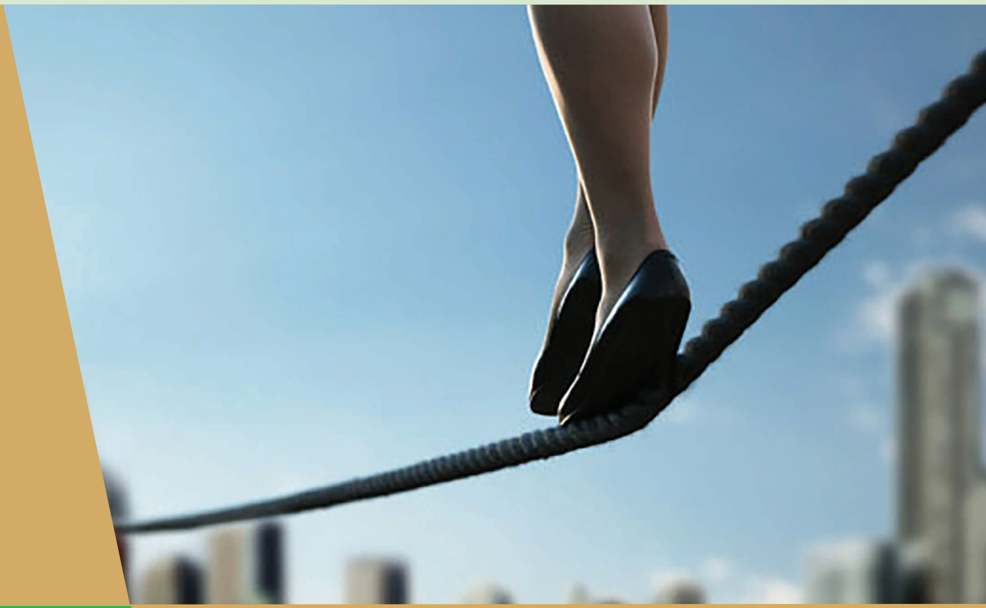
ZIPAR
Zambia Institute for Policy Analysis & Research

Walking a tight rope to economic recovery



Analysis of the 2017 Budget Speech

"Restoring Fiscal Fitness for Sustained Inclusive Growth and Development"

17 November 2016

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The big picture

The 2017 Budget was presented to the National Assembly by the Minister of Finance on 11 November 2016 under the theme "Restoring Fiscal Fitness for Sustained Inclusive Growth and Development". The following are the key highlights of this budget analysis:

- **Against expectations, spending to go up.** It was widely anticipated that there would be aggressive measures towards cutting spending. However, it is projected that there will be significant increases on expenditures such as interest payments on public debt, Farmer Input Support Programme and road infrastructure projects. Therefore, overall Government spending in 2017 is set to increase by 2.3% of GDP compared to 2016 – it is proposed to rise to ZMW64.5 billion or 27.7% of GDP from ZMW53.1 billion or 25.8% of GDP in 2016. We raise some important questions here. Does increased spending on roads make economic sense in the current slowdown? Is this a case of 'counter-cyclical spending to protect jobs and the poor? Does the three-fold increase in the FISP tie in with Government's call for a review of the programme which is fraught with targeting challenges. Is this increase in spending on FISP part of the wider agricultural diversification plan?

- **Revenue collection measures fall short.** While the current economic malaise offers few options for broadening revenue sources, the budget has attempted to maximise collections from the current base while seeking new tax handles at the same time. Thus, some bold revisions to claimable input VAT on selected supplies, surtaxes on selected imports, border crossing charges, increased road tolling and a raise in the top rate of Pay as You Earn (PAYE) have been announced. But all these measures are proposed to raise domestic revenue collections only by 2%.

- **Deficit, debt to go up further.** With increased spending and flat revenues, the fiscal deficit is to increase to 7% of GDP on a cash basis. As part of the measures to finance the 2017 budget, Government projects a higher level of borrowing as well as a higher level of grant assistance from cooperating partners. However, project grants have often had low levels of realisation in the past. Thus, there is a big possibility that project grants may underperform in 2017. This might in turn result in increased domestic borrowing thus further crowding out the private sector and further increasing the fiscal deficit, which will add to the stock of public debt.

