital formation. As production efficiencies declined, so did GDP growth.

*Figure 2.1:Incremental Capital Output Ratio (ICOR), Zambia, 2005-2017*




*Source: Constructed from IMF World Economic Outlook (April 2018) data*

Zambia is a relatively small open economy susceptible to exogenous economic fluctuations. Firstly, it is highly exposed to fluctuations in international prices of copper – Zambia's main export and major source of foreign exchange earnings. In 2015, copper prices plummeted, *inter alia*, caused the Kwacha to lose close to 60% of its annual value compared to 2014. The currency has since struggled to recover. Secondly, the exogenous vulnerability seen in the 2015 currency depreciation pushed up inflation from single digits to 21.1% by the end of the year. Fortunately, tight monetary policy saw the inflation rate subside to within the 6-8% band since end-2016. Thirdly, Zambia's international reserves have not been spared from diminishing over time, from a high of US$3.1 billion in 2014 – or approximately 4.8 months of import cover – to US$2 billion in 2017 (2.5 months of import cover), mainly due to external sector pressures, including the country's heavy import bill. In part, it is against this macroeconomic background that Zambia found itself having to apply austerity measures.

## 2.2 Macroeconomic Programming in Times of Austerity

Realising that the economy needed a lift out of this subdued growth and macroeconomic fluctuations after 2015, the authorities formulated the Economic Stabilisation and Growth Programme (ESGP) 2017-2019. The ESGP understood that entrenching macroeconomic stability through fiscal consolidation was crucial for attaining stable and sustainable growth. The ESGP was aligned to the Seventh National Development Plan (7NDP), with the latter providing developmental plan up to 2021; all building towards the Vision 2030.

Implementation of the ESGP has not been without challenges. GDP growth in 2017, at 3.4%, was short of the 3.9% ESGP target; and domestic revenues and grants were at 5% below target. Total expenditures excluding amortisation were below target by 6.3% and the fiscal deficit (revised), at 7.1% of GDP, was deeper than the target of 7% of GDP. Despite the slower expenditures in 2017, debt contraction was still fast paced with over US$2 billion added to the external debt stock and domestic debt increasing by close to 50%.

The 2019 Budget macroeconomic targets are expected to align with the ESGP and MTEF. A review of how well the targets in the 2019 Budget align with the ESGP and the 2019-2022 Medium Term Expenditure Framework (MTEF) is undertaken. Table 2.1 presents a summary of the 2019 targets across the various planning and budgeting instruments, and reflect general alignment across the short- and medium-term instruments, except the targets on GDP. Notably, no targets are presented for jobs, which is a key indicator in any macroeconomic framework.

*Table 2.1: 2019 Macroeconomic Targets in Various Planning and Budgeting Instruments*

| Indicator[1,2] | Budget Speech 2018 | Budget Speech 2019 | ESGP[3] 2017-19 | MTEF[4] 2019-21 |
|---|---|---|---|---|
| GDP (%) | 5 | 4 | 5.2 | 4.3 |
| Inflation (%) | 6-8 | 6-8 | 6-8 | 6-8 |
| Reserves (min. months import cover) | 3 | 3 | 4 | 4 |
| Domestic Revenue (min. % of GDP) | 17.7 | 18 | 18 | 18 |
| Fiscal Deficit (% of GDP) | 6.1 | 6.5 | 4.1 | 6.5 |

Notes:

1. Additional indicator on arrears aims to "prioritise dismantling of arrears and curtail accumulation" across all instruments

2. Additional indicator on debt aims to "reduce the pace of debt accumulation and ensure sustainability" across all instruments

3. The targets set for 2019 in the ESGP 2017-2019

4. The targets set for 2019 in the MTEF 2019-2021

In the implementation of the 2018 Budget a number of macroeconomic targets are reportedly already off-track, as reported in the 2019 Budget Speech. The budget deficit is estimated at 7.4% of GDP against a target of 6.1% in 2018.

## 2.3 Selected Macroeconomic Headliners to Look Out For…

***GDP performance:*** While the 2019 Budget Speech claims to be in line with the ESGP, the macroeconomic objective on growth in the 2019 Budget is set at 4%, in disparity with the ESGP target for 2019 which was set at 5.2%. However, the 2019 target on growth is more realistic because there have been a number of constraints that have limited growth within the ESGP period. For instance, erratic rainfall in the 2017/2018 farming season led to low agricultural output and affected agricultural growth. Additionally, fluctuating commodity prices, particularly for copper, have led to a sustained trade deficit in 2018 and a deteriorated external sector. Moreover, the Government has had challenges to fully finance its commitments to suppliers and contractors further subduing growth.

For these reasons, GDP growth for 2018 is expected to be sluggish. This is because of the low recorded growth of 2.6% in quarter one 2018 - the lowest level of growth since quarter four, 2015- which was caused by poor performance in agriculture and livestock (-1.9%), transport and storage (-0.2%) and public administration (-0.1%) sectors. In this quarter, the mining sector posted the highest growth, driven by good copper prices. However, copper prices have been fluctuating making growth unpredictable in the sector going forward. Additionally, predictions for the 2018/2019 farming season point to insufficient and erratic rains according to SADC El-nino projections and this may have an additional negative effect on the growth of agriculture.

Another key reason for poor growth has been the policy inconsistency exhibited by the Government and the crowding out effect over the period, that has affected confidence for sustained private sector investment. This has affected the aim to ensure greater economic stability, growth and job creation as espoused in the ESGP. The economy is now missing out on growth and is likely to face a risk of growth lower than 4% in 2019. This would entail lower revenues, the potential of a higher fiscal deficit, and generally less wealth to go around.

***Inflation:*** Since 2017, the Bank of Zambia (BOZ) has broadly succeeded in maintaining the inflation rate within the target range of 6-8%. This is the one target that is at least consistent across the budget, the ESGP and the current MTEF. However, the recent exchange rate depreciation of the Kwacha to major currencies entails that risks of exchange-rate-pass-through inflation will remain significant going forward.

