



# Nurturing the Seeds of Growth

**#ZIPARBudgetTalk**

**Analysis of the 2020 National Budget**

September 2019



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## 2020 VISION OF THE BUDGET: AT A GLANCE

The 2020 National Budget is centered on “Focusing national priorities towards stimulating the domestic economy”, a break from fiscal consolidation which has threaded the themes of recent past Budgets. This Analysis describes how Zambia should ensure that the expansionary fiscal policy stance and debt accumulation yield growth rather than stifling it; implementation of the 2020 Budget plants and nurtures seed for growth; and it minds the rising climate change adversities and diminishing social sector support. The Analysis offers key insights and recommendations.

**The growth outlook remains modest:** real GDP growth is targeted at 3% in 2019 compared to a projected 2% in 2019. Planning and implementing measures to stimulate the domestic economy therefore makes economic sense. The growing inflationary pressures heighten the risks of monetary policy tightening, which further risks crowding out the already subdued private sector. The external economy remains uncertain, hampering the country’s ability to rebuild its depleted international reserves. Thus, the authorities should balance between stability and growth objectives.

**Planned 2020 Expenditure is set to rise further:** The 2020 Budget pegs total planned spending at K106 billion or 32.4% of GDP compared to 28.9% of GDP in 2019, thus confirming the expansionary fiscal policy stance in 2020. The escalating debt servicing costs emanating from the huge debt overhang is a key expenditure pressure point. Persistent infrastructure spending appetite is another pressure point. Managing the expenditure-side of the budget will be a critical challenge that the authorities should be aware of in 2020.

**Revenue targets will be increased in 2020**, as the Government tries to keep domestic revenue in pace with the increased expenditure. The fiscal deficit target, at 5.5% of GDP in 2020, will be shallower than the 6.5% target of 2019, but deeper than the project 5.3% projected outturn for end-2019. The fiscal deficit target is another confirmation of a lax fiscal policy stance. In search of further revenue-side fiscal space, the authorities will do well to focus on harnessing the following tax and non-tax measures in 2020: modernisation and automation of revenue collection processes; enhancing property tax collections; enhancing the road tolling programme; and targeting inelastic taxes and non-tax revenues. The abandonment of the proposed Sales Tax and refocusing on improving VAT administration is economically rational and commendable.

**The mounting debt overhang while no longer the proverbial elephant in the room** needs to be addressed, particularly towards containing escalating debt servicing costs. Given the unrelenting appetite to borrowing, the authorities will have to spiritedly

### THE GROWTH OUTLOOK

Targeted  
GDP growth **3%**

### PLANNED 2020 EXPENDITURE

2020 **K106Bn**

### FISCAL DEFICIT TARGET (% OF GDP)

2020 **5.5%**

2019 **6.5%**

apply the measures for curtailing debt accumulation and dismantling payment arrears. More importantly, key interventions for addressing the debt overhang in the 2020 budget will include: the increased allocation to the sinking funds for the Eurobonds; refinancing of the Eurobonds; expediting the development and implementation of the 2020-2022 Medium-Term Debt Management Strategy (MTDS); and finalising the long overdue legislative reforms for fiscal governance, which risk remaining in abeyance in 2020 and pose further risk of missing the opportunity to enhance rule-based fiscal restraint, austerity and discipline.

**Moreover, putting the brakes on unsustainable debt servicing costs** will require a high degree of creativity and innovativeness, in, for instance, pursuing options such as: bond buy-backs; strengthening of Ministry of Finance officials’ capacities in debt management; innovative term financing of infrastructure; the use of Public-Private Partnerships; issuance of Infrastructure Bonds targeting retail investors; and the financing of infrastructure using extra proceeds from road tolls. However, the expansionary fiscal policy stance, with ambitious expenditure and borrowing plans in 2020, means pathways to affordable term financing options such as the IMF may close up.

The 2020 Budget identifies **agriculture, tourism, mining, energy and manufacturing as sectors for public and private investments, to stimulate and reinvigorate economic diversification, job creation and growth.** The main **enablers of growth** will include: harnessing information and communication technology; operationalisation and commercialisation of international airports; and enhanced financial and insurance services. The Government will also have to mind the risks of **key growth decelerators** hampering productivity and growth, particularly: high input costs due to, inter alia, the electricity shortage, rising costs of fuel, and labour cost escalation from the new Employment Code Act No. 3 of 2019; and isolation (and

neglect) of rural areas. **Nurturing the seeds of growth** will particularly require the diligent use of the measures in the 2020 Budget to transform agriculture, support the mining business environment, and making good on the industrialisation commitments. Among the main policy gaps to fill towards unlocking growth will be: the easing of onerous regulations; the offering of concessions through tax cuts and tax rebates; and the lowering of commercial lending interest rates.

**Addressing the rising climate change related variabilities and resultant socio-economic and environmental effects** will require more attention to climate-smart interventions in the energy and agriculture sectors than what is currently provided for in the 2020 Budget.

**Safeguarding and sustaining the recent gains in the social sectors** will require true commitment to honouring the relatively sparse 2020 commitment to: programmes for protecting the poor; inclusive water and sanitation infrastructure and services that leave no one behind; effective universal health coverage that

sustains the gains of the recent past; and establishing balance between diminishing fiscal space and quality in education and skills development.

Ultimately, the 2020 Budget holds promise to stimulate the domestic economy and position Zambia for growth. Planting and nurturing seeds for growth in 2020 and beyond will not be easy in view of the anticipated difficult macroeconomic conditions, challenging fiscal and debt expansions, adverse climate change effects and urgent social sector demands. In executing the 2020 Budget, the authorities will do well to mind the critical gaps and potential slippages inherent in the design of public policy. A key requirement will be the ability of the authorities to stick to the script, ensuring to effectively and efficiently implement the policies and interventions as pronounced in the Budget. Re-establishing robust growth over the medium term is not out of Zambia's reach, but will require being mindful of challenging macroeconomic conditions, the policy stance of the fiscus and debt and the confounding effects of climate change.

## 1. Introduction

On 27th September 2019, the Finance Minister delivered to the National Assembly the 2020 National Budget, with the theme: "Focusing national priorities towards stimulating the domestic economy". Aspects of fiscal consolidation and austerity were not part of the theme and not heavily pronounced in the main body of the Speech, signalling a break from Budget themes of yesteryears. Consequently, expenditure and borrowing are both set to increase in 2020. Essentially, 2020 will focus on stimulating growth in the domestic economy and will maintain the expansionary fiscal policy path seen over the past eight years or so.

Two questions therefore loom large: firstly, how should the 2020 Budget ensure that the expansionary fiscal stance, particularly the further planned debt accumulation, enhances growth and does not stifle it as has happened in recent years? Secondly, how should the Budget be implemented to ensure that the seeds for growth are properly planted, well-watered and nurtured to realise the intended growth in 2020? This Budget Analysis offers insights and recommendations in this regard.

The rest of the paper is organised as follows: Section 2 offers a perspective on macroeconomic policy outcomes and prospects; Section 3 considers domestic resource mobilisation as Zambia continues searching for revenue-side fiscal space; Section 4 highlights options for addressing the mounting public debt and escalating debt service costs; Section 5 elaborates on the Budget's ideas for stimulating and reinvigorating growth; Section 6 explains how to weather the vagaries of Climate Change; Section 7 highlights the safeguards for sustaining social sector gains; and finally, Section 8 closes the paper with a few parting words.

## 2. Tipping the Scale of Macroeconomic Management

### 2.1 Macroeconomic Targets

**Subdued growth to continue:** Since the 2015 economic downturn, Zambia has continued to experience persistent macroeconomic imbalances and declining growth rates. From an annual growth of 4.7% in 2014 compared to 2% projected for 2019, the 2020 Budget aspires to stimulate the domestic economy and increase real GDP growth to 3%. However, the review shows that there is a mismatch between growth targets and actual annual growth rates. With 2019 growth estimated to close at 2%, the Government has opted for an expansionary fiscal policy to target an additional 1 percentage-point growth in 2020. There is significant risk of this strategy falling short, particularly given the current context of constrained aggregate demand, liquidity challenges, escalating debt interest payments, reduced agriculture output and constrained electricity generation.

Table 2.1 below presents a summary of the 2016-2020 macroeconomic targets vs actual outturns. Accurate growth projections are important because they define revenue projections (as % of GDP) and in turn revenue expectations define expenditure and borrowing (fiscal deficit) ambitions. Given the above, it is imperative to have as accurate growth projections as possible unlike what has been obtaining.

Table 2.1: Macroeconomic targets and outcomes, 2016-2020

		2016	2017	2018	2019*	2020 Targets
GDP growth rate (%)	Target	5	3.4	5	4	3
	Outcome	3.8	3.4	3.7	2.6 (Q1)	
Inflation (%)	Target	7.7	9	6-8	6-8	6-8
	Outcome	18.3	6.5	7.4	8.4 (Ave. to Sept-19)	
Expenditure (incl. Amor.) (% of GDP)	Target	25.8	27.7	25.9	28.9	32.4
	Outcome	27.1	26	28.3	20.3 (to Aug-19)	
Revenue (% of GDP)	Target	20.4	18	17.7	18.7	22.0
	Outcome	18.6	18	18.9	14.1 (to Aug-19)	
Fiscal deficit (% of GDP)	Target	3.8	7	6.1	6.5	5.5
	Outcome	5.7	7.6	7.2	3.5 (to Aug-19)	
International reserves (min. months of import cover)	Target	4	3	3	3	2.5
	Outcome	3.3	2.5	2.5	1.7 (Jul-19)	

\* 2019 outcome estimates up to September

Note: It is worth noting that, despite job creation being mentioned consistently in last five budget speeches, there is no consistency in setting job creation targets, begging the question of how this aspect can be factored into economic planning and budgeting

Source: Author's construction



**Growing inflationary pressures and private sector crowding out risks:** The 2020 Budget maintains the conservative inflation target range of 6-8%. In 2019, however, the upper-bound of this range has already been breached a few times; as at September 2019, the inflation rate stood at 10.5%. Given the current macro-economic environment, the Government should flex its inflation target to avoid putting too much pressure on maintaining the 6-8% target. Tighter monetary policy in current conditions has the potential to constrain credit to the private sector and further stifle already subdued growth. This is particularly true given that the domestic economy generally faces high cost of money and limited access to finance. Excessive borrowing by the Government has created a general rise in lending rates which remain defiantly high despite the gradual reduction of the policy rate by the Central Bank. These high rates are allegedly due to the high stock of non-performing loans. In this regard, therefore, the fiscal authorities will have to work closely with the monetary authorities to ensure that policy measures on both ends are working to stimulate the domestic economy as stated in the Budget.

**Dwindling international reserves still worrisome:** Good practice recommends that a country maintains at least 3 months of import cover in international reserves. However, the 2020 Budget Speech reports the stock of international reserves to be US\$1.4 billion as at July 2019, providing approximately 1.7 months of import cover. The 2020 Budget aims to maintain 2.5 months of import cover. Whether this is attainable will depend on the macroeconomic environment for the coming year in terms of import and export dynamics as import demand is likely to remain subdued.

## 2.2 Expenditure, Budget Size, and the Resource Envelope

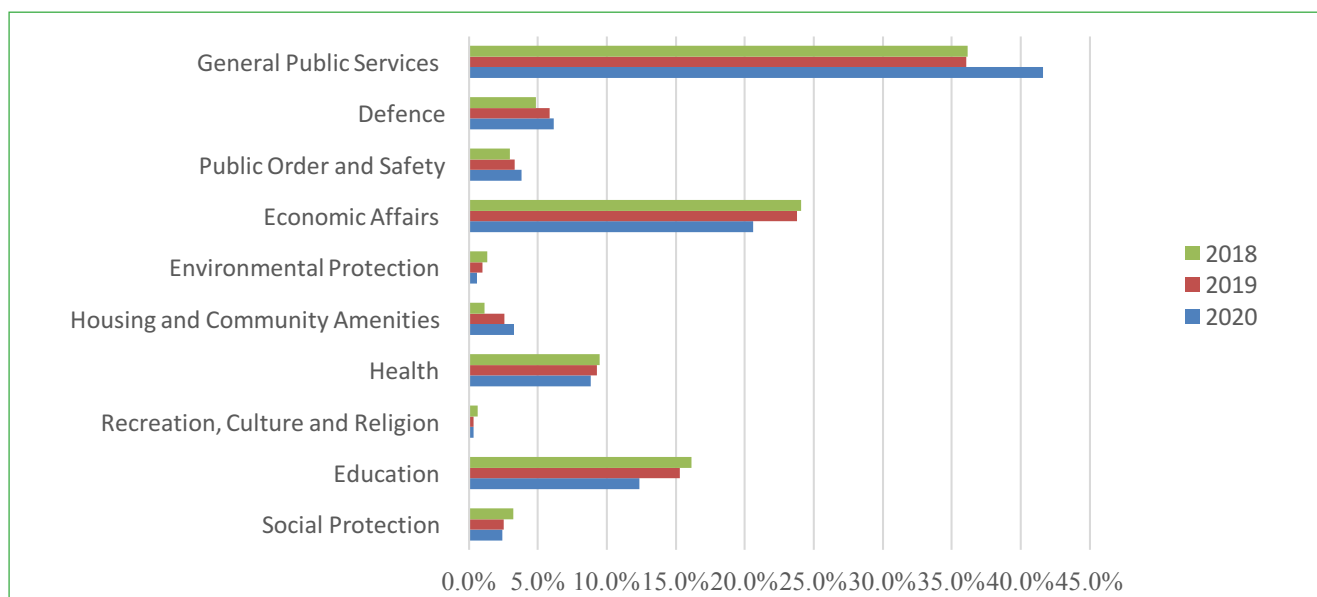
**Planned spending set to continue rising:** The proposed 2020 Budget amounting to K106 billion is 22.1%

larger than the 2019 Budget, compared to a 21.1% increase for last year's Budget. The Budget is therefore cast to be expansionary despite the constrained macro-economic environment and ongoing tight fiscal space, particularly owing to heightened debt servicing pressures. Conversely, expectations were for a budget that would be more constrained, but without threatening sending the economy into a recession. Moreover, even the spirit of doing more with less is not carried through the overall Budget as, alongside some welcome increases in social sector spending, we also see a 62% increase in road expenditure which will largely be funded by external debt.