- **Bold measures on addressing energy sector challenges.** These include moving to cost reflective tariffs by the end of 2017; increasing electricity generation capacity; moving to a better energy mix, and the review of the overall market structure – including review of ZESCO; dealing with inefficiencies in the sector and disengaging Government from the fuel sub-sector; and examining the viability of Indeni and TAZAMA pipeline. Policy to disengage from petroleum sub-sector effectively will require ensuring that adequate measures are put in place to guarantee sufficient strategic reserves. Pricing of the commodity would also pose serious challenges given the possibility that the finished products could be imported from different sources. This would require a very strong regulator to effectively regulate private sector profit motives. Further, Government will need to deal with the 25% import duty on petrol and diesel which currently is the major deterrent for direct imports of finished products by OMCs.

- **Diversification measures more progressive.** Government is proposing a number of measures to boost production in agriculture beyond maize and support local production among industries away from mining of base metals. These include introduction of customs duty on semi-processed edible oils and on spare parts for various machinery and equipment; a Cashew Nut Infrastructure Support Programme valued at US$55.4 million is expected to be implemented in Western Province; and the development of the newly created Kafue Iron and Steel Economic Facility Economic Zone and the private sector led Kalumbila Multi Facility Economic Zone. These specific measures are more progressive when compared to the diversification measures in 2015.

- **Overall the budget is more realistic:** Given the current macroeconomic conditions, reality has set in and the 2017 budget sets out some conservative or perhaps more realistic fiscal objectives, policies and strategies on growth, inflation, domestic revenue and international reserves. There are also some good measures around fiscal discipline, in line with pillar 3 of the Zambia Plus economic recovery programme.

- **Budget sets a footing to economic recovery in the medium term.** The budget is anchored on the medium term home-grown economic recovery programme called “Zambia-Plus”. In this regard, the budget is expected to serve as a key instrument for establishing a foundation for the implementation of the programme, achieving recovery, and eventually fostering sustained and inclusive growth over 3-5 years. While the five pillars of Zambia Plus have been treated to varying degrees in different parts of the 2017 budget, many of them have been variously forwarded before in previous budgets. Ultimately the taste of the pudding of economic recovery will be in the eating; setting Zambia on the path to recovery will depend on how well the authorities stick to the budget execution plan. Clearly, the Government is walking a tight rope to economic recovery given the inherent tension between the current scarcity of public resources and the pressure to hasten recovery, inclusive growth and sustained development. Although it will not be an easy feat, the Government will have to muster the political will and stewardship that keeps it steadfastly walking the tight rope. The Government should remain steadfast in walking the tight rope to recovery.

Cutting the coat according to the cloth

> *… I carry a message for my fellow Zambians this afternoon. The message is simple. We cannot spend what we do not have. We cannot borrow beyond our ability to repay.*
>
> *Hon. Felix Mutati, MP, Minister of Finance, 11 November 2016*

In 2015, Zambia saw an end to its lustrous growth story and experienced an abrupt decline in economic growth. It was hoped that 2016 would present a turn in fortunes. Therefore, the 2016 budget embodied some optimistic macroeconomic projections buoyed by the remarkable performance of non-tax revenues particularly fees, fines and charges in 2015. With growth not materialising in 2016 – the economy is expected to grow by 3.0% - reality has set in and the 2017 budget sets out some conservative or perhaps more realistic fiscal objectives, policies and strategies.

In order to take back the economy to a sustainable footing, the Government has devised a home-grown economic recovery programme. With the fiscal deficit expected to breach 10% of GDP in 2016[1], it was anticipated that there would be aggressive measures towards cutting spending and raising revenue. However, this budget seems too thin on the ground, particularly regarding measures on cutting spending.

Government spending in 2017 is set to increase by 2.3% of GDP compared to 2016 – it is proposed to rise to ZMW64.5 billion or 27.7% of GDP from ZMW53.1 billion or 25.8% of GDP in 2016. It is projected that there will be significant increases on expenditures such as interest payments on public debt, Farmer Input Support Programme and road infrastructure projects.

While the current economic malaise offers few options for broadening revenue sources, the budget has attempted to maximise collections from the current base while seeking new tax handles at the same time. Thus, some bold revisions to claimable input VAT on selected supplies, surtaxes on selected imports, border crossing charges, increased road tolling and a raise in the top rate of Pay as You Earn (PAYE) have been announced. But all these measures will only result in domestic revenue collections rising by 2%. Particularly, revenue targets from non-tax collections have been revised downwards compared to the 2016 budget.

Therefore, against domestic revenues of 18.4% of GDP, the Government's spending plans are likely to increase the fiscal deficit to 9.3%[2] of GDP. This is about the same as the current levels of the deficit.