Additionally, if the El-nino forecasts materialise, lower harvest will inevitably put upward pressure on food prices. With inflation breaching 8% in August 2018 (though falling to 7.9% in September), inflation is already pushing the upper bound of the target. These factors suggest a credible risk to breaching the

inflation target in 2018 and possibly in 2019. Thus, the monetary authorities will have to play a balancing act between keeping inflation low by raising the policy rate and being supportive to the already subdued growth by keeping the policy rate unchanged.

***International Reserves Position:*** The macroeconomic objective for international reserves is presented in the form of months of import cover. Good international practice is to maintain a minimum of 3 months import cover, the 2019 Budget Speech aims for this. Meanwhile, the 2019 to 2021 MTEF is slightly more ambitious, aiming to attain 4 months import cover in 2019.

The Budget Speech reports the stock of international reserves to be US$1.8 billion as at July 2018, providing approximately two months of import cover, down from US$2.1 billion as at December 2017. This low level in international reserves is of particular concern given the openness of Zambia's economy and the country's high propensity to import. These conditions create a situation in which the country can be left vulnerable to speculative attacks on the currency, for example. Or a situation in which the country is unable to pay its import bill, which would have detrimental effects for our heavily import dependent economy.

The Government should therefore develop a solid strategy for accumulating international reserves and provide regular updates on their progress toward the three month target. Furthermore, measures will need to be put in place to not only minimise the import bill, but also diversify the export portfolio in order to improve export earnings.

***Financing: :*** Going into 2019, the biggest risk faced in the macros is on the financing objectives. Fiscal consolidation may be the theme, but the Government's expenditure appetite has not waned in 2019 (28.9% of GDP) with domestic revenue targets set at 18% of GDP. Maintaining spending levels and increasing taxation should decrease the deficit, but will be challenging in the face of dismantling arrears, reducing the pace of debt accumulation and curtailing domestic borrowing (and ZIPAR note there are no clear targets for the first two objectives). Factoring debt amortisation the deficit looks set to stand at 9.6% of GDP in 2019. The Government's approach to the financing challenge is on the right lines, but risks been undermined by the informal nature of Zambia's economy. The solution lies in a medium-term formalisation of the economy, growth of the tax base and improved collection. Forecasting these gains from these changes is difficult, yet a key challenge of this budget is that many of the tax rises seem premised on them.

### 2.4 Macroeconomic Wrap-up

Overall, Zambia's macroeconomic fundamentals remain intact if the macro-economic targets set out in the Budget can be achieved. There are challenges to this, notably external shocks and economic trends but also internally. The key question on the delivery of this macro-economic path is the ability of domestic and fiscal policy to support growth, manage risks and deliver this path.

## 3. Promoting Private Sector Led Economic Growth

The Budget Speech projects the GDP to grow at around 4% in 2019. This projection is expected to be higher than the 2017 GDP growth rate of 3.4% but lower than 4.5% attained in 2016. As we have set out the 4% target is not without risk - the debt burden, exchange rate volatility, subdued growth rates in agriculture caused by climate change which could all persist in 2019. ZIPAR's view is that the economy is slowing down and the debt burden is likely to slow it down even further. Zambia will continue to record positive economic growth but will most likely be at a decreasing rate and growth will definitely not be at the levels set out in the Vision 2030, posing a challenge to Government's quest for poverty reduction and improved livelihoods.

As Zambia draws closer to the end of the Vision 2030, Government should formulate and implement budgets with strong strategies to boost economic growth. Given the fiscal challenges, this means focussing on enabling private sector led growth, enabling the private sector to lead investment and job creation. The Budget Speech talks to this point, but provides less clarity than previous Budgets and Government strategies – particularly on job creation.

Crucially the 2019 Budget is also silent on employment objectives. The current unemployment rate stands at 41.2%. This is too high and highlights the opportunity of private sector led growth. We would like to see the Government return to a job strategy, and deliver on the 7NDP target to create one million jobs between 2017 and 2021.

The main growth-contributing sectors in 2017 included Wholesale and Retail, Mining and Quarrying, Agriculture, Construction and Manufacturing contributing 18.4%, 13.7%, 12.8%, 8.2% and 7.2% to GDP, respectively. It is expected that growth will continue to be driven by these sectors even in 2019 which are also identified as priority in the 7NDP with the exception of Wholesale and Retail. The 2019 Budget provides an opportunity to facilitate greater private sector involvement in these sectors to support growth.

The Wholesale and Retail Industry is currently the main driver of growth having taken over from agriculture in recent years. Typically, however, the sector is characterised by low productivity which is problematic if most of the country's growth will come from this sector. Additionally, most workers in this sector are low skilled and earn wages lower than those in the agriculture sector. Wholesale and Retail trade therefore poses a challenge on how it can be leveraged for economic growth. Given the rise of the Wholesale and Retail sector the Government should consider if an explicit strategy for the sector should be developed.

Mining and Quarrying is the second largest contributor to GDP growth but also faces challenges that threaten the sustainability of growth. Being largely capital-intensive, it contributes less than 2% to employment and has very weak linkages to the local industries and remains an enclave industry procuring only 10% of its goods and services locally.[1] However, the sector is vital for generating foreign currency reserves and reducing Zambia's trade deficit. One question arising from the budget is if the increase in mineral royalties, coupled with a tightening global demand for copper will deter investment. There may be opportunity to offset some losses through development of a strong local content strategy and encouraging local participation in mineral production. In addition, some measures – such as those to reduce income tax for companies adding local value to copper cathodes may also encourage local investment and support growth.

Notwithstanding, the 2019 Budget has outlined a number of growth-oriented strategies. The strategy to facilitate irrigation, for example, is important in moving away from depending on rain-fed agriculture and could help generate growth of agriculture. However, the role of Private Sector does not come out clearly indicating that the burden may be shouldered by the Government. The focus of the agriculture budget on subsidies (e-voucher/FISP and FRA represents over one-third of the budget) suggests there could be challenges releasing funding for this important intervention which may offer greater growth opportunities, and so risks not being fully implemented in 2019. Like in other areas, the Government should be looking to crowd in the private sector through the design of policy and spending measures in agriculture. The e-voucher does this by enabling private traders to play a key role in delivery of inputs and therefore job creation.