As a proportion of projected nominal GDP, the 2020 budget is expected to be equivalent to almost a third of GDP at 32.4%. This is compared to 28.9% in 2019 and 25.9% in 2018. Moreover, looking at budget allocations by function, General Public Services has jumped from 36% of the Budget in 2018 and 2019, to 42% in 2020. This surge has primarily been driven by external debt payments projected to take up 19.9% of the 2020 budget, compared to 17.2% in 2019 and 10.1% in 2018.

As seen in Figure 2.1, even as a proportion of GDP, the largest aspect of the Budget is General Public Services which increased to 13.5% of GDP compared to 10.4% of GDP in the 2019 Budget. Of this, 6.4% of the value of GDP will go to External Debt payments. This is almost equivalent to the 6.7% of the value of GDP that has been budgeted for Economic Affairs which, for a budget aimed at boosting the domestic economy, shrunk slightly from 6.9% of GDP. As regards Economic Affairs, 48% of this will be allocated to Roads Infrastructure (3.2% of GDP). This is followed far behind by an 8% allocation to international airports (1.7% of GDP), and 5% allocation each to energy power infrastructure and the Farmer Input Support Programme (FISP).

Figure 2.1: Growth in Spending as a Percentage of GDP, 2018-2020



Source: Author's construction

**Revenue resources ramped up, while fiscal deficit remains a concern:** To finance the planned increase in expenditure, the Government has ramped up the domestic revenue target for 2020 to 22% of GDP from 18.7% in 2019. This means that the Government is expecting the domestic economy to grow enough to partially fund this gap. Furthermore, the fiscal deficit target has been set to reduce from 6.5% in 2019 to 5.5% in 2020, compared to the fiscal deficit of 3.4% suggested by the IMF<sup>1</sup>. However, this 5.5% deficit still implies high levels of borrowing amounting to K31 billion, of which K27.5 billion will be sourced externally. Moreover, despite data indicating that the 6.5% deficit of 2019 is likely to be met given that the realised fiscal deficit stood at 3.5% of GDP by August 2019 (see Table 2.1 above), the devil is in the details as to how this has been achieved. The data indicates that in order to meet the demands of debt servicing, other line items have suffered through accumulation of arrears non-disbursement of funding. The risk is therefore that a similar pattern will manifest during the implementation of the 2020 budget.

Table 2.2: Consolidated Fiscal Framework, 2018-2020 Budgets

% of GDP	2018 Budget	2019 Budget	2020 Budget
Domestic revenues	17.7%	18.7%	22.0%
Tax revenue	14.9%	15.6%	16.4%
Non-tax revenue	2.9%	3.0%	5.4%
Total expenditure	25.9%	28.9%	32.4%
Debt expenditure	5.1%	7.9%	10.3%
External debt	2.6%	5.0%	6.4%
Domestic debt	2.5%	2.9%	3.9%
Non-Debt expenditure	20.8%	21%	22.1%
Fiscal Balance (Cash Basis)	-6.8%	-6.5%	-5.5%

**Doing more with less:** Despite the foregoing reservations, the intention of stimulating the domestic economy to put the economy back on the path of growth is well placed. However, this requires accurate targeting of pro-growth policies. Previous Incremental Capital Output Ratio (ICOR) analysis<sup>2</sup> shows that over the years, the return on total investment in terms of GDP growth has diminished in recent years. With a large proportion of financing targeted at roads, the approach to infrastructure project selection and operationalisation in 2020 will be critical; it will require, *inter alia*, mandatory comprehensive project appraisals, to ensure greatest value-for-money and economic (growth) returns. Low-cost rural feeder roads are an example of investment that would achieve both objectives. Further, the existing stock of road infrastructure should be protected by ensuring adequate financing allocations to maintenance, for example through ring-fencing of road tolls. Short of this, investments will remain non-growth enhancing.

1 IMF, 2019. IMF Article IV Consultation in 2019 (Zambia), IMF Country Report No. 19/263.

2 ZIPAR, 2018. Taking the Road Less Travelled: In Pursuit of Fiscal Consolidation.

### Revenue concessions and liquidity improvements:

Beyond increasing investment financing, however, other measures can also be adopted to stimulate the domestic economy, particularly given the constrained macro-economy. For example, at 3.8% of GDP, Personal Income Tax is the largest component of income taxes in the Budget. While it appears a very productive revenue measure, the tax also constrains household spending and limits domestic demand, which is counterproductive to growth. The tax takes up between 25% and 37.5% of the total income of individuals<sup>3</sup>. Similarly, over the years, domestic arrears have been systematically accumulated by the Government, creating liquidity constraints in the local business environment. By end-June 2019, suppliers of goods and services were owed K20.2 billion; nearly a 30% increase from the K15.6 billion owed in December 2018. Therefore, revenue (tax and non-tax) concessions and liquidity replenishment through dismantling arrears are key fiscal measures that will stimulate demand and economic growth.

### 2.3 Macroeconomic Governance and Legislation

Beyond fiscal policy adjustments, the fiscal regime should also be backed by a sound legislative and governance environment, but Zambia lacks a rules-based fiscal regime. The Government has been able to borrow with little oversight and accountability, which has resulted in the rapid accumulation of debt over the last decade. The Government continues to reiterate the need for legislative reform over the contraction and use of debt, but since the reform of the Public Financial Management (PFM) Act in 2018, little progress has been made. This has inevitably affected macroeconomic targets and resulted in an open expansionary fiscal regime. The outstanding regulatory reforms are: Loans & Guarantees (Authorisation) (L&G) Act, Public Procurement (PP) Act 2008 and enactment of the Planning & Budgeting (P&B) Bill.

Notably, the PFM Act was reviewed and enacted in July 2018 to strengthen provisions pertaining to the institutional and regulatory framework for the management of public funds. While this is commendable, complementary reforms to legislation relating to fiscal and debt management need to be reviewed accordingly so as to strengthen the public financial management. For instance, reform to the L&G Act will operationalise Parliamentary oversight over the Executive's borrowing. Similarly, reforming the PP Act will allow for international benchmarking and best practices to curtail incidences of overpriced tenders. Additionally, in order to enable a reacting scope for quantitative fiscal rules and/or a rule-based fiscal regime which will foster transparency, accountability and citizens' participation in public finance management, finalisation of the P&B legislation is critical. The Ministry of Finance critically needs to finalise the reforms and take on legislative fiscal discipline to ensure that there are no statutory inconsistencies.

3 Banda-Muleya & Nalishebo, 2018. Looking Within: The Promise of Public Resource Mobilisation.



## 3. In Search of Revenue-Side Fiscal Space

### 3.1 Efficient Resource Mobilisation

Of the K106 billion planned expenditure for 2020, about 68% is proposed to be financed from domestic resources, while 29% is to be raised from domestic and foreign borrowing and 3% from foreign grants. Given that domestic resources will have a greater share of revenue mobilisation, the authorities have proposed a number of measures that are in line with the Economic Stabilisation and Growth Programme (ESGP). Notable measures in this regard include:

#### **Modernisation and automation of revenue collection**

**processes:** In order to improve efficiency in revenue collection, the 2020 Budget has proposed to continue the roll out of the modernisation and automation of revenue collection methods and implementation of electronic fiscal devices to curb tax evasion. This means that several functions are simplified which include electronic submissions of tax documents at the Zambia Revenue Authority (ZRA), e-payment of tax obligations and direct deposits of user fees and non-tax charges to the Treasury.

For instance, in 2017 revenue and grants fell short of the targeted amount by 5%, and the underperformance was mainly on account of non-tax revenue which fell short of the target by 19%. Non-tax revenues continued to underperform in 2018 by 28% due to the delay in the implementation of automated measures. However, other revenue streams such as VAT performed above target by 32% and 28% in 2017 and 2018, respectively, mainly on account of modernisation in the collection process which had increased compliance owing to withholding VAT at source by appointed agents and the installation of fiscal cash registers.

However, these measures should be made with the realisation that modernisation and automation do not directly increase tax but just aid the collection of revenue. If not well implemented, the impact may be in reverse as some tax payers may lack access to the platforms and be left behind. Therefore, the Government should put mechanisms in place such as sensitisation programmes to ensure that citizens are equipped to use the systems with little extra costs imposed on them.

**Revenue from Property Taxes:** To enhance receipts from property taxes, the 2020 Budget proposes to accelerate implementation of land titling and revaluation of properties following the enactment of the Rating Act No.21 of 2018. These pronouncements are commendable and we hope the Government

will act quickly and earnestly on them during 2020. But as of 2016, only 200,000 land titles had been issued nationwide and, in the succeeding years, the Government has made efforts to increase the issuance of land titles by 300,000. However, even with this increase, the authorities may not realise the expected gains as only 10% of the revenue has been collected from the current registered land parcels. Many factors have contributed to the inefficiency in the collection of property taxes and ground rent, which include the lack of publicity on who should pay the tax. Therefore, there is need to address these inefficiencies and also strengthen the collection capabilities at Ministry of Lands and Natural Resources, while increased land titling should be pursued in a more realistic time.

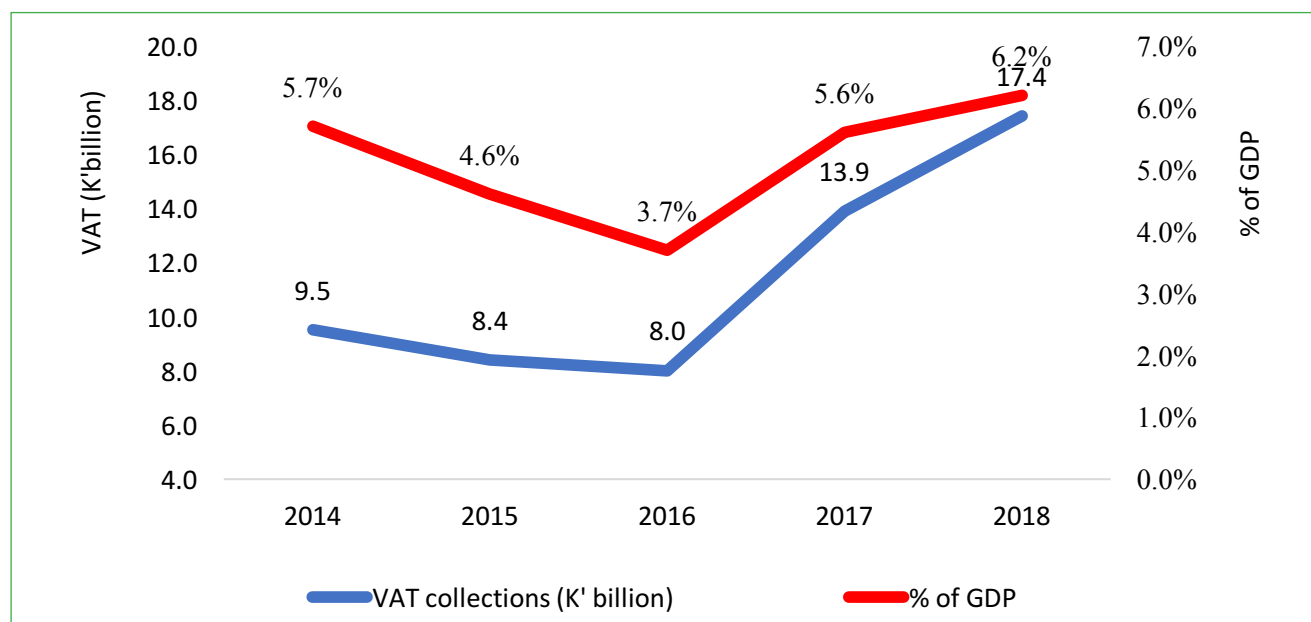
**Road Tolls:** The 2020 Budget has proposed to continue the road tolling programme, which is considered globally as an effective means of boosting domestic resource mobilisation to finance the maintenance of road infrastructure. In Zambia, the programme is meant to augment the revenue base and ensure sustainable financing of roads. In 2018, Government raised K1.6 billion, which was 51% above projections, and this was mainly on account of upward revision of the toll tariffs and the increase in the number of inland toll points. Therefore, this revenue is worth pursuing by the authorities as it will create more fiscal space and reduce borrowing for road infrastructure.