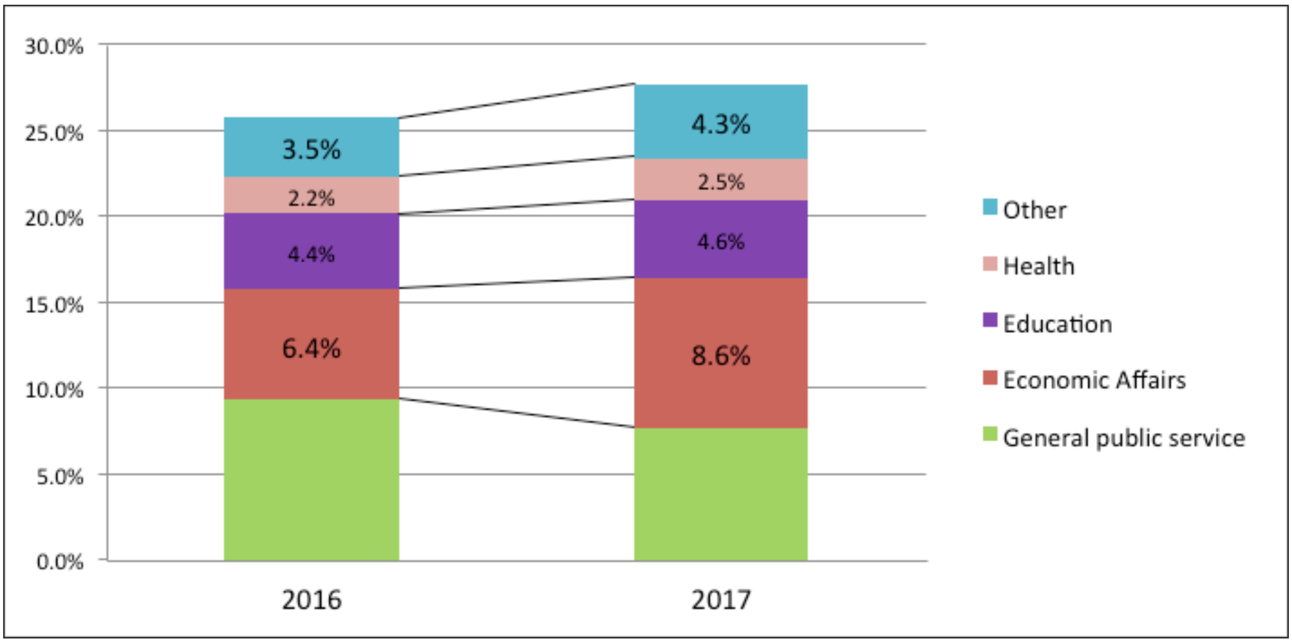
Resizing the coat …

While spending on general public services in 2017 is set to fall to 7.7% as a share of GDP compared to 9.3% of GDP in 2016, spending on economic affairs will increase from 6.4% of GDP to 8.6% of GDP. This is largely driven by the Farmer Input Support Programme

1 http://www.mofnp.gov.zm/index.php/achived-ministrial-statement/260-statement-by-honourable-felix-c-mutati-mp-minister-of-finance-on-the-state-of-the-economy-and-economic-recovery-programme-to-be-supported-by-the-imf

2 A fiscal deficit occurs when a government's total expenditures exceed the revenue that it generates, excluding money from borrowings. The authorities' reported macroeconomic objective of limiting the fiscal deficit to 7% of GDP is on cash basis.

Figure 1: Expenditure by function as % of GDP, 2016 & 2017 budget estimates



Source: Budget speeches 2016 & 2017

and roads infrastructure. Indeed all the other expenditure components are forecast to increase as shown in Figure 1. Health and education and social protection are forecast to increase from 6.6% of GDP in 2016 to 7.0% of GDP in 2017. This is in line with Government's intention to protect critical social sector spending.

The public sector wage bill and interest payments on public debt are two of the notoriously difficult to control expenditures that the government has to grapple with. As part of the fiscal targets and policies, Government therefore intends to restrict new public sector recruitments to only frontline workers in the health and education sectors. This partial recruitment freeze on the other categories of workers is likely to slow down the growth of the wage bill. However, it is unclear if this measure is only for 2017 or if it is to be implemented over the medium term.