Similarly Multi-Facility Economic Zones (MFEZ) are an opportunity to encourage private sector led growth – if properly supported. MFEZ have rebounded in the 2019 Budget despite the fact that there is no evidence of their contribution to economic growth since their inception. The infrastructure costs of creating zones are high and to date there seems to have been few significant returns on this investment. So there is a real need to develop the MFEZ strategy to help create the significantly more jobs than the 15,000 confirmed in the Budget.

The move to implement the National Local Content Strategy in 2019 is a positive step in as far as fostering linkages between Micro, Small and Medium Enterprises (MSMEs) is concerned. However, Zambian MSMEs still face challenges that need to be addressed for this strategy to spur growth of MSMEs: problems such as access to credit, poor infrastructure services and poor standards. Unless these issues are addressed in the 2019 budget, the local content strategy will not be successful.

High lending rates, and an unstable kwacha, are likely to compound problems of SMEs to support private sector led growth. Therefore, the Government need to do more to enable SMEs and MSMEs to access credit perhaps through greater use of empowerment schemes.

Energy remains the engine of growth and the 2019 Budget has listed ambitious projects which if successfully completed will make Zambia energy sufficient. However, the Government must accelerate diversification of the energy mix through the Renewable Energy Feed-in-Tariff Strategy which aims to bring an additional 200 megawatts to the national grid. The Government must also ensure that the Cost of Service study for the electricity sector is done to inform migration to cost reflective tariffs. The allocation to Rural Electrification Authority in the 2019 Budget has reduced significantly by 27% compared to what it was in 2018. Meanwhile access to electricity is still low in rural areas and stood at 4% in 2017. Low access to electricity in rural areas is likely to have a negative impact on rural industrialisation.

Finally, the Budget makes a strong commitment to continue ambitious infrastructure spending. As set out earlier in this document the contribution of this investment to growth seems to be diminishing, yet upgrading infrastructure is a key enabler of the private sector. In light of the tightening fiscal conditions the Government

should consider ways of accelerating PPP engagement in public service delivery and infrastructure provision.

In view of the foregoing, the financial constraints facing the Government in 2019 are obvious. The Government should focus on playing a more facilitative role in creating a conducive environment for private sector investment, and a private sector led recovery. This calls for elimination of constraints that make it difficult for the private sector to contribute positively to economic growth and therefore achieving the set growth target for 2019.

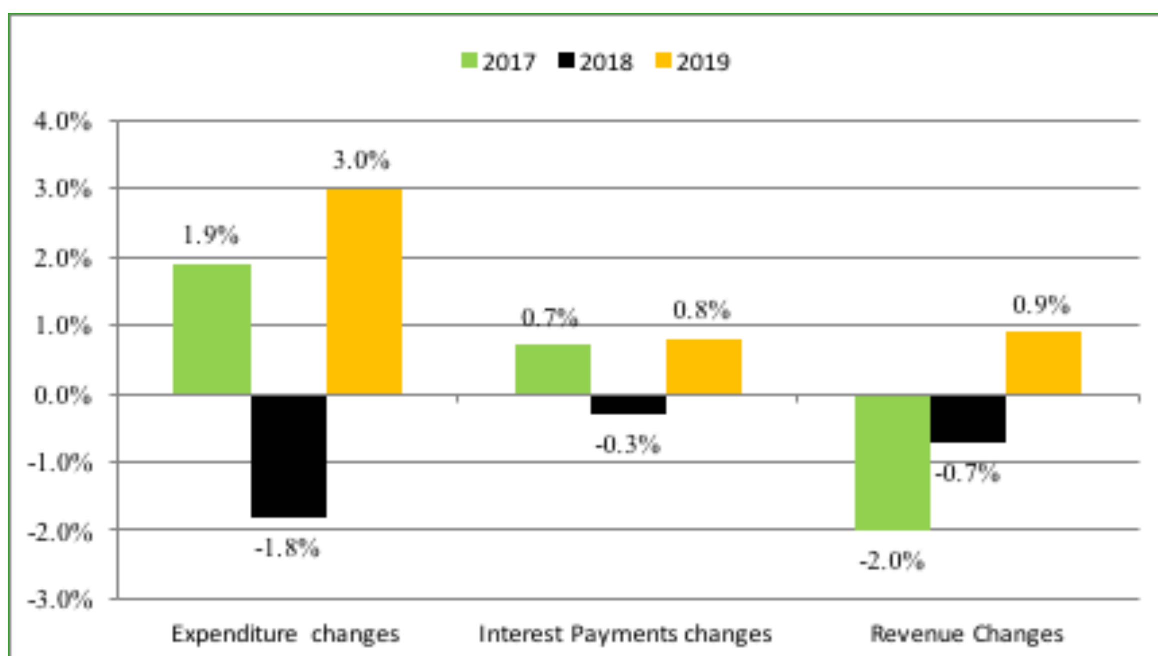
# 4. Mounting Risks of Falling Off the Fiscal Consolidation Wagon

## 4.1 Relapse to an Expansionary Fiscal Stance

The 2019 National Budget is set in the context of a debt overhang that has compelled the authorities to apply austerity measures to deliver on fiscal consolidation. Somewhat at variance with the fiscal consolidation objective, the Government plans to increase expenditure by K15.1 billion to K86.8 billion in 2019, an amount 21.1% and 15.3% higher than the 2018 budget and the MTEF projection, respectively. As a proportion of GDP, expenditure is expected to increase by 3 percentage points from 25.9% in 2018 to 28.9% in 2019. While revenue will increase by 0.9 percentage points, it is not sufficient to offset the expenditure increase, leading to a wider fiscal deficit.