**Inelastic taxes and non-tax revenues:** We further encourage the Government to continue looking out for innovative taxes, which are relatively inelastic and therefore buoyant such as the proposed 20% increase on Carbon Tax on all motor vehicles entering the country, and increase of specific excise duty on cigarettes from K240 per mille to K265 per mille. Such taxes are easy to administer and unlikely to adversely affect the welfare of average Zambians. Other smart taxes already in effect include borehole taxes and skills development levy.

### 3.2 Rationality in Tax Reforms

We would like to commend the Minister for retaining VAT in the 2020 Budget. Despite challenges associated with VAT such as low yields due to many exemptions and the problem of high refunds (ZIPAR, 2019), VAT is still a simpler and far much better tax to administer than Sales Tax (hybrid or otherwise). Inter alia, this is because it has a self-enforcing compliance mechanism and flexibility of being collected throughout the supply/value chain. This is evidenced by the continued better performance of VAT collections over the years from as low as K8.0 billion (3.7% of GDP) in 2016 to as high as K17.0 billion (6.2% of GDP) in 2018 as shown (Figure 3.1) below.

Figure 3.1: VAT Collections as a Percentage of GDP (2014 - 2018)



Source: Constructed by Author using data from fiscal tables (Ministry of Finance)

Government needs to address compliance and administrative challenges associated with VAT, notable among them being the issue of high refunds. Some solutions may include:

- The need by the Government to muster the necessary fiscal discipline to ring-fence VAT refunds to avoid being diverted to other unintended purposes.
- In addition, the Zero rating of capital equipment and machinery for the mining sector is commendable as it will encourage acquisition of these equipment, thus increasing production, and at the same time address the issue of over-accumulation of VAT refunds from the mines (ZIPAR, 2019).
- To further enhance compliance and revenue collections, the Government should consider providing incentives such as VAT lotteries. This has been the case in many countries including the State of Sao Paulo in Brazil where consumers were given the opportunity to record their tax payer identification number on receipts which the retailer was required to send to the tax authorities. Consumers who did so were then entered into a lottery and earned tax rebates. They were also encouraged to report retailers who would not participate in the scheme. Millions of consumers participated; tax revenues increased; and noncompliance was reduced.

The planned upwards revision, to cost reflective levels, of various fees and fines charged by Government departments is a matter of concern, especially given the prevailing high cost of living. According to Central Statistical Office (CSO), annual inflation in September 2019 increased by 10.5%. This is a high increase,

especially assuming constant income levels over the same period given the sluggish economic growth (approximately 2%) experienced. Therefore, although such measures may be necessary to attract private investment in certain circumstances such as in the generation of electricity, we urge the Government to be cautious in making these adjustments to avoid overtaxing an already overburdened small formal sector that predominantly demand these services. In addition, the quality of services (e.g., queuing and processing times) provided by Government departments should be commensurate to charges applied.

On legislative measures, the Government proposed to reform, update and strengthen a number of Acts such as the Income Tax Act, Customs and Excise Act, Property Transfer Act, and Valued Added Tax Act in an effort to render their administration more effective. This is commendable. However, we urge the Government to follow through with this pronouncement. In the past, a number of similar reforms (e.g., revision of the Public Procurement Act and restructuring of State-Owned Enterprises (SOEs), etc.) have been promised in 2017 and 2018 but are yet to materialise.

Lastly, we strongly urge the Government to ensure that resources remitted to Government departments, institutions and agencies are well utilised and value-for-money results are tracked accordingly. For instance, between 2015 and 2018, ZRA received more than K2.5 billion (or K625 million per year on average; bigger than water and sanitation budget allocations) earmarked for modernising, **automating and** improving the operational efficiency of the tax system. We urge the Government to demand accountability for value-for-money for resources allocated to departments, institutions and agencies going forward.

## 4. Addressing the Debt Overhang and Servicing Costs

By the Government’s own admission, tight liquidity conditions mainly attributed to external debt service and the accumulation of domestic arrears have contributed to subdued economic growth. How did we get here? The country’s development strategy is centred on rapid infrastructure spending, financed by borrowing. Borrowing for capital investments such as schools, hospitals, roads, railways, water, and electricity is undoubtedly desirable as it unlocks economic growth opportunities. But in Zambia’s case, the very infrastructure that is supposed to bring about economic growth and social transformation is actually killing growth. This is partly because most infrastructure projects are almost exclusively financed by non-concessional external borrowing. For example, of the K19 billion spent on infrastructure over the January-August 2019 period, K16 billion (87%) was externally-sourced (See Figure 4.1).

This comes with considerable risks as demonstrated below:

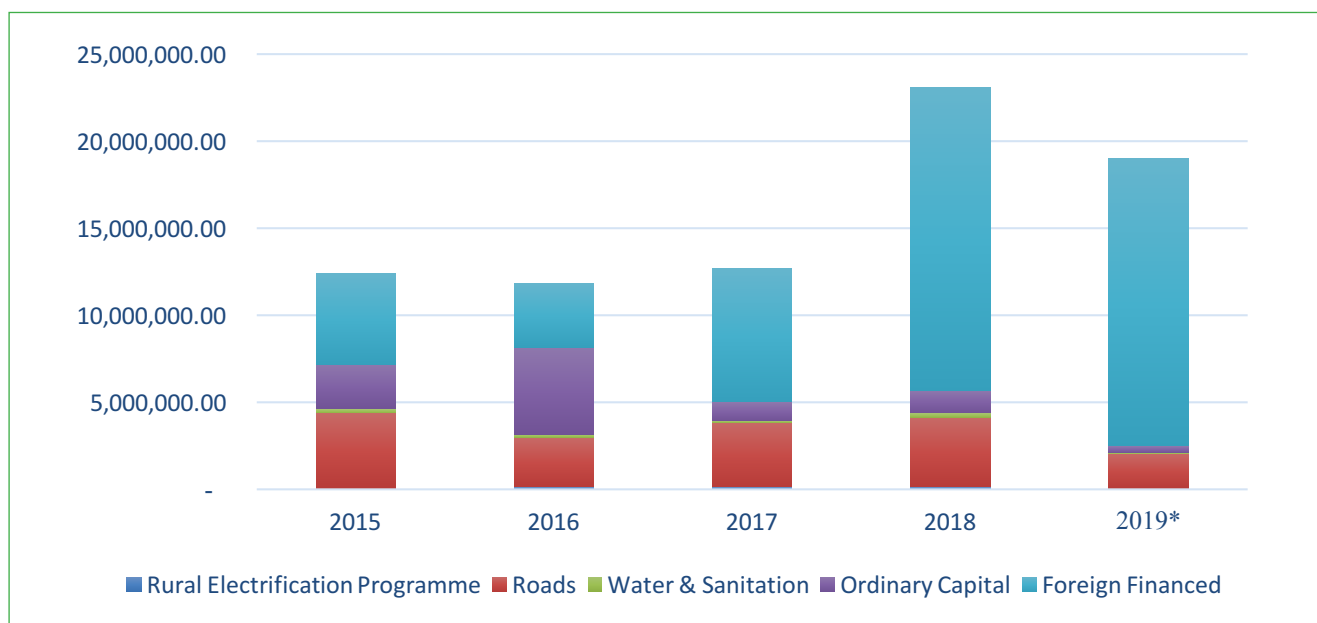
- The unrestrained borrowing has put Zambia’s public debt on an unsustainable path. The total public and publicly-guaranteed debt, including arrears, as at June 2019 was estimated at 76% of GDP, way above the sustainability threshold of 55% of GDP.
- Related to this high stock of debt, debt servicing costs are projected to increase by 43% in 2020. As a percentage of domestic revenues, the debt servicing costs are projected to increase from 42% to 47%, largely driven by the external component of debt servicing. This increase signals the Government’s inability to slow down the costs of

servicing the debt.

- Debt servicing costs squeezed out funds meant for other recurrent spending in 2019 and this is likely to continue in 2020. Borrowed funds have to be paid back with interest. And when the projects financed by debt do not generate positive returns, interest payments are financed from recurrent expenditures, and by extension, through domestic revenues – the same pot used for other recurrent spending. Against a target of K16.2 billion expenditure on debt servicing in the first eight months of 2019, K19.7 billion was spent, representing an overspend of 22%. The situation was similar in 2018 when debt servicing costs escalated by 35%.
- The non-payment for other critical spending items has resulted in mounting payment arrears. As at end-June 2019, domestic arrears increased to K20.2 billion from K15.6 billion. This translates to about K760 million (or approximately US\$60 million) per month.

Despite the current debt and debt servicing burden, the appetite for infrastructure investment is not waning. Around K25 billion will be spent on energy, transport, education and health infrastructure. Specifically, the 2020 budgetary allocation (K10.5 billion) to road infrastructure is higher than the 2019 allocation (K6.5 billion) - somewhat at odds with the Minister of Finance’s pronouncement to do “more with less”. Of this amount, only K2.8 billion will be financed by government resources, implying that the rest will be borrowed. While road infrastructure is pivotal to development, the returns have been elusive; weak capacity to implement, select and evaluate road projects has contributed to the construction of roads with little or no economic returns. Further, lengthy procurement processes, poor or absent engineering designs and generally poor workmanship tend to escalate the cost of delivering these projects.

Figure 4.1: Capital Expenditure 2015-2019, K'000



Note: Data for 2019 reported for January to August only

Source: Ministry of Finance 2019



Table 4.1: Debt Service Payments, 2018-2020

	2018			2019			2020
	Budget	Outturn	% execution	Budget	Outturn [Aug 2019]	% execution	Budget
Interest Payments	10,923,277		124%	14,183,205	12,221,396	86%	
Domestic	6,763,852	7,414,048	110%	7,964,622	5,825,267	73%	
External	4,159,426	6,180,590	149%	6,218,583	6,396,130	103%	
Principal Payments	3,217,786	5,505,070	171%	9,390,150	7,472,338	80%	
Domestic	208,417	2,082,574	999%	661,656	1,944,857	294%	
External	3,009,369	3,422,496	114%	8,728,494	5,527,481	63%	
Total debt Service	14,141,063		135%	23,573,355	19,693,734	84%	33,725,643
Domestic	6,972,268	9,496,622	136%	8,626,278	7,770,124	90%	12,634,848
External	7,168,795	9,603,086	134%	14,947,077	11,923,611	80%	21,090,795
Liabilities	1,329,734	436,794	33%	487,839	87,325	18%	2,278,734
Sinking Fund for Eurobonds	100,000	0	0%	100,000	0	0%	636,000

Source: constructed from Ministry of Finance

Despite pronouncements about not embarking on new projects, the Government is fixed on the K861 million FTJ University construction project in Luapula. While investment in education infrastructure is cardinal, the priority use of borrowed funds to construct a green-field university during a time of severe fiscal constraints while the existing universities are dogged with many funding and operational challenges seems economically irrational. Alternatively, the funds could have been better invested in aquaculture, an activity Luapula Pprovince has comparative advantage in.

#### 4.1 Adequacy of Measures to Curtail Debt Accumulation

The Minister of Finance in his budget address underscores the need to improve the efficiency of delivering road infrastructure by “doing more with less”. Among the measures proposed, the Government plans to re-evaluate existing road projects, seek alternative financing and increase the use of local contractors in the implementation of these projects. While increasing the participation of local contractors in the delivery of road projects has its own perks not least the empowerment of citizens, the 20% reservation policy has not worked very well partly because of weak enforcement of the policy and, to a larger extent, the discriminatory practices underlying the selection of beneficiaries.

The Government has devised an Arrears Dismantling Strategy. Under this strategy, the Government intends to increase the allocation of funds and use debt swaps to reduce the stock of arrears, as well as enhance commitment controls to curtail the accumulation of arrears. It has therefore increased the allocation to the liquidation of arrears and allocated K2.3 billion in the 2020 Budget compared to K487 million in the 2019 Budget (Table 4.1). While this allocation is dwarfed by the current stock of arrears, it will help to alleviate pressure in the private sector but should be seen in the context of the total arrears of K20.2 billion.