Interest payments on public debt will grow to ZMW11.5 billion in 2017. To put it into context, Zambia will spend more in paying interest on public debt than it spends on road infrastructure. The country will be faced with a huge interest payment burden amounting to 4.9% of GDP in 2017. This is an increase from 3.5% of GDP in 2016. Interest payments are expected to amount to 26.7% of domestic revenue. This means that for every one Kwacha collected as domestic revenue, 27 ngwee would go into interest payments, leaving the larger part of the remainder for other recurrent expenditures, including wages and salaries which take up about 50 ngwee of that.

The long 'shopping list' of strategic road infrastructure and the subsequent increase in the road infrastructure budget requires reconsideration. The increase in the budget from ZMW6.6 billion to ZMW8.6 billion suggests the scale of road infrastructure implementation will even be higher than 2016 which was an election year.

Government proposes to increase the Farmer Input Support Programme almost threefold from ZMW1 billion in 2016 to ZMW2.9 billion in the 2017/2018 agricultural season and target 1 million small-holder farmers. It is not entirely clear why this is proposed to be scaled up in this period when the Government recently announced that there will be a review of the programme which is currently fraught with challenges of targeting.

The fact that the fiscal deficit of 9.3% of GDP will add close to US$2 billion to the existing debt stock next year means debt servicing costs are likely to increase further, unless such debts are used to finance projects that can generate revenue within a reasonable period to pay off the debts. This situation is alarming because very soon the country will have to use nearly one-third of its domestic revenues to pay interest on public debt and one-fifth on road infrastructure. When the public sector wage bill is added, they will be little domestic revenue left to finance other activities.

In line with the Minister's message of not borrowing beyond our ability to repay, Government needs to develop a coherent strategy to help align the country's high debt servicing costs with its medium-term capacity to repay. Therefore, we welcome Government's intention to "develop, publish and implement a robust medium term debt management strategy in 2017". This is long overdue as it will help address refinancing, *interest rate* and exchange rate risks associated with the current debt portfolio.

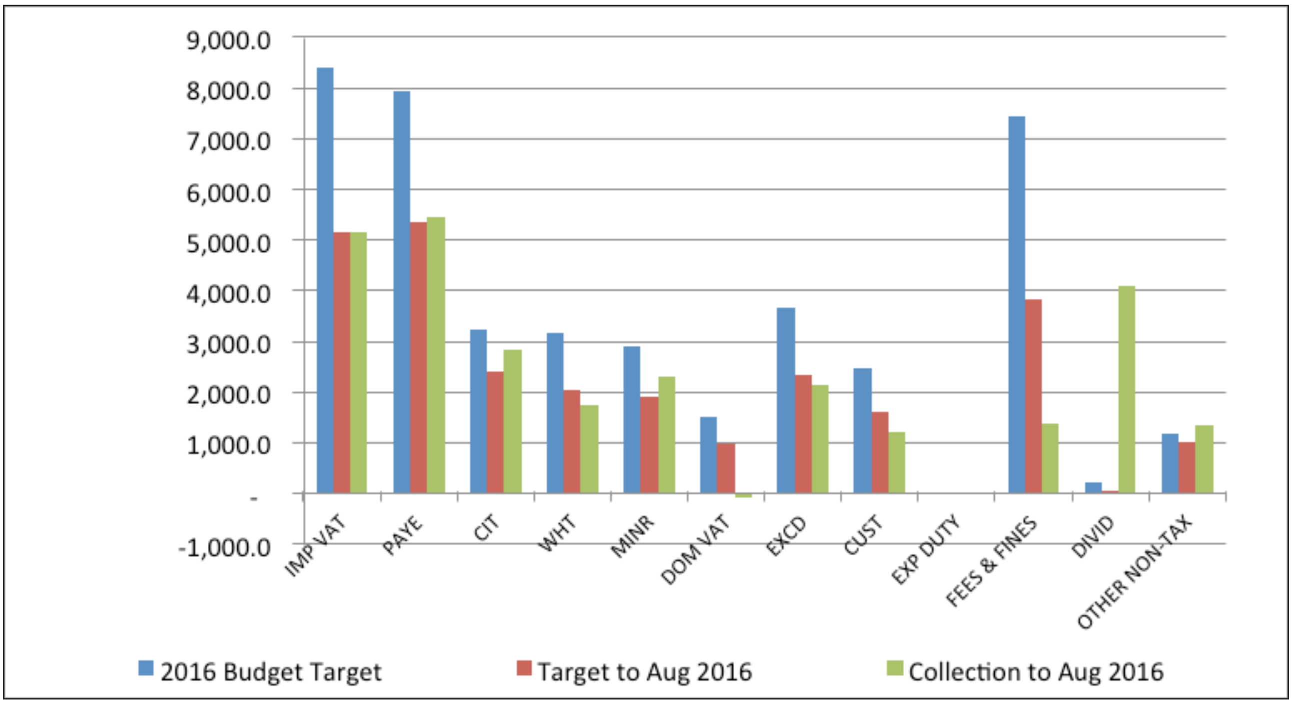
With regard to road infrastructure, there is need to have these prioritised by taking into consideration extensive project appraisals that take full account of the availability of long term financing. The scale proposed for 2017 is still too huge and may not be paced according to the current resource availability and economic circumstances.