Already, indications are that expenditure (including dismantling of arrears and debt) in the first half of 2018, is above the target. Going by Figure 4.1, this is likely to be the case in 2019 as well. Therefore, the Government's fiscal consolidation efforts risk going further off-track due to the increased planned spending in 2019.

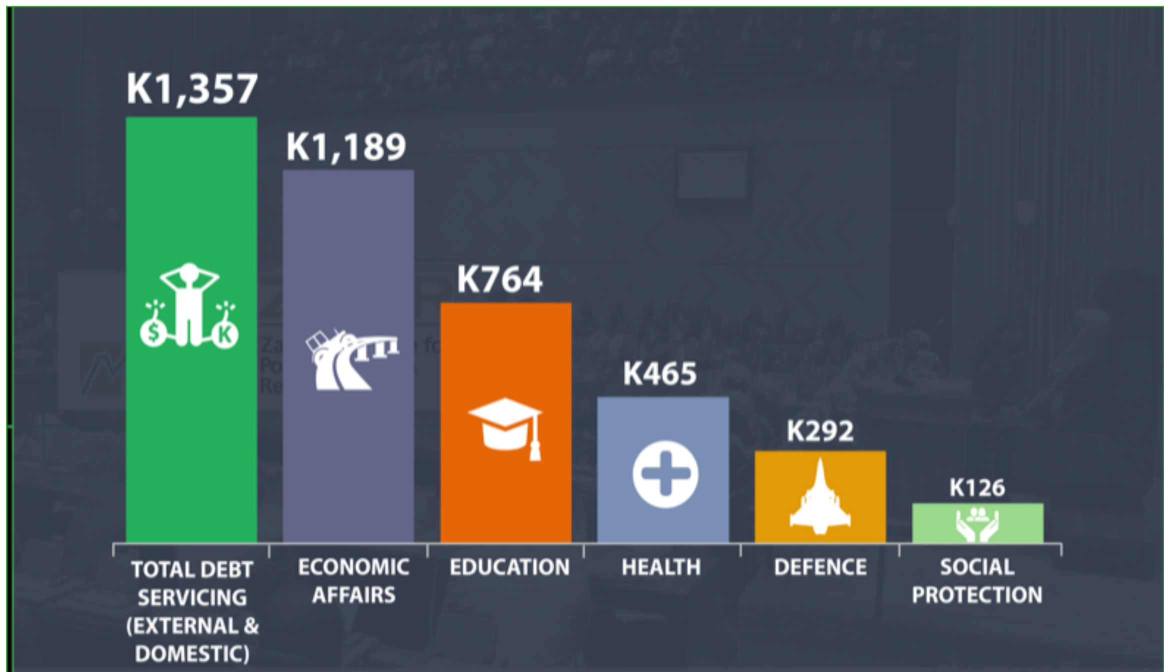
*Figure 4.1: Fiscal Consolidation Measures*




*Notes: *** An ideal fiscal consolidation programme should reduce the fiscal deficit and expenditure (including interest payments), and increase revenues.*

Debt payments will be a dominant area of spending in 2019. External and domestic debt payments will together increase by K9.3 billion in 2019, representing an increase of 66%. As a percentage of GDP, debt payments are projected to increase by as much as 3 percentage points from 4.7% in 2018 to 7.9%. Interest payments alone will take-up 4.7% of GDP, almost one percentage point higher than in 2018. The depreciation of the Kwacha against the US Dollar will further increase the cost of debt servicing. The debt servicing burden is best illustrated in per capita terms (Figure 4.2): on average, each Zambian will contribute K1,394 towards debt payments in 2019. More importantly, critical spending on social spending, for example, will be at the tail end.

*Figure 4.2: 2019 Selected Planned Spending Per Capita*

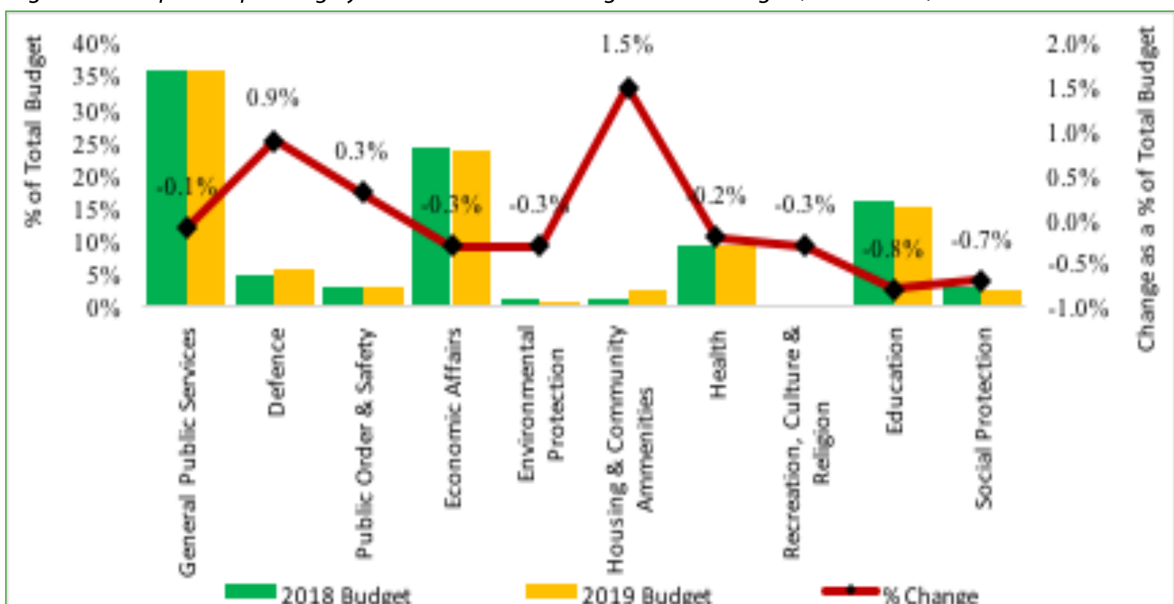



## 4.2 In Search of Better Spending Prioritisation

The quality of planned spending allocation has an important influence on whether the public sector can do more with less. A review of the planned expenditure by function in 2019 reveals seemingly marginal spending shifts across broad function lines. The shares of some of the large spending functions in 2018, such as General Public Services, Economic Affairs, Education and Health, are projected to all reduce as a percentage of the total 2019 Budget compared to 2018 (Figure 3.3). However, this is simply a reduction to the shares in spending. In nominal terms, health expenditure and education shows an increase in spending.