**While domestic arrears in 2017 were reduced to K12.7 billion from K19 billion in 2016, the liquidation of arrears in the subsequent years has not been impressive.** Despite budgeting K1.3 billion in 2018 to liquidate arrears, only K437 million or 33% was funded. The situation in 2019 is not that much different as, by August 2019, only 18% of the allocated funds towards arrears had been funded (Table 4.1). With further deterioration in the macroeconomic environment, the Government has to show more commitment in funding this budget item which is meant to, among other things, unlock private sector growth.

Increased allocation to the yet-to-be operationalised sinking funds for Eurobonds: Despite the sinking fund being set up in 2016, it has had operationalisation challenges, showing that simply stating the amounts of funds to be allocated is not enough. The Government needs to specify how the money will be raised this time around, considering that it has failed to do so in the last 3 years. Further, with just two years remaining before the first Eurobond is due for repayment, the funds allocated (K636 million) only account for less than 10% of the outstanding US\$750 million or only about 2% of the total US\$3 billion Eurobond portfolio. Given that the legislation governing the setting up of a Sinking Fund – the Loans and Guarantees (Authorisation) Act – is quite restrictive, the current macroeconomic circumstances, and the time remaining before the Eurobonds are due, it is unlikely that the Government will be able to have sufficient funds, or extra resources for that matter, to finance the Sinking Fund.

Refinancing of the Eurobonds: The authorities’ plan to refinance some of its loans is a welcome move as it will lower borrowing costs and extend maturities. There are a number of options available. First, Zambia can tap into the world’s emerging creditors such as China and India. Second, the country also has the option of refinancing through a bond buy-back. Financing options for buying back the bonds are discussed in the next section. Third, going to the IMF for financial

support would not only help with balance of payments issues, but also unlock other financiers to come on board. However, the Government's insistence on an expansionary fiscal policy stance with still overly ambitious expenditure and borrowing plans in 2020, the pathways to the IMF are fast closing. Moreover, given the lacklustre implementation of fiscal consolidation, the downgrading of the country's credit ratings by all the major international rating agencies, and low international reserves, the country is unlikely to have access to the international markets or, if it did, the refinancing will be very costly, defeating the whole purpose of refinancing.

The Government plans to develop the 2020-2022 Medium-Term Debt Management Strategy (MTDS): This will ensure sound debt management, meet the government's financing needs at lowest cost with a prudent degree of risk. Lessons can be drawn from the 2017-2019 MTDS which prioritised domestic borrowing over external borrowing. Without deepening of the domestic financial market, this Strategy ended up crowding-out private sector investment. Thus, the authorities reverted to prioritising external borrowing which, subject to high exchange rate risk, rapidly increased debt servicing costs. Without a MTDS to inform debt contraction decisions for the next three years, the status quo is likely to continue, so the development of this MTDS should be a matter of priority.

#### 4.2 Putting brakes on unsustainable debt servicing costs

While the aforementioned measures are welcome, they skate around the issue of dealing with high debt servicing costs. Evidently, Zambia cannot do away with public investment in infrastructure as the country still has significant infrastructure gaps. However, the Government has already borrowed heavily to finance infrastructure projects that have not generated the desired economic returns:

**a) Bond Buy-Back:** A bond buy-back refers to the process whereby the issuer approaches the open market and repurchases its bonds from holders. The bond buy-back will not only reduce the risk of default but it will also reduce debt servicing costs, but the current economic constraints leaves little room for pursuing this option. This notwithstanding, the Government has a number of options to choose from including the sale of assets. Offloading some of the country's stake in mining companies could produce the much-needed resources to buy back some or part of the bonds. The Government should consider the offer by First Quantum Minerals to sell off all or part of the 20% ZCCM-IH shares in Kansanshi mine<sup>4</sup>.

**b) Strengthen Staff Capacity in Debt Management.** Debt management has increasingly become more sophisticated as the Government starts using debt management transactions such as exchanges and debt buy-backs, currency and interest rate swaps. Ministry of Finance should therefore strengthen staff capacity to meet these emerging needs. Leveraging on technical assistance from the World Bank, IMF and other donor institutions would be a low cost way of achieving this.

**c) Options for Financing Infrastructure:** The Government needs to reduce reliance on borrowing to finance infrastructure development by considering other alternatives. These include devolving much of the country's infrastructure development plans to the private sector through Public-Private Partnerships (PPPs), issuing an infrastructure bond and use of extra proceeds from road tolls.

- **Use of PPPs:** PPPs for infrastructure and service delivery offer a low-hanging option for improving the efficiency of delivering road infrastructure projects. However, the success of PPPs is dependent on strong insulated institutions and policy consistency as the private sector demand a stable and predictable business environment.
- **Issuing an Infrastructure Bond targeting retail investors.** The Government should work on mechanisms to issue a specific infrastructure bond to raise money locally (to avoid exchange rate risks) and use the proceeds to pay for infrastructure projects as well as raise money to operationalise the Eurobonds Sinking Fund. Government could leverage on the existing infrastructure of the Bank of Zambia for the small investors to buy and sell these bonds via their smart phones or basic-features phone as has been done in Kenya. The coupon could be paid directly to the phone automatically on the maturity dates.
- **Financing infrastructure using proceeds from road tolls.** Given that infrastructure should be able to pay for itself, some of the money from tolls should be used to pay back the loans for road development. Since their inception, the actual collections from road tolls always surpass the projected collections. As at June 2019, an excess of K424 million was realised – funds that could be earmarked for paying off the debt.

<sup>4</sup> As at 31<sup>st</sup> December 2018 the estimate total mineral reserves at Kansanshi mine, both proven and probable as well as stock piles, and defined using the valuation copper price of \$3 per pound is 642 million tonnes at an average ore grades ranging from 0.14% to 0.62%. Based on this information, and excluding gold deposits, Kansanshi mine is grossly valued at about \$30 billion. Therefore, 20% ZCCM-IH shares are worth over \$6 billion gross, enough to offset the \$3 billion Eurobond debt.

## 5. Reinvigorating Growth

### 5.1 Seeds of Growth in the 2020 Budget

The 2020 Budget identifies agriculture, tourism, mining, energy and manufacturing as sectors for public and private investments to drive economic diversification and job creation in line with the Seventh National Development Plan (7NDP). For the most part, based on the decomposition of Zambia's GDP, these sectors indeed hold considerable potential for creating employment as well sustaining growth. In Figure 5.1 below, mining, manufacturing, accommodation & food (proxy for tourism) and electricity, recorded positive growth rates in both value-added output (ranging between 2% to 12%) and employment growth (ranging between 2% to 47%) between the years 2017 and 2018.

On the other hand, agriculture, while a critical seed for employment, remains unproductive thus limiting opportunities for raising incomes and realising inclusive growth. Output in the sector contracted between the years 2017-2018 even as employment increased. Relative to other sectors, actualising the full potential of agriculture to drive growth, economic diversification and productive employment creation requires more concerted efforts that will increase and modernise agricultural output and turn the sector around.

### 5.2 Growth Enablers

Aside from the above sectors earmarked for public and private investment, information and communication technology (ICT) – an important enabler of growth in other sectors, productivity growth and technological progress – also takes a central role in the 2020 Budget. The sector alone recorded an increase in value added and employment of 40% and 44% respectively in just one year. The 2020 Budget proposes to continue rolling out electronic platforms aimed at improving the efficiency of public service delivery and reducing

the cost of doing business. This will further expand the sector and its contribution towards sustaining growth. Notable ICT measures that have been proposed with the potential to improve the competitiveness of other sectors - tourism in particular, includes the online processing of visas and work permits.

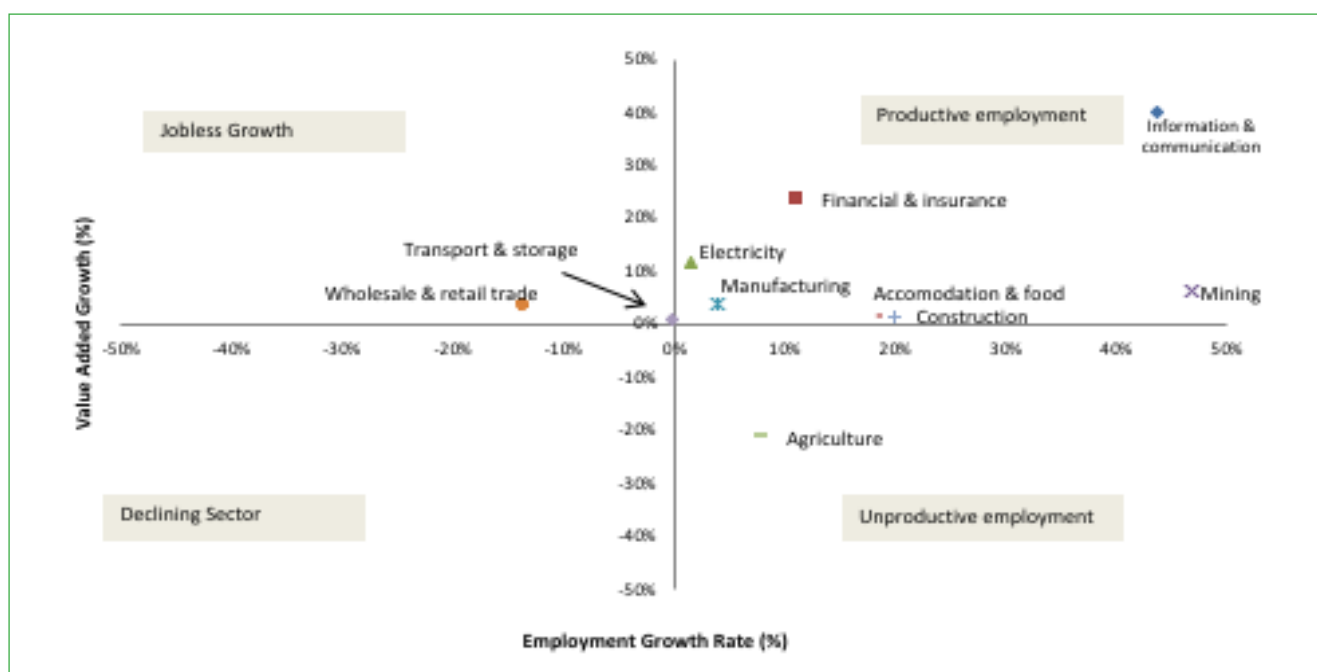
Related to this, the on-going investments into international airports should be harnessed to truly boost economic activity particularly in tourism and other service industries, as well as employment creation. In operationalising the airports, the Government should unwaveringly pursue the option of swapping some of the debt with private sector equity. Concurrently, the Government should seek to engage world-class management to run the airports more efficiently. Failure to do this, our investments in international airports will render them inefficient.

Notably, the 2020 Budget misses the opportunity to prioritise the financial and insurance sector as a growth enabler. Between 2017 and 2018, output and employment in the sector grew by 24% and 11%, respectively. This sector therefore also presents a low hanging fruit for employment creation. In addition, the financial sector is a key source of capital required to expand private sector investments and invigorate growth.

### 5.3. Growth Decelerators

The motivation to stimulate the domestic economy as threaded in the 2020 Budget comes amidst several growth decelerators. The factors range from fiscal and monetary factors, high input costs and rural connectivity, to limited climatic resilience of agriculture. Combined, these factors represent momentous force against the growth initiatives outlined in the budget. This section focuses on high input costs and rural isolation as the rest of the growth decelerators are discussed in other sections.

Figure 5.1: Valued added and Employment Growth Rate in Selected Sectors, 2018-2017



Source: Author's construction based on CSO data



**High input costs:** Electricity is a major input with both direct and indirect effects on the cost of production. Therefore, Zambia's current power deficit which has resulted in intermittent power supply has negatively impacted on productivity and output. To buttress the power crisis, the cost of electricity was adjusted upward by 75% in 2017 on the back of a proposal to migrate towards cost reflective tariffs which consequently raised production costs for businesses. Consistent with this policy direction, the 2020 Budget aims to ensure that cost reflective electricity tariffs are fully attained in order to attract increased investments in the sector. The perception of many businesses is that the sharp rise in the cost of electricity has negatively affected their growth (BoZ 2019) and any further increase may be devastating. At the same time, businesses perceive energy rationing as a major constraint on production. Therefore, while some businesses welcome the idea of cost-reflective tariffs if it guarantees reliable electricity supply, others are equally concerned about the imminent increase in production costs. For firms with power back-up systems run on hydrocarbon fuels, the rise in the cost of fuel further exacerbates their production costs making them less competitive. Therefore, the rising cost of fuels constrains the firms' choices on energy adaptation strategies. This situation is worse for SMEs with limited adaptation capacities. On the other side, the rise in the price of fuel and production costs when passed on to consumers, raises the prices of goods and services thereby dampening consumer demand.