How wide is the cloth?

The revenue targets of the 2017 budget are premised on the initial intent of the first pillar of the Zambia-Plus economic recovery programme which is to enhance domestic resource mobilisation. The 2017 tax proposals work as a double-edged sword aiming to raise revenue but also to enhance local production and increase equity. Thus direct tax proposals appear to aim at widening the tax base and redistribute income whilst changes in excise and customs duties aim to raise revenue but also reflect a desire to protect local industry.

Looking back, 2015 was the tipping point in Zambia's economic fortunes where growth declined sharply and saw high volatility in the exchange rate, a spike in inflation, declining terms of trade and a rapid accumulation of public debt. Despite the challenges, the revenue target in 2016 was ambitious at 20.1% of GDP. However, a surprise surge in non-tax revenue of 39% above target, driven by dividends, led to total revenue collections being above target by 3% although tax revenue collections fell short by 7%.

Figure 2: Domestic Revenue Targets and Actual Collections – January to August 2016



Source: Ministry of Finance 2016 Fiscal Tables

Table 1: Comparison of 2016 and 2017 Budget Targets and Revenue Contributions

	2016 Approved Budget	2017 Budget Speech	2016 % of Revenue	2017 % Revenue	2016 % of GDP	2017% of GDP
Domestic Revenue	42,109.13	42,939.79	100%	100%	20.1%	18.4%
a. Tax Revenue	30,410.26	37,662.46	72%	89%	14.5%	16.1%
Income Tax	14,340.26	19,647.92	34%	47%	6.8%	8.4%
Value Added Tax (VAT)	9,893.50	9,507.34	23%	23%	4.7%	4.1%
Customs and Excise Duties	6,132.51	7,992.62	15%	19%	2.9%	3.4%
Other revenue		518.58	0%	1%	0.0%	0.2%
b. Non Tax Revenue	11,698.87	5,317.33	28%	13%	5.6%	2.3%

Source: 2016 Fiscal Tables and 2017 Budget Speech (Revenue figures in ZMW million)

The battle in tax collections was especially steep on domestic Value Added Tax (VAT) which missed the target by 106%. Other taxes that underperformed include customs duties by 24%, withholding tax by 15% and excise duty by 10%. Some taxes performed exceptionally well and these included export duty which was above target by 50%, similarly mineral royalty and company income tax were above target by 20% and 18%, respectively.

Additionally, non-tax revenues were largely above target, the surprise element on non-tax revenue arose from dividend payments from ZCCM-IH which beat estimates by 8,083% and FRA proceeds from crop sales exceeded expectations by 89%. However, fees, fines and charges were below expectations by 64% and FISP recoveries were a mere 2% of the target. While the economic challenges from 2015 still linger, relative calm has been restored as the exchange rate has stabilised and inflation is on the decline in 2016.

Resource Envelope in 2017

Unlike the 2016 budget which had high expectation on revenue at 20.1% of GDP, the 2017 budget sets a lower target at 18.4% of GDP. The composition and projected contributions have markedly changed in 2017 with tax revenues anticipated to increase from 14.5% to 16.1% of GDP while non-tax revenue is posited to reduce from 5.6% to 2.3%.

Table 2 shows that the driving factors for the increase in tax revenues will be company income tax, PAYE and customs and excise duty. Some of the taxes that are expected to contribute less include withholding tax and mineral royalty.

Notably, mineral royalty collections are estimated to reduce to 5% of total revenue in 2017 as opposed to 9% in 2016. This target reflects the new mining tax regime that was approved by Cabinet during 2016 for 2017.