The functions that will secure increasing share of the total budget in 2019, notably Defence, Public Order and Safety, and Housing and Community Amenities, will experience share increases of 0.9, 0.3 and 1.5 percentage points, respectively. The rationale for the shifts in expenditure by broad function between 2018 and 2019 is not explained in the 2019 Budget Speech, and thus remains unclear.

*Figure 4.3: Proposed Spending by Function as a Percentage of total Budget (2018 - 2019)*




*Source: Constructed by Author from the 2018 and 2019 Budget Speeches*

A closer look at detailed sub-function allocations, particularly in the Economic Affairs function, reveals that the 2019 Budget is still highly expansionary on some sub-lines. Although allocations to road infrastructure

(K6.5 billion) and the Farmer Input Support Programme (K1.4 billion) have reduced substantially by 25.3% and 22.2%, respectively, from 2018, enormous increases in allocations to other infrastructural projects have been made.

For example, allocations for expansion and modernisation of international airports increased in nominal terms by 70.2% from K940.5 million in 2018 to K1.6 billion in 2019. Within a two-year period (2018 – 2019), more than K2.5 billion has been allocated for international airports. Although this relates to debt financed projects, the amount is too high given the relative priority of the activity (not likely to bring returns in the short – to medium-term). During these times of austerity, options should be explored for delaying and shifting the loan financing. Total allocations to infrastructural projects in the 2019 Budget alone amounts at about K12.5 billion, surpassing the allocation to health at K8.1 billion and only K800 million shy of the allocation to education (K13. 3 billion).

In addition, spending on Water Supply and Sanitation is expected to increase more than three-fold from K565 million in 2018 to almost K2 billion in 2019. This is commendable as access to water and sanitation remains low at 15% and 27% in rural and urban areas, respectively. However, 60% of the planned spending has been earmarked for projects in Lusaka and Ndola, largely reflecting the need to control water borne diseases such as Cholera that are prominent in urban areas. Despite this urgency to control waterborne diseases in urban areas, this is likely to promote inequality between urban and rural areas.

This continued expansionary spending stance adopted in the 2019 Budget is unsustainable during these times of austerity. The Government should adopt pro-growth strategies by identifying priority sectors that are likely to bring quick returns in the medium-term to pay off the debt and help jump-start the much-needed economic growth. For example, the K443 million earmarked for the construction of the FTJ University in Luapula Province can be invested in aquaculture, an activity the province has comparative advantage in.

Further, the proposal of building a new university is both premature and ill-timed. According to the Annual Economic Report for 2017, the ratio of primary schools to secondary schools in Zambia currently (2018) stands at nine to one, meaning nine primary schools for every existing secondary school. Therefore, the Government should first prioritise the building of secondary schools before adding more universities to our still struggling pool of higher learning institutions.

Lastly, ZIPAR is still urging the Government to reengage the IMF and continue negotiating for a US$ 1.3 billion bailout package for Budget and balance of payment support. This will allow the Government some fiscal space to pursue pro-growth economic strategies while at the same time repay the debt without undue stress.

# 5. Taking Bold Revenue Measures

## 5.1 Performance and Projections

The 2019 Budget projects that total domestic revenue will increase to 18.7% of GDP from 17.7% of GDP projected in the 2018 Budget. In 2017 actual total revenue collection was 17.6% of GDP against a target of 18.4% of GDP indicating an under-performance against the target. The first half of 2018 shows that the revenue collection was 0.9% below target. This underperformance in the past two years is due to the underperformance from all tax types with the exception of the Value Added Tax (VAT). VAT collections in the first half of 2018 show that collections were above 46% of what was projected. In terms of non-tax revenue only Mineral Royalty Tax (MRT) and road tolls performed above expectations. Despite the sluggish performance of the revenue streams in the last two years, the Government has proposed to collect more revenue in 2019 than what was projected in 2018. This increase in projected revenue is driven by significant forecast increases in VAT and income taxes and significant increase in mineral royalties (equivalent to 25% at current copper prices). These increases are welcome, but are not without risks.

## 5.2 Proposed Revenue Measures

To support the projected increase in total domestic revenue, the Government has proposed bold revenue measures for tax and non-tax components in 2019. Key among these measures are: Introduction of the Earnings Before Interest Taxes, Depreciation and Amortisation (EBITDA) system; new tax regime on casino, lottery, betting and gaming industry; re-introduction of sales tax in place of VAT; and changes to the mining fiscal regime. Furthermore, to encourage local manufacturing and create jobs, the Government

has reduced income tax to 15% from 35% for firms that add value to copper cathodes. What is important therefore is assess whether given these bold revenue measures and their implications, the projected revenue target is plausible. We look some of the key measures in turn together with their implications.

### *Revenue Losses from Interest deductions curbed*

The 2019 Budget departs from the Thin Capitalisation Rules system in preference for the EBITDA system. The proposed EBITDA system helps in preventing tax revenue losses through interest deductions. In addition, by setting the allowable deductible interest limit at 30%, the new tax system encourages long-term investment behaviour and discourages rent-seeking behaviour which was incentivised under the Thin Capitalisation Rules system.