Regards labour policies, since 2012 firms in Zambia have had to contend with the Minimum Wages and Conditions of Employment Act which they associate with escalating labour costs and constrained growth. Consequently, some SMEs have resorted to laying off employees as part of their cost optimisation measures. The enactment of the Employment Code Act No. 3 of 2019 which repeals the 2012 labour legislation, covers more than minimum wages, and posing further threats to labour costs escalation, job losses and decelerated growth.

**Poor quality of human capital:** On top of the labour legislation costs concerns, firms have to contend with a poorly-skilled workforce – a major constraint to industrialisation and inclusive growth. Improved human capital is essential for improving productivity, innovation, competitiveness, income and output. This is critical for achieving sustainable and inclusive growth. The 2020 budget had a perfect opportunity to create a point of departure through increased investments in human capital accumulation, with particular emphasis on science and technology, but like the 2019 budget, it falls short on this premise.

**Poor feeder road network:** The condition of Zambia's rural roads has continued to deteriorate despite the recognition that infrastructure is a key growth enabler. Poor feeder roads limit access to input and output markets as well as access to social services.

#### 5.4 Nurturing the Seeds of Growth

**Transforming Agriculture:** Agriculture is a major sector earmarked for economic diversification and

employment creation in the 7NDP. Agriculture is the second largest employer contributing 26% to employment albeit with high level of informality at 79%<sup>5</sup>. Factor productivity is very low, with maize yields falling below two metric tons per hectare. Over-reliance on traditional farming methods – low mechanisation, inadequate livestock health management and infrastructure, dependence on rainfall for production, and lack of hydro-meteorological information and inadequate risk management – limit the sector's productivity (ILO 2019). The potential of the agricultural sector to increase its production and productivity and keep its place as a priority sector of the economy is now increasingly under threat due to increasing climate variability.

Development of agriculture requires modernisation and diversification within the sector towards agro-processing. However, because of low mechanisation, lowly skilled labour, poor accessibility to markets and social services, ineffective agricultural policies, output in the sector has remained subdued. The 2020 Budget could do more to transform agriculture. Continued investment in irrigation infrastructure is a step in the right direction but the scale and the spatial distribution of the projects is in dissonance with the need to reduce dependency on rain-fed agriculture. Improved provision of meteorological and hydrological data should be leveraged to support planning.

Under the livestock and fisheries sub-sector, Africa offers a huge market demand for meats which Zambia is yet to take advantage of due to endemic livestock diseases. The measures outlined to improve the livestock sub-sector are also a step in the right direction but because of the communal nature in which most livestock farming is undertaken, the measures may not be sufficient to facilitate entry into the export market. Armed with the recent livestock census data, the Government should be aiming at establishing and maintaining cordoned and certifiable livestock disease free zones in partnership with the private sector where livestock is concentrated. The measures directed towards aquaculture development are broadly on point.

**Mining: Nurturing the Golden Goose that Lays the 'Dollars':** The 2020 Budget proposes sweeping mining sector reforms including, limiting input VAT claims by mining companies on diesel to 70% from 90%, on electricity to 80% from 100%, and zero-rate mining capital equipment and machinery. The Budget also proposes to zero-rate the copper cathodes sold locally in order to encourage value addition and create employment. These measures have been introduced against the backdrop of a long-held view that mining companies do not contribute their fair share of taxes to the economy as well as, in the Minister's words, "to raise revenue for the government and discourage transfer pricing".

While these measures are intended to increase government revenue, they are too burdensome on the mining companies to achieve the objectives of encouraging value addition and boosting job creation as envisaged by the Minister. Their implementation may

<sup>5</sup> Bwalya, Mwenge and Mulenga (2019)

also be ill-timed given the uncertainties in the world economy which have resulted in decreased global demand for metals. Notably, the Government's proposal to zero-rate mining capital equipment and machinery in addition to resolving the VAT refunds challenges will also unlock mining firms' liquidity and stimulate investments. Conversely, the combination of reducing VAT claims and dis-allowing VAT claims on other consumables in the midst of a gloomy global economic outlook may discourage investments in the mining sector. On the other hand, the zero-rating of copper cathodes sold locally is a commendable move for encouraging copper beneficiation and job creation in the mining value chain.

In addition to the proposed mining tax reforms, the 2020 Budget seeks to intensify the diversification of mining by allocating more resources to exploration for non-traditional minerals such as gold and manganese. This is commendable given the rising earnings from Non-Traditional Exports (NTEs) as seen in 2017-2018 period (\$1,752.8million – \$2,036.1million). However, in view of the country's fiscal position and competing needs, the government will do well to leave exploration to the private sector as opposed to increasing spending. Notably, the aforementioned VAT reforms may be counter-productive to the growth in non-traditional mining.

Overall, the sector's real GDP contribution grew by 7.3, 3.0 and 5.9 percentage points in 2016, 2017 and 2018 respectively. Given that the mining sector is a key driver of growth, contributing 15.2% to GDP in 2018; and the major source of foreign exchange earnings, accounting for 70% of total export earnings in 2018; extra caution must be taken to ensure that we do not hurt *the goose that lays the 'dollars'*. Moreover, the sector is already at risk of subdued growth emanating from

geopolitical and macroeconomic headwinds such as the US-China trade war, higher fuel prices, stringent labour laws and the effects of the 2019 fiscal reforms namely: increased mineral royalty rates, non-deductibility of mineral royalty from company income tax, import duty on copper and cobalt concentrates, export duty on precious metals, and export duties on manganese ores and concentrates. It is therefore imperative for Government to review these fiscal reforms in order to encourage investments and growth in the mining sector and derive the multiplier growth effects in manufacturing, business services, wholesale and retail trade and transport and storage services.

#### **Making Good on the Industrialisation Promise:**

Industrialisation continues to be a recurring theme in all the national budgets in tandem with the development priorities in the national development plan. Likewise, the 2020 Budget aims to promote industrialisation albeit with a focus on export-led industrialisation. The process of transitioning from low income and low productivity activities to higher income, higher productivity, and higher value-added activities – dubbed structural transformation – is critical for realising inclusive economic growth. Moreover to sustain growth, Zambia needs to reduce its vulnerability by transitioning towards export-oriented activities more resilient to external shocks - manufacturing. Further, the strong backward and forward linkages associated with the manufacturing implies strong multiplier growth effects in other sectors.

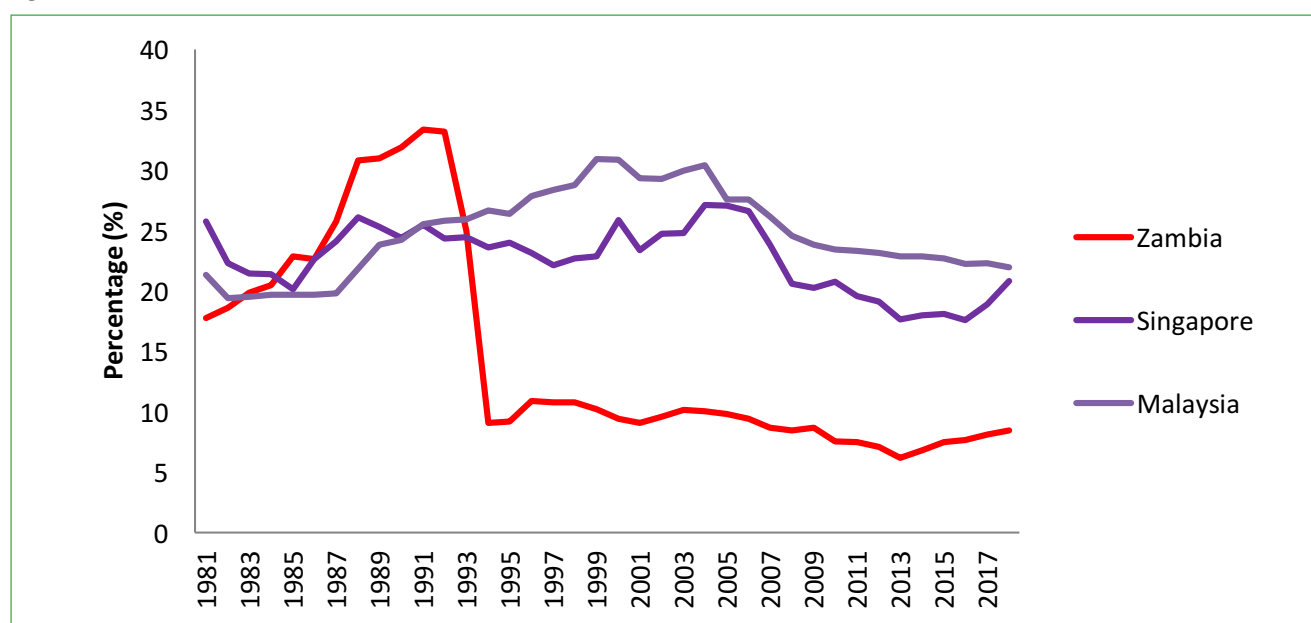
So far, Zambia has recorded little traction in industrialising despite the array of budgetary measures over the years to spur industrialisation which suggests that the measures have largely been ineffective (Table 5.3).

Table 5.3: Summary of Budgetary Measures for Spurring Industrialisation, 2018-2020

2018 National Budget	2019 National Budget	2020 National Budget
<ul style="list-style-type: none"> <li>- Development of multi-facility economic zones (MFEZs) and industrial parks</li> <li>- Review of the performance of existing MFEZs and industrial parks</li> <li>- Agricultural and Industrial Credit Guarantee Scheme</li> <li>- Encourage lending to small and medium enterprises using movable assets, securities and stocks as collateral</li> </ul>	<ul style="list-style-type: none"> <li>- Investment into the MFEZs estimated valued at US\$ 3.3 billion</li> <li>- Implementation of the National Local Content Strategy</li> <li>- Business linkage programme</li> <li>- Government Procurement of locally manufactured goods</li> <li>- Buy Zambia Campaign</li> <li>- Investments in agro-processing</li> <li>- Development of out-grower schemes for palm oil trees.</li> </ul>	<ul style="list-style-type: none"> <li>- Export-oriented industrialisation</li> <li>- Carpentry and Foundry Industrial yards</li> <li>- Zero rate copper cathodes</li> <li>- Suspension of import duty for 3 years on machinery for processing solid waste into energy and production of organic fertilisers.</li> <li>- Surtax of 5% on Flexible Intermediate Containers</li> <li>- Increase the specific excise duty rate on cigarettes</li> </ul>

Source: Author's construction

Figure 5.3: MVA Share in GDP



Source: World Bank WDI data

Using the share of manufacturing value added (MVA) in overall GDP, a common measure of gauging industrialisation, Zambia's manufacturing sector has failed to rebound following the structural and economic reforms of the early 90s (Figure 5.3.3 below). MVA as a share of GDP drastically reduced from 33.2% in 1992, to 9.1% in 1994 revealing rapid deindustrialisation. More recently over the last 5 years, Zambia's industrialisation process has stagnated with MVA as a share of GDP averaging 7.7% per annum.

In contrast, successful new industrialist countries like Malaysia and Singapore have sustained high shares of manufacturing in overall economic activities. Consequently, to realise effective export-led industrialisation, this requires:

- i) Measures aimed at identifying industries with export potential premised on industries with existing exports that can be boosted or industries in which the country has a latent comparative advantage that can be unlocked; and
- ii) Recourse measures for addressing the factors constraining manufacturing and export growth such as weak productive capacities, excessive regulation, low productivity, cumbersome and inefficient border procedures, poor transport infrastructure, non-tariff barriers, import competition and the other growth decelerators expounded under section 5.2 as well other sections.

Against this backdrop, the measures proposed in the 2020 Budget fall short of adequately supporting export-led industrialisation. The continued development of industrial yards is a welcome move that presents opportunities for micro and small enterprises to harness positive agglomeration effects such as scale production, shared input and distribution costs and knowledge and technological spill-over effects. However, these yards need to extend to agro-processing which has more export potential. In addition, the proposed

increment in the specific excise duty rate on cigarettes is likely to reduce import competition thereby making the tobacco industry more competitive. As one of the key sub-sectors under manufacturing for growth and employment creation, this is a positive development. Similar measures however need to be extended to other carefully selected industries with the most potential for output and export growth and employment creation.

The 5% surtax on flexible intermediate bulk containers is another commendable initiative with potential to stimulate the local production and local supply chain of industrial containers. However, being an intermediate product, other measures aimed at guaranteeing sufficient local capacity to meet industrial demand for containers should be implemented.