### *Hooking into all handles of the gaming industry*

The 2019 Budget proposes to abolish the 20% levy on casino, lottery, betting and gaming industry and replace it with a much more comprehensive tax regime which considers the various aspects of this industry. The proposed changes are timely and therefore commendable because this is one of the emerging industries with seemingly high potential as a source of tax revenue. Because the activities of this industry can be addictive and therefore pose adverse effects on the citizenry, the enhanced tax regime will also act as a deterrent on abuse of activities in the industry. With the Government having announced plans to rebase the GDP, this will be a good time for the Central Statistical Office to collect comprehensive data on the industry in order to definitively determine its revenue potential.

### *A Re-entry of the Sales Tax*

The 2019 Budget proposes to abolish the VAT and replace it with a Sales tax. The current VAT system was introduced in July 1995, to replace a Sales tax, as part of the tax reforms initiated under the Structural Adjustment Programme (SAP) of the 1990s. This proposed change is a bold move and goes against international trends given that the VAT over the years has been a consumption tax of choice by many countries. Both the VAT and Sales tax are consumption taxes and in theory can raise equivalent amounts of revenue at the same tax rate.

However, the difference in the two taxes lies in the way they are collected and seemingly makes the sales tax a much simpler tax to collect and therefore the motivation behind the Government's reverting to the sales tax after more than two decades of implementing the VAT. While the VAT is collected at every stage of the production process, the sales tax is only collected at the final stage of production or the retail stage. This has the following implication on revenue collections which has to be considered as the Government re-adopts the Sales tax.

Since the sales tax is a single stage tax levied at the point of sale of the final product, it is vulnerable to evasion unlike the VAT which is collected at several points and hence secures revenue. For instance, under a VAT system, if the final seller is not taxed, say due to evasion, only the tax on the value-added at the final stage is lost. On the other hand, under the sales tax all the tax is lost if the final seller is not taxed. The vulnerability to evasion is said to heighten if the rate of sales tax is pegged at higher rates than 10%.

The sales tax does not have the self-enforcing feature of the credit-involve mechanism under the VAT (the notion that the purchasers will help enforce the VAT due to their interest in obtaining a proper invoice from their suppliers in order to claim VAT paid on their inputs) and therefore will require extra enforcement.

Further, in practice under the Sales Tax it is difficult to ensure that tax burden does not fall on production inputs as in the case of VAT. Therefore, this may lead to cascading, which is simply a 'tax on tax' which may result in distorting production decisions.

Therefore, the design of the sales tax will require to take into consideration these issues to ensure that it comes out more superior than the VAT it will replace in contributing to revenue.

### *Minding the gaps in the mining fiscal regime*

The Government has proposed changes to the mining fiscal regime in 2019. These changes have been necessitated because of a widely held view that the mining sector has not been contributing its fair share to Government revenue. This can be seen by the various proposals in past Budgets to change the mining tax regime, such as the introduction of windfall tax in the 2008 Budget, changes in the mining income tax and MRT rates in the 2015 Budget, and now the changes in the in the 2019 Budget. Both the proposal in 2008 and 2015 Budgets were reversed in their respective fiscal years after bowing to pressure from the mines.

One of the changes in the 2019 Budget is the increase of the export duty from 10% to 15% on gold, precious metals, gemstones and manganese. This change has broadened the tax base, and clarified ambiguities in the classification of what rates to use for these products. The next key proposed change is a 5% import duty on copper and cobalt concentrates. This duty incentivises mining companies to develop the local mineral resources, thus helps to protect Zambian based jobs.

In terms of the MRT, the Government has introduced a fourth tier rate and also increased the existing rates across the tiers by 1.5 percentage points. A summary of these changes are given in Table 5. 1 below:

**Table 5.1**: Current and Proposed Mineral Royalty Rates

| Min. Royalty Tax scales | 2018 | 2019 |
|---|---|---|
| US$ 1 to US$ 4,449 | 4.0% | 5.5% |
| US$ 4500 to US$ 5,999 | 5.0% | 6.5% |
| US$ 6,000 to US$ 7,499 | 6.0% | 7.5% |
| US$ 7,500 and above | 6.0% | 10.0% |

Besides the changes in the structure and rates of the MRT, for both cobalt and copper, the MRT will now be a non-deductible levy for income tax purposes. While this in principle implies increased revenue for the Government from the sector, it also translates into loss of income for the mining companies. Depending on the significance of these losses, the mining companies could defer their capital investments decision; which would impact production in the long term. Low growth of the industry would in turn imply reduction in revenue collected from the sector. In the short term, however, the mining companies might respond to these changes in a negative way as was the case during the 2015 fiscal year.

To avoid these possible short-term impacts, the Government should put in place a law or regulation that requires all mining companies to receive all payments of their exports (produced in Zambia) into an account that is based in Zambia. This measure, among others, will also help promote transparency. The other measure that can be put in place to minimise losses as a result of changes in MRT rates, could be for the Government to reduce the rates of income tax for mining companies that produce copper cathodes as their main product. This is important in two ways: firstly, it will incentivise tax compliance. Secondly, it will incentivise mining companies to invest more in downstream capital stock, such as smelters and refineries. This would help create new jobs and also safeguard jobs that could have otherwise have been lost.

# 6. The Elephant Remains in the Room

## 6.1 Public Debt Stock Continues to Rise

The 2019 Budget seeks to, among other things, progressively reduce the fiscal deficit and maintain a sustainable debt position. The fiscal deficit remains persistently high and the level of public debt continues to rise rapidly. The deficit and the debt continue to be the elephant in the room. Of the several macro-economic targets set out in the 2019 Budget, four relate to Zambia's fiscal deficit and debt management. These are to: (i) limit the fiscal deficit, on a cash basis, to 6.5% of GDP; (ii) curtail domestic borrowing from 4% of GDP to 1.4% of GDP; (iii) prioritise the dismantling of arrears and curtail its accumulation; and finally; (iv) reduce the pace of debt accumulation and ensure debt sustainability.