By and large, while the 2020 Budget mentions the potential of the African Continental Free Trade Area (AfCFTA) market to stimulate growth and employment creation, it remains mute on the measures required to address the production, regulatory, infrastructure and non-tariff barriers impeding Zambia's effective participation in intra-African trade. We fill in some of these policy gaps in the ensuing sub-section.

### 5.5 Filling in the Policy Gaps

Stimulating domestic growth has become one of the most salient objectives reverberating through the 2020 Budget aimed at turning the country's economic fortunes around and realising sufficient revenues required to reduce the fiscal deficit and create the much-needed employment for poverty alleviation. With a more optimistic 3% growth target in 2020, up from the projected 2% for 2019, the proposed stimuli to reinvigorate the economy will require additional measures henceforth elaborated:

**Stimulating growth with deregulation:** Streamlining regulations particularly those related to starting a business, renewing licences, and importing and exporting goods can greatly reduce the cost of doing



businesses and stimulate business growth. Moreover, removing excessive government regulation (export bans) on the export of agricultural commodities such as maize will bring certainty and predictability to trade thereby increasing the competitiveness of Zambian exporters. In addition, harnessing the full potential of the AfCFTA (and COMESA and SADC) for growth and industrialisation requires amongst many other measures, predictable export policies, efficient customs and border procedures, and transparent sanitary and phytosanitary requirements.

#### **Stimulating growth through tax cuts and tax rebates:**

A real missed opportunity in the 2020 Budget is the use of tax cuts and tax rebates to stimulate growth. Notwithstanding the fiscal constraints, tax cuts to PAYE are necessary for increasing disposable income and stimulating consumer spending on various goods and services. Similarly for businesses, tax rebates are a means of creating financial slack for reinvestment and production expansion. For micro and small businesses constrained by limited capital, waiving various licencing fees could encourage their growth.

#### **Stimulating growth through lower lending**

**rates:** Tight liquidity underpinned in part by the upward adjustment in the monetary policy rate, rising commercial banks' lending rates and excessive government borrowing have increased the cost of borrowing and dampened private sector investment and thus growth. A monetary stimulus involving a cut in interest rates can reduce the cost of borrowing and induce private sector borrowing and investments thereby stimulating growth. Notably, this measure will have to be delicately balanced with a counter tight monetary stance aimed at reducing and maintaining inflation within the bounds of 6%-8% and stabilising the exchange rate.

## 6. Weathering the 2020 Vagaries of Climate Change

Climate change and variability is one of the main constraints to growth the nation has experienced in the recent past. On account of this constraint, the 2019 Budget targeted a GDP growth of 4% but the result is estimated to be about 2%. This poor performance is attributed to the energy and agriculture sectors, among others. The Budget has outlined many measures that are critical for adapting to climate change. It goes further to highlight additional measures, such as increasing carbon tax, focused on mitigating change in the climate.

The adverse impacts of climatic change such as reduction of river run-off (due to drought) led to a reduction in electricity output from the hydro plants and crop failure. These impacts, if left unaddressed, can have severe impacts on the economy. For instance, Zambia could lose an estimated 4.4% of its GDP due to climate change effects in the long-run (by the 2100), and the Rest of the World could lose 1.9% .

### 6.1 Proposed Energy Measures: A "Grey" Silver Bullet

Due to drought in the 2018/2019 season, the electricity sub-sector, which is about 84% hydro power dominated, could not supply the required power to sustain the economic growth. The shortage of power, led to increased load management events, impacted and disrupted both economic activities and social life of the country.

**The electricity sub-sector:** To mitigate the impacts of the climate on the electricity sub-sector, the Government has proposed diversification of the energy mix. If followed through, this would lead to reduced dependence on hydro power. However, for the diversification drive (a long-term measure) to be successful, the Government has rightly recognised the need for a cost reflective tariff. A cost reflective tariff is not a panacea for the sub-sector but is key to attracting new investments.

At the current tariff level of USc6.4 per kWh, the Zambian electricity market has struggled to attract investments in new capital power generation projects. Major electricity players in the SADC region, such as South Africa and Mozambique, offer better tariffs for the investors, at USc7.2 and USc8.7 per kWh, respectively .

The importance of a cost reflective tariff (estimated to be about USc10 per kWh ) illustrated using Ngonye Solar Power Plants, commissioned in 2017, has an average generation cost of USc7.5 per kWh (reported as USc6.2 per kWh-dc). At this generation cost, this project is one of the world's lowest cost solar projects . Yet, even at this cost, the average generation cost is significantly higher than the tariff. This implies that Zambia has essentially maintained electricity subsidies.

In addition, beyond the need to attract investment, a cost reflective tariff, in the short term, would enable the Government to effectively manage its expenditure side by reducing the need to significantly subsidise the consumption of electricity.

However, it should be recognised that a cost reflective tariff is not a panacea for all the challenges that this sub-sector faces such as poor financial practices by the industry players. Further, a cost reflective tariff means that many more people would fail to access clean energy and the cost of doing business would increase. Therefore, measures to minimise the negative impacts of a cost reflective tariff, such as targeted electricity subsidy programmes for the poor, should be developed.

**The petroleum sub-sector:** To reduce the pressure that cooking and heating services put on the electricity sub-sector and the roles that these services play in exacerbating deforestation and environmental degradation through the use of charcoal and fire-wood, the Government proposes to zero rate usage and importation of Liquefied Petroleum Gas (LPG), gas stoves, other gas cookers and gas boilers. As short-term measures, these are commendable. However, usage of LPG and natural gas has significant impacts on the environment and increase climate change, as they are high carbon emitting fuels.

To sustainably address the environmental challenges

that come with the use of LPG and natural gas, we recommend that the Government should hasten the development of the liquid biofuel industry. This is important in three ways: 1. it will link the energy sector to the local farmers, 2. reduce pollution and carbon emissions that come with usage of petroleum energy; and 3. reduce the country's fuel import bill.

Overall, while the proposed measures will not arrest the current problems in the sector, they are progressive. These proposals act as both short- and long-term incentives for different sector players to respond positively. However, some measures targeted at mitigating the effects of climate change will actually lead to an increase in climate change, as highlighted above.

## 6.2 Agriculture and Climate Change: Thinking Twice...

The agriculture sector has seen a declining contribution to the economy in recent years, falling from 20% of GDP in 1999 to 7.2% in 2018, partly due to recurring droughts in 2014/2015 and 2018/2019. Undoubtedly, the sector's high dependence on rain and favourable weather conditions for both livelihoods and production renders it vulnerable to climate variability.

Specifically, for crop farming, production has contracted in times of droughts. Figure 6.1 illustrates the correlation between drought occurrence and drops in maize production.

From Figure 6.1, area planted (crops) in 2016 was 1.16 million ha. Conversely, K97.9 million is allocated to climate-smart technologies in 2020, specifically for extension services for crop, livestock and fish production to mitigate climate change related adversities on the sector. Assuming the whole allocation went towards crops only (1.2 million ha), this implies K84.56 per ha in

2020, which is highly insignificant given the high costs associated with climate-smart technologies.

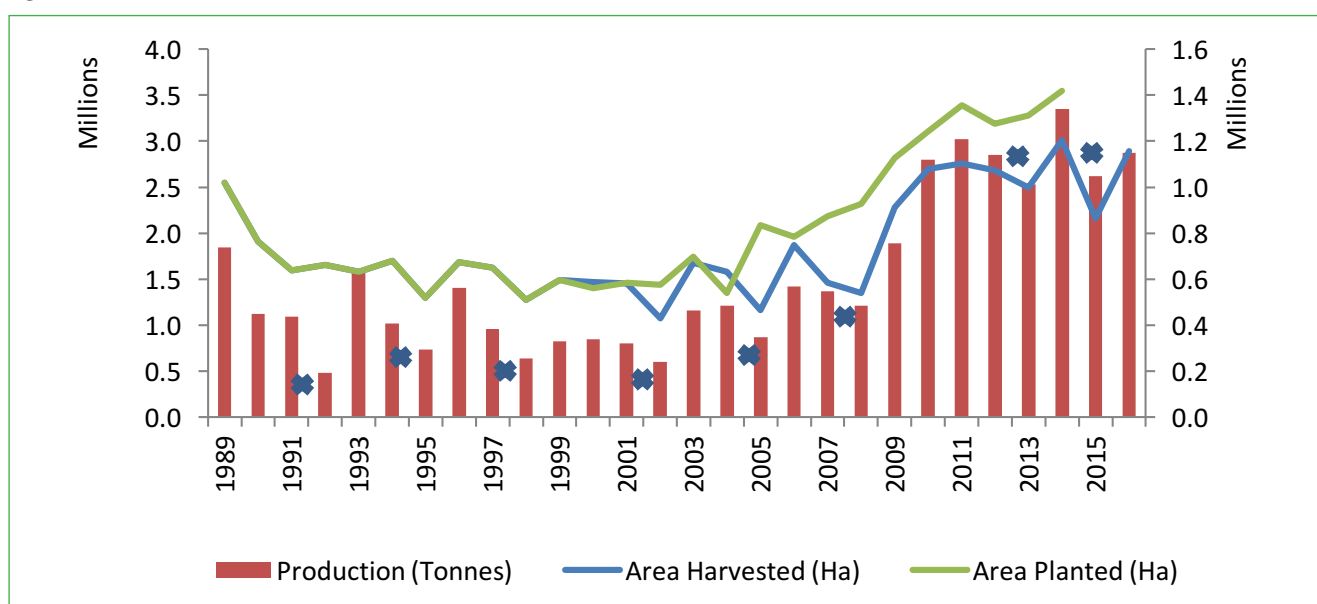
Further, the 2020 Budget allocation to environmental protection, which includes climate resilience, is a notable 21% less than 2019's allocation. This reduction is higher than the 8% reduction recorded in the 2019 allocation compared to 2018. These reductions are important to note given that the 2017 Budget allocation significantly increased by over 200% compared to the 2015 allocation.

The FISP continues to crowd out spending on other critical areas in the sector. In the 2020 Budget allocation, the FISP allocation is almost ten times the allocation to climate smart technologies. Though budget allocations to the FISP have followed a downward trend since 2018 with the proposed 2020 Budget allocation 21% lower than 2019, FISP and FRA still account for over 90% of the agricultural resource envelope.

In view of the above, K97.9 million allocation towards climate smart agriculture is only a step out of the cave. Given the country's significant drought challenges, climate-smart technologies are critical in sustainably increasing productivity and building the climate resilience of farming systems. Climate variability and change presents a critical challenge to the FISP. The continued allocation of resources to FISP without addressing climate change may further negate expected gains. For this reason, climate-smart technologies need significant investments. We, therefore, recommend that Government continues mobilisation of funds under the Green Climate Fund (GCF) in addition to reallocating some resources from FISP to climate-smart technologies.

Government pledges to continue to work with cooperating partners to complete various irrigation projects. ZIPAR commends the continued construction of multipurpose dams given their benefits in flood

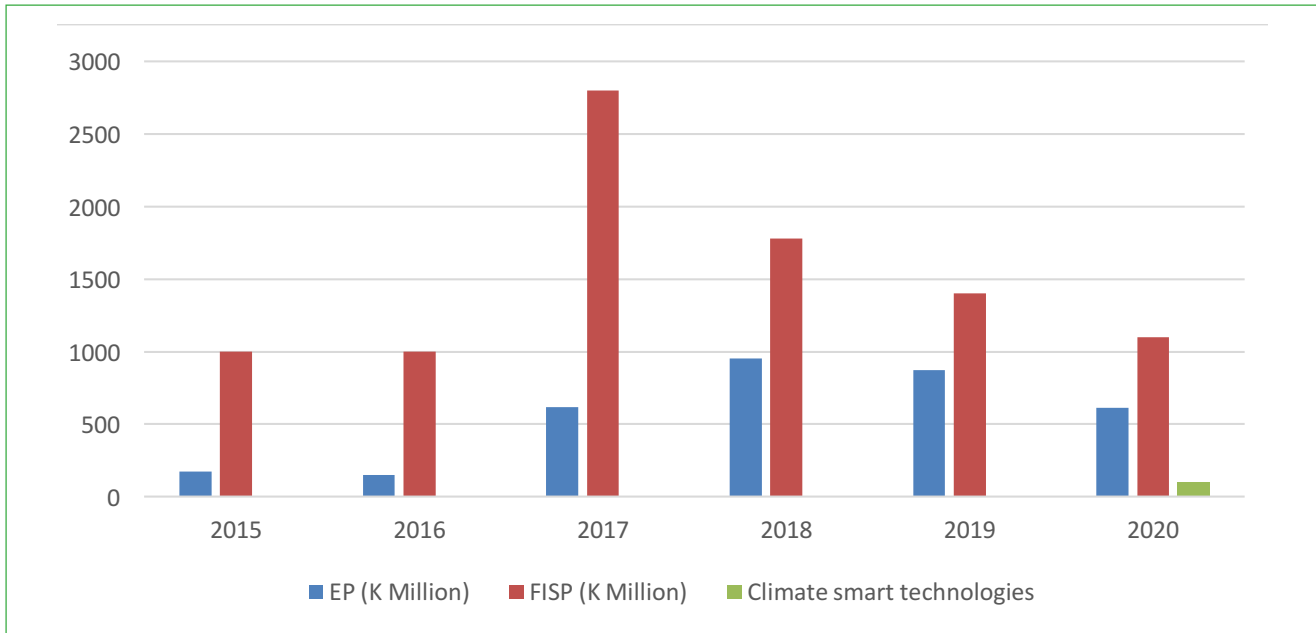
Figure 6.1 Annual Maize Production (MT), Area Harvested (Ha) and Area Planted (Ha)



Note: denotes drought (or partial drought) years

Source: Author's construction using CSO Data

Figure 6.2 Comparing FISP and Environmental Protection (EP) Budget Allocations (2015-2020)



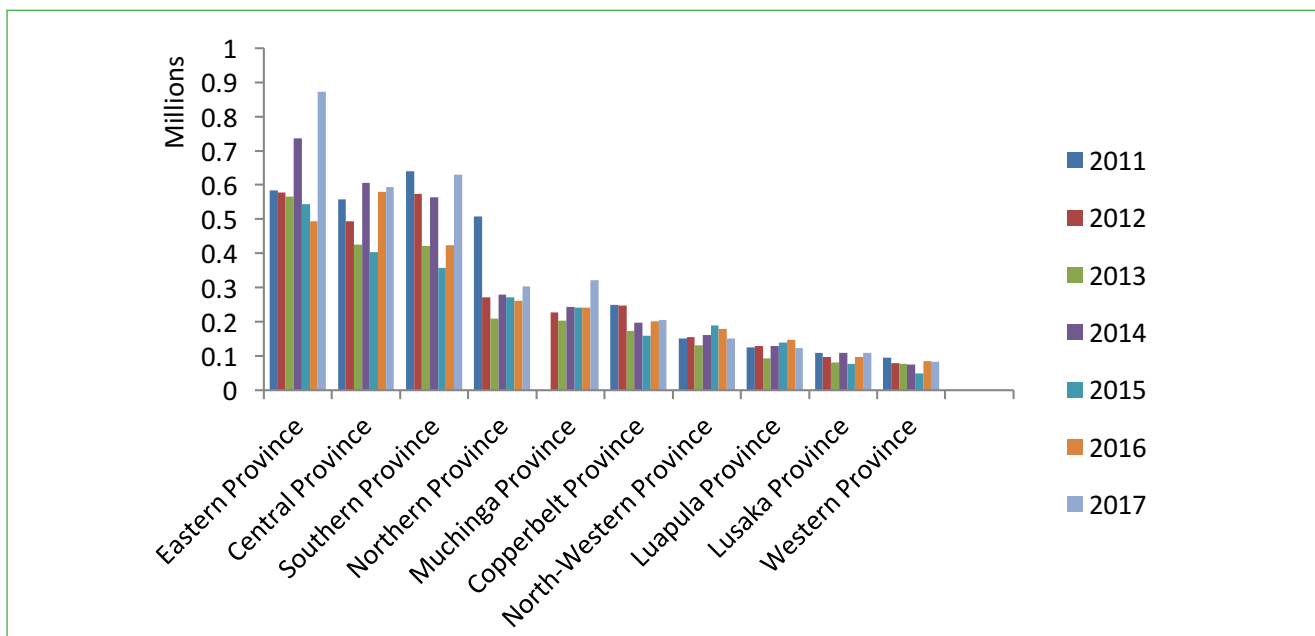
Source: Author's construction using CSO Data

control and the provision of reliable and quality water supply for irrigation. Additionally, the establishment of irrigation schemes in areas found in the most vulnerable agro-ecological zone (Region I) is commendable. This is an important step towards building climate resilience. Future trends project less rainfall and drier weather. We further recommend implementation of additional irrigation projects in the Eastern, Central and Southern provinces of Zambia, given their significant role in food security coupled with their vulnerability to the climate. The three provinces combined have over the years

accounted for approximately 50% of the national maize production.

Evidently, in the face of climate change, the Government needs to implement urgent adaptation interventions in agriculture. The 2020 Budget emphasises the need to address climate change in order to develop Zambia's agricultural sector and outlines some notable measures. We must however, make mention that sustainable development of Zambia's agricultural sector needs a more holistic approach that tackles not one area – e.g., climate change – but all key issues that impact on the agricultural sector.

Figure 6.3: Maize Production (millions of metric tonnes) by Province (2011-2017)



Source: Author's construction using CSO Data



## 7. Safeguarding and Sustaining Gains in the Social Sectors

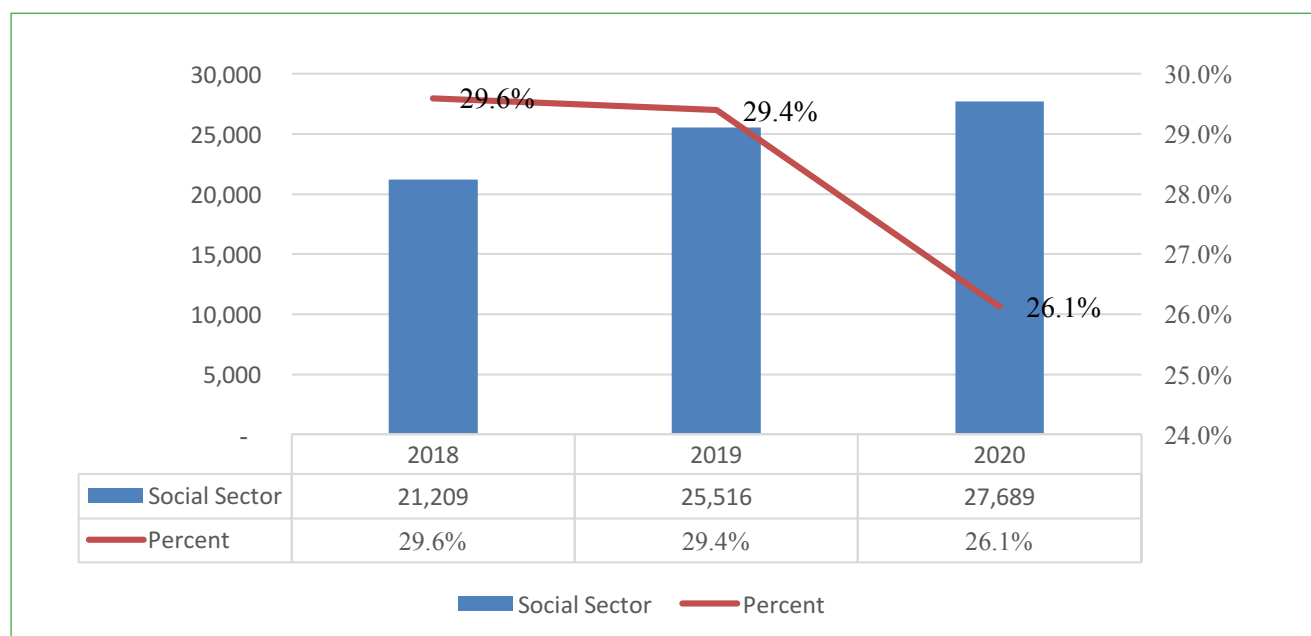
Zambia's current fiscal constraints have affected social sector spending more than any other function of Government. For instance, of the approved K1.7 billion for social benefits in 2019, only K141 million or 8% of the approved budget was released by June 2019. Additionally, the social sector budget as a share of the total budget has declined and moved from 29.4% in 2019 to 26.1% in 2020 as shown in Figure 7.1. This is an indication that budgetary allocations to the social sector are not being safeguarded within the context of a constrained fiscal space.

Thus, the levels of underspending, the redirection of resources away from the social sectors and the diminishing relative importance of this sector in relation to the other priorities of Government in the budget threaten to erode the gains that Zambia has made so far.

### 7.1 Diminishing Commitment to Protecting the Poor

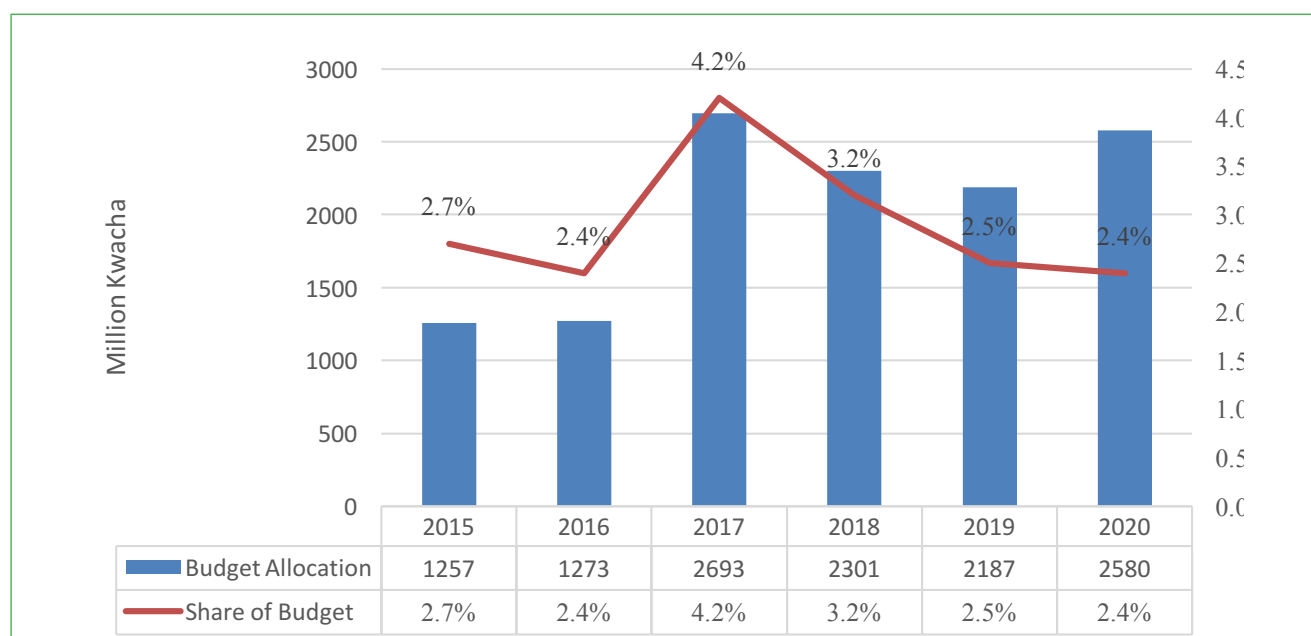
The Government has been implementing a number of interventions which have been key in reducing poverty and vulnerability. Notwithstanding, Zambia's current fiscal challenges make it hard for the Government to continue investing in poverty reduction, risking a reversal and failure to sustain the gains realised so far. For instance, as shown

Figure 7.1: Evolution of social sector budget: Absolute K'million and share of the budget



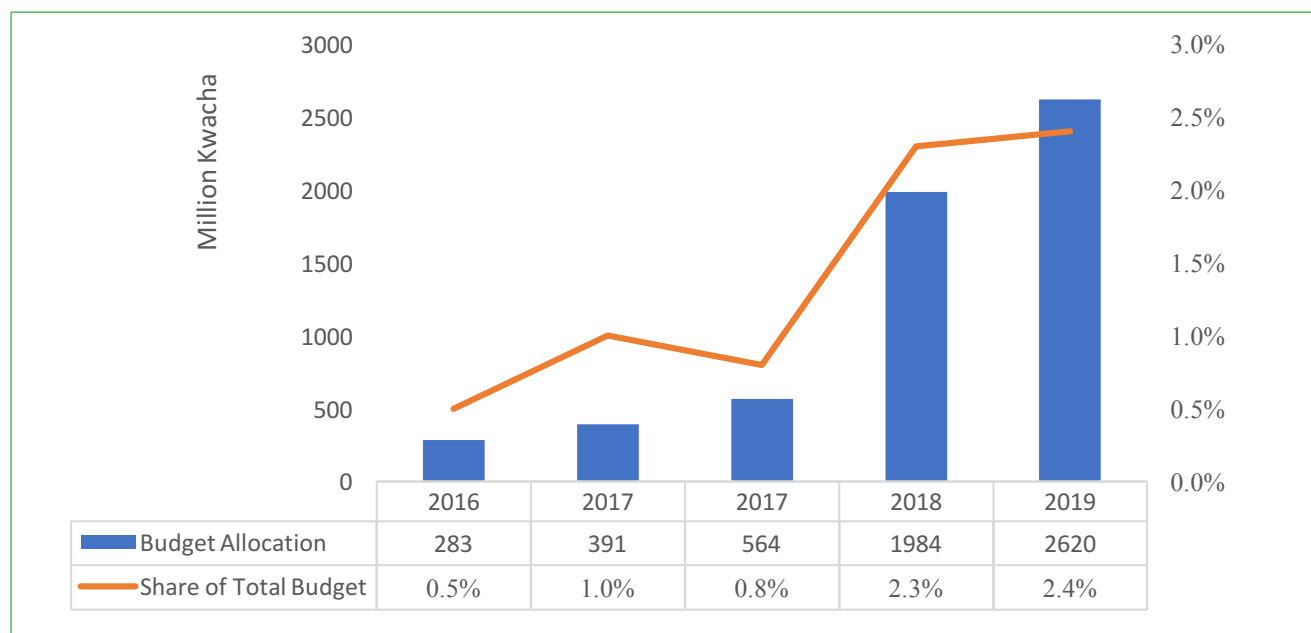
Source: Author's construction using CSO Data

Figure 7.2: Social sector budget, 2015-2020



Source: Author's construction from budgets

Figure 7.3: Water and Sanitation budget, 2015-2020



Source: Author's construction from budgets

in Figure 7.2, the social protection budget as a share of the total budget has declined from 4% of the total budget in 2017 to 2.4% in the 2020 Budget.