The 2019 Budget shows a projected increase in the stock of debt and domestic arrears. At end-June 2018, Zambia's external debt stock was US$9.4 billion or 34.7% of GDP, recording an increase of K700 million (8%) over the level as at end-December 2017 (US$8.7 billion). The stock of domestic debt amounted to K51.9 billion as at end-June 2018 compared to K48.4 billion as at end-December 2017. Government accumulated more arrears in 2018. As at end-June 2018, domestic arrears amounted to K13.9 billion from K12.7 billion as at end-December 2017. Publicly-guaranteed debt was estimated at US$1.2 billion.

The total stock of public debt is an accumulation of fiscal deficits. According to the 2019 Budget, the fiscal deficit is expected to remain high at 6.5% of GDP mainly due to the worrisome debt service payments. Decomposing the fiscal deficit into the primary deficit and interest payments helps determine the main drivers of the deficit. Interest payments are expected to rise from 3.9% of GDP in 2018 to 4.7% of GDP in 2019. The primary deficit, on the other hand, is projected to decline from 2.1% of GDP in 2018 to 1.7% of GDP in 2019. Therefore, interest payments are the main drivers of the deficit. Further, the difference between expenditure with and without amortisation shows that principal payments are also projected to

rise to 3.1% of GDP in 2019 from 1.2% of GDP in 2018. This shows that a number of loans have reached their maturity and will fall due in 2019.

The Government plans to balance its budget to meet the shortfall between revenues and expenditures by borrowing from both external and domestic sources. The gross borrowing requirement is expected to be K28.8 billion in 2019 compared to K20.1 billion in 2018. Borrowing from domestic and external sources will take up 33.2% of the budget in 2019 compared to 28.1% in 2018. This shows that the borrowing requirements are higher in 2019 than in 2018 and will add to the already high stock of public debt.

The 2019 Budget highlights stronger reliance on external financing over domestic financing. External financing is projected to account for 85% of the total financing; that is, K24.6 billion for externally funded programmes and projects compared to K4.2 billion for domestic financing of programmes and projects. The reliance on external financing will result in the continued rise of the external debt in the total debt portfolio and this is not in line with the 2017-2019 Medium Term Debt Strategy (MTDS) which prioritises a higher share of domestic debt over external debt.

Increased debt has several consequences, including being a drag on economic growth and requiring interest and principal payments that consume significant government resources. Of the total K86.8 billion budget that was presented by the Minister of Finance, 27% will be allocated to debt-servicing costs. As per budget estimates, the cost of interest and principal repayments on public debt will increase by 66% year on year in 2019 and consume 42% of projected domestic revenues from 29% in 2018. Debt servicing payments, which are expected to increase from 5.1% of GDP in 2018 to 7.9% of GDP in 2019, will be as high as the spending on the wage bill which normally hovers around 8% of GDP.

The share of external debt repayment to domestic revenue in 2019 is expected to increase to 26.6% from 14.8% in 2018. As a percentage of GDP, external debt repayments are expected to rise to 5.0% in 2019 from 2.6% in 2018. While this strategy mitigates the crowding out effect on the domestic market, it is susceptible to significant exchange rate risks as the depreciation of the Kwacha against major convertible currencies, as was the case in September 2018 when the Kwacha depreciated by 20%. If this depreciation trend continues, there is likely to be significant increases in the debt servicing costs. This is also likely to feed into domestic prices and therefore fuel inflation.

The debt servicing costs are likely to displace other critical spending such as education, health care and social benefits. Indeed, all these expenditures are projected to reduce in 2019. Though Government intends to prioritise the dismantling of arrears and curtail its accumulation, the reduced funding to non-interest expenditures is likely to have the opposite effect. Spending cuts and delays in the processing of payments due to late release of funds is likely to lead to further accumulation of arrears.

## 6.2 Dealing with the Rising Debt Stock

In order to curtail the persistently high fiscal deficits, a good place to start is the medium term expenditure framework (MTEF)._The MTEF provides the rolling-three-year budgetary plan, with revenue estimates and spending projections by the main economic categories and with the fiscal deficit targets showing a consolidation plan over the medium term. It is therefore supposed to serve as a hard budget constraint. However, the annual fiscal targets are not binding as executed budgets have typically deviated by significant margins from approved budgets, and the 2019-2021 MTEF is no exception. This violation jeopardises budget credibility and may lead to the accumulation of arrears.

The fact that the levels of debt and its accompanying debt service costs continue to rise rapidly brings into question whether the MTDS is an effective Strategy for debt management. It shows that, on its own, the MTDS is not enough to stem the rising debt challenge. It needs to be supported by commensurate actions to deliver its objectives and extra effort to reverse the high risk of debt distress. These measures include limiting spending overruns, improving domestic resource mobilisation (by removing hurdles to growth mostly faced by the private sector), exercising restraint on commercial debt and obtaining only concessional and semi-concessional borrowing as outlined in the debt strategy. Cardinal to this is that debt should be utilised on high-return capital projects.

Another aspect to consider is reducing the cost of external borrowing. Borrowing at reasonable cost depends on the lender's perception of the borrower's ability to repay. The considerations include the credibility of a government's macroeconomic framework, the integrity of state institutions, the political environment and the country's economic growth prospects. These assessments are captured in sovereign credit ratings. In Zambia's case, international rating agencies recently downgraded Zambia's sovereign

credit ratings and near-term outlook amid concerns about the country's high fiscal deficits, fast debt accumulation, as well as continued uncertainty about the government's commitment to consolidate public finances. The Government needs to pay attention to these ratings as adverse sentiments are priced into the cost of credit.

There is need to follow through the austerity measures announced in June 2018. The Government announced a number of austerity measures that would help to reduce planned and existing debt and to reduce debt service obligations over the medium and long term. The Minister of Finance has promised to go back to the National Assembly with specific details on the implementation of austerity measures related to debt. We give some cursory remarks on some of the measures:

- *Indefinitely postpone the contraction of all pipeline debt until the debt is brought back to moderate risk of debt distress:* this is likely to address the reported disagreement with the IMF with regard to access to a credit facility.
- *Cancel some of the current contracted loans that are yet to be disbursed to reduce the debt service outlays*: while this brings some relief in the short term, it is likely to be costly in the long term as Government is likely to be sued for breach of contract, and the earmarked projects will stall.
- *Undertake refinancing on selected bilateral loans, both local and external to extend the maturity profile and attain lower costs on debt*: this will offer the much-needed short term relief. But bilateral loans are only a small part of the debt portfolio and account for less than 5% of the total external debt.
- *Cease the issuance of letters of credit and guarantees to state-owned enterprises that are technically insolvent until their balance sheet challenges are resolved*: state-owned enterprises are the main source of contingent liabilities which are presently estimated at US$1.2 billion. High levels of contingent liabilities can lead to an increase in the risk premium on public debt
- *Government to only sustain loans whose projects are at least 80% completion*: the allocation of K442.7 million for the construction of the FTJ University, a green-field project in Luapula Province, and the Copperbelt International Airport, at 13% completion, goes against this measure.

# 7. Laying a Strong Foundation for Fiscal Consolidation

In order to anchor fiscal consolidation, the 2019 Budget proposes a number of reforms of which some have been deferred from 2017 and 2018. These legal, policy and structural reforms are critical to laying a strong foundation for fiscal consolidation. The identified key areas for reform include revisions and enactment of key legislation, rationalising of public sector recruitments and the restructuring of state-owned enterprises (SOEs).

Revisions to the Public Procurement Act that are aimed at strengthening the procurement process are yet to be made. Recently concerns have been raised over the country's procurement. A 2017 World Bank study found that Zambia paid US $360,000 per kilometre which was more than twice the African average. Curbing wasteful expenditure such as overpayment resulting from weaknesses in the procurement processes will aid fiscal consolidation.

In its quest to broadening the revenue base, the Government has reiterated undertaking key measures such as National Land Titling Programme. The Budget proposes to establish the Land Management Authority to handle all land management related manners. These efforts will be further complemented by the review of the Rating Act which seeks to facilitate mass valuation for tax and fees collection. These measures will reduce the challenges faced by local authorities regarding resource mobilisation.

Further, the Budget commits to table in 2019 the Planning and Budgeting Bill and Public Procurement Act before Parliament. The Minister in the Budget also commits to establish a multi-sectoral Public Investment Board to scrutinise investment proposals before they are included in the National Budget.

All these efforts to identify the key legislative reforms necessary for fiscal consolidation are commendable but we realise that a number of these reforms have been pending from one budget to another for the past few years. Therefore, we urge the Government to conclude the committed revisions and enactments proposed in the Budget in 2019.

Of importance to note is that the Budget is silent on the Loans and Guarantees (Authorisation) Act CAP 366 of the Laws of Zambia which has been pending from the 2017 Budget. The pending revision to this Act is aimed at strengthening Parliamentary oversight over the entire debt contraction process. The delayed revision to the Loans and Guarantees Act has limited Parliament's role on debt to simply approving the debt ceiling and not providing oversight on the entire debt contraction process. This has limited the control on debt accumulation and led to significant increase in the debt stock.

Institutional reforms in the 2019 Budget relate to improvement of the efficiency of State Owned Enterprises (SOEs). However, a commitment regarding this was also made in the 2017 and 2018 Budgets. Various reports have shown that most of Zambia's SOEs are loss making. The 2019 Budget shows that only 17 out of 45 (38%) SOEs were profitable and out of the 17, only eight declared dividends. While this shows some progress in turning around the SOEs, this remains minimal. The continued sustaining of loss making SOEs continues to put pressure on the already financially constrained fiscus.

The 2017 Budget announced that the IDC would undertake a situational analysis of SOEs to decide on which ones to recapitalise and which to hive off based on viability. Since then, there has been no update of this analysis. However, the 2019 Budget proposes to restructure ZESCO Limited, ZAMTEL Limited, Zambia Daily Mail and Times of Zambia. The Budget also states that efforts will be made to identify equity partners for INDENI Petroleum Refinery Limited and ZSIC General Limited, while plans to list ZSIC Life Limited and the Zambia Forestry and Forest Industries Corporation (ZAFFICO) on the Lusaka Securities Exchange have also been announced.

While all these efforts are commendable, the pace at which the restructuring of the SOEs is taking place is slow given the number of loss making SOEs. Therefore, we urge the Government to act on loss making SOEs to reduce the drain on the treasury.

In order to support the delivery of fiscal consolidation the support of Cooperating Partners is critical. The Government in the 7NDPcommits to aggressively engage Cooperating Partners to obtain significant fiscal relief through access to grants and concessional loans. Therefore, we urge the Government to develop a strategy for engaging and strengthening relationship with Cooperating Partners. This strategy should target the different Cooperating Partners given their diverse interests and form of support.

Ultimately, in order to lay a strong foundation for fiscal consolidation, we strongly recommend that Government implements the measures pronounced in the 2019 Budget and revisit key measures from previous Budgets that are still unresolved.

# 8. Parting Word

Recalling the words of Dr M. Scott Peck: "confronting and solving problems is a painful process which most of us attempt to avoid. And [yet] the very avoidance results in greater pain and an inability to grow..." The ZIPAR Analysis of the 2019 Budget has provided key insights into Zambia's optimal road less travelled. It has explained what the authorities must do in order to steer the country to fiscal consolidation and eventual growth through refined and consistent execution of the 2019 Budget.

Borrowing the Minister's words from the 2019 Budget Speech: "We all have a legitimate and rightful stake in this country and we must all work together as a united people to make our Vision 2030 a reality". In taking the 2019 step towards the Vision, we must be mindful of the considerable risks and challenges along the road. More importantly we must be firmly aware that we have viable solutions and pathways that would navigate the country away from the risks and challenges, and towards robust, sustained and inclusive growth. We must have the presence of mind and will to find the road less travelled and the fortitude to persistently walk along that road.

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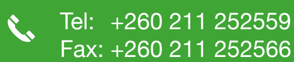
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