Additionally, budget execution performance for the past years has been very poor, waning confidence in national budgets to realise set aspirations. For example, in 2019 only 8% of the total K3.8 billion meant for the Poverty and Vulnerability pillar under the 7NDP has been spent. Similarly, the social cash transfer was underspent by 47% in 2016, 41% in 2017 and 37% in 2018.

In order to safeguard the poor, efficiency in the execution of budgets through timely and consistent release of funds is required. The Government should also consider ring-fencing the social protection budget so that it is not prone to reallocations during the fiscal year.

## 7.2 Installing Taps and Sanitary Systems without Leaving Anyone Behind

The 2020 Budget proposes to spend K2.6 billion towards water supply and sanitation. The proposed amount is almost five times the size of the K546 million 2018 water and sanitation budget, indicating that the water and sanitation budget has increased its share in the national budget, to 2.5% in 2020 from 2.3% in 2019 (see Figure 7.3). The budget increase is made on the backdrop of improvements in rural water and sanitation coverage. Water coverage improved in rural areas from 35% in 2016 to 56% in 2018 while sanitation in rural areas also improved from 30% to 57.6% during the same period. Thus the 2020 Budget is an opportunity to sustain these gains amidst threats of the adverse effects of climate change which are likely to result in reduced water availability and increased risk of water sources contamination due to flooding.

However, 66% of the 2020 Budget is allocated to peri-urban and urban water supply projects such as the Kafue Bulk Water Supply Project, a trend that has

persisted since 2018. These skewed allocations imply that the rural population and urban poor remain unserved. For example, in Lusaka, which was the epicentre of the 2018 Cholera Outbreak, it is estimated that 70% of the population live in high-density unplanned areas where 90% use pit latrines.

Lastly, the greatest concern for water and sanitation that threatens loss of gains highlighted is the poor budget execution performance which stood at an average of 56% between 2014 and 2018<sup>6</sup>. Thus, the Government should improve efficiency of budgets in 2020.

## 7.3 Sustaining Gains in the Pursuit of Universal Health Coverage

Figure 7.4 shows that the allocation to the health sector has increased by 16% from K8.1 billion in 2019 to K9.4 billion in 2020. As a share of the total budget, however, the allocation to health reduced from 9.3% in 2019 to 8.8% in 2020.

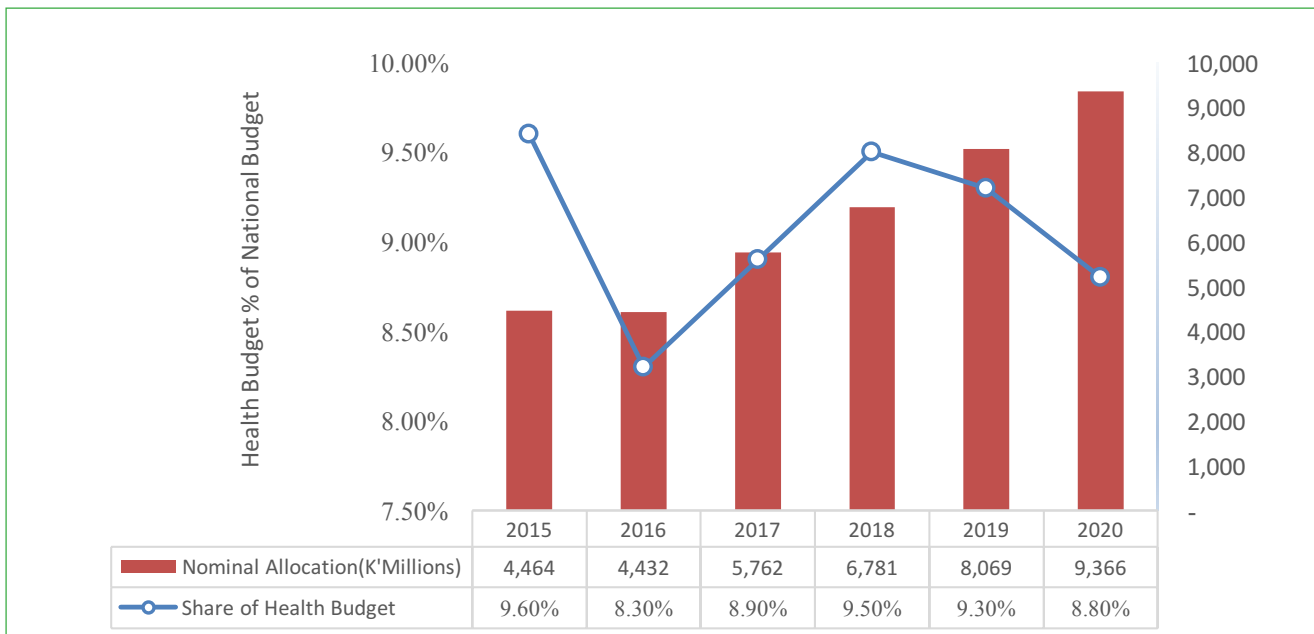
By function, the health sector budget remains predominantly an infrastructure budget, with allocation towards health infrastructure increasing by 140%. While allocation to essential drugs and medical supplies has remained stagnant at K900 million, the 2020 Budget reduces allocation to the hospital operations budget line by 5.5%, posing a threat to effective hospital operations and ultimately healthcare service delivery. The delayed implementation of the National Health Insurance Scheme impedes the drive towards the achievement of financial risk protection and universal health coverage.

## 7.4 Balancing Diminishing Fiscal Space and Quality of Education

The allocation to the education sector in 2020 has reduced both in absolute terms and as a share of the national budget, from K13.3 billion in 2019 to K13.1 billion in 2020. Consequently, the proportion of the

<sup>6</sup> Annual Economic Reports, Ministry of Finance

Figure 7.4: Share of the Health Sector Budget to the National Budget, 2015-2020



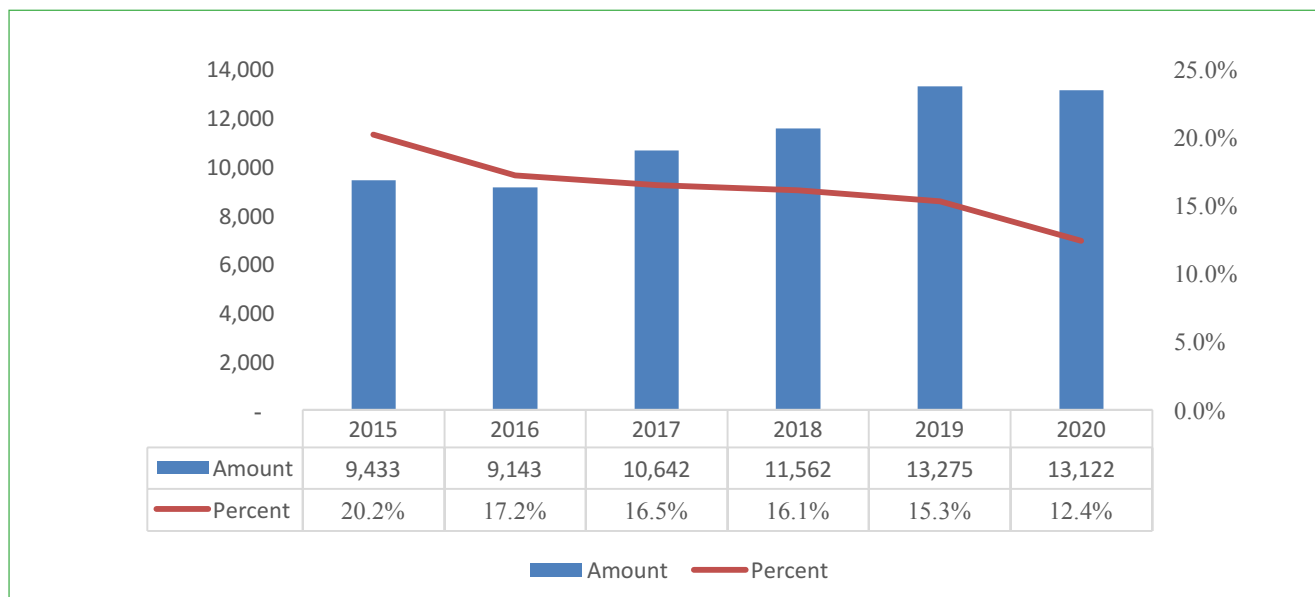
Source: Author's construction from budgets

education budget has further dropped to 12.4% of the total budget in 2020 from 15.3% in 2019 and 16.1% in 2018 as shown in Figure 7.5. This reduction is coming on the backdrop of an increase in the allocation to Defence and Public Order and Safety budgets. While the budget has committed to improving access and quality of education, prioritise the completion of some infrastructure development projects and provide school materials, we note that certain budget lines such as the FTJ University which is a huge capital expenditure accounting for 80% of the infrastructure projects in education should be rationalised and resources diverted towards the completion of some infrastructure projects as stated in the budget speech preamble on education.

There is need to safeguard the gains that have been registered in education over the years such as the

attainment of the Millennium Development Goal (MDGs) on universal primary education, increased completion rates to grade 9 and increased school transition rates. However, while the transition rates have increased over the years, the indicators also show that 68.2% of the learners do not successfully complete grade 12 compared to 28.3% at grade 9. Both these measures assess the absorptive capacity of the next level of education and are also an indicator of the quality of education. We note that the 2020 Budget in this respect does commit to improving the progression rate from primary to secondary level by completing and constructing secondary schools by 2020. The Budget also proposes to reduce the pupil-teacher ratio which as at 2017 stood at 42.1 at primary level and 30.2 at secondary level. We commend Government

Figure 7.5: Evolution of education budget: Absolute K'million and share of the budget



Source: author's construction from budgets



for the recruitment of the 2,009 teachers in 2019 and more so for responding to the shortage of teachers in science, mathematics and technology (STEMS) by recruiting most of the teachers from STEMs. However, the Government should improve the quality of teacher training centres and facilitate in-house retraining for teachers that are already recruited to enhance their skills.

We note that despite that Technical Education, Vocational and Entrepreneurship Training (TEVET) which has been identified as a sector with significant labour market relevance and supports skills development of not only postsecondary students but also primary and secondary school dropouts, the sector remains relatively underdeveloped. This is due to inadequate funding relative to other subsectors. Therefore, the Government should not embark on heavy capital projects but should instead concentrate on completing existing projects and supporting TEVET. The Government should further safeguard the allocation to education and reconsider allocations towards Defence and Public Order and Safety budgets which have been

## 8. In Closing...

The 2020 Budget seeks to position Zambia for growth through stimulation of the domestic economy. It articulates a range of macroeconomic, fiscal and debt management, sectoral growth, climate change and social sector policies, strategies and interventions for stimulating growth while protecting the social sector (though the ideal of "leaving no one behind" is lost). The seeds for growth in 2020 and beyond have been identified. Now Zambia will have to pay keen attention to planting and nurturing the seeds. It will have to mind the critical gaps and potential implementation and management slippages of the recent past, the heavy debt overhang, which threatens to trample all over the growth, the increasing vagaries of climate change and the weak record of past protection of the social sectors.

Sticking to the script in 2020 and effectively and efficiently implementing the policies and interventions as pronounced in the Budget will probably be Zambia's greatest test yet; it will be a defining moment for finding the path back to robust growth over the medium term.










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