Table 2: Proportion Contribution of Different Taxes to Tax Revenue in 2016 and 2017

YEAR	CIT	PAYE	WHT	MINR	IMP VAT	DOM VAT	EXC DUTY	CUST DUTY	EXP DUTY	OTH-ER	TOTAL
2016	10%	24%	10%	9%	25%	5%	11%	7%	0%	0%	100%
2017	13%	26%	8%	5%	25%	0%	12%	9%	0%	1%	100%
Average 2011-2016	15%	26%	5%	6%	23%	4%	10%	9%	0%	2%	100%

Source: Ministry of Finance and Zambia Revenue Authority

The mineral royalty rate was reduced from 9% to 5% for base metals and 6% for precious stones. The variable profit rate was removed and a price based royalty introduced. This decision was made at a time when the price of copper was at $4750 and was meant to lower the tax burden on the mines. Currently even before getting to 2017 the price of copper has increased and is currently at $5600. As a result of the new regime the target amount for the tax in 2017 is only ZMW 1,891 billion, a tad below the amount collected so far in 2016 of ZMW 2,308 billion. It will be interesting to see how the implementation of the new changes will pan out in terms of revenue especially that the price of copper is on the rise.

The compensating measures in customs reflect the aim to use cross border tax as a revenue raising mechanism. These taxes were below target in 2016 by 15% mostly on account of a depreciated kwacha which had made importation costly. Now that most people and businesses have adjusted to the new level of the exchange rate and its stability, it is anticipated that cross-border taxes would increase. However, unlike custom duty which has a number of proposals that are expected to increase its tax collection, there may be a tall order faced in collecting excise duty. This is because the average target on excise duty in the previous 5 years has been 10%, and in most of these years this target has not been met. Yet it is now set to contribute 12% to tax revenue in 2017 and the increase of rates on airtime and cigarettes may not fill this gap.

In 2017, some inland taxes that will be used to widen the tax base include the measure to introduce a rental income tax on statutory bodies which have been exempt from the tax. This move will increase tax revenue as statutory bodies like NAPSA that have ventured into profitable property development projects such as shopping malls can now be captured within this tax net.

Additionally, the move to increase the Advanced Income Tax is essentially to encourage voluntary compliance and ensure that those in the shadow economy contribute to taxes. The increase from 6% to 15% will yield revenue from informal cross-border trade activities and other non-tax compliant individuals and businesses thereby promoting more equitable taxation.

A number of measures on trade taxes, including surtax on imported goods that can be locally manufactured, are meant to increase tax revenues from trade. However, these have a double edged sword because in addition to raising revenue, they also have an aspect of protecting industries from stiff foreign competition and also to encourage exports of value added products away from primary raw exports in 2017. In particular, a surtax, which is an additional tax above the existing tariff, is proposed at the rate of 5 per cent on selected imported goods which are also locally produced. It is useful to mention that current international trade agreements discourage adopting unilateral protection measures such

A highlight of revenue measures and concessions

Direct Taxes	Customs and Excise Duties	VAT	Non Tax Revenues	Export Taxes
- 10% rental income tax on Statutory Bodies - 15% Advanced income tax - Specific rates K100-K1,025 +3% TOT - 100% capital allowance on agric equip - Exempt PAYE threshold K3,300 - Income above K6200 at 37.5%	- 17.5% excise duty on airtime - 15% on Spare Parts - K240 per mille on cigarettes - Carbon tax rates K70-K275 - 5% surtax on locally manufactured goods - 15% semi-processed edible oils - 40% plastic bags	- Input VAT not claimable by non registered supplier - 90% diesel input VAT claimable, input VAT on petrol non-claimable - Abolish VAT group registration	- skills development 0.5% - fees on cross border vehicles $20-$75 - increase in various user fees and charges	- K10/kg on raw timber - K5/kg on semi-processed timber - 10% on maize

as raising tariff charges as they undermine the predictability of the rules-based trading systems.

In exceptional circumstances, protectionism in international trade is permitted to enable a country to deal with threats towards its infant industries and unfair imports provided there is concrete evidence and prior notification to the other members. It is not clear why Government has decided to introduce surtax although the full details of the list of products and the implementation modality are not yet available. Currently, Zimbabwe is the only country that is collecting import surtaxes on a relatively long list of products although a differential treatment applies on goods imported under Bi-lateral Trade agreements, SADC and COMESA.

In 2015, Canada filed to retaliate with 100% surtax on a variety of imports from the US after the WTO Appellate Body upheld findings that the US Country of Origin Labelling (COOL) measures violated WTO trade rules and unfairly discriminated beef and hog products imported into the United States. This suggests that Government needs to identify appropriate products were it can demonstrate sufficient evidence that surtaxes will protect infant industries and goods that suffer from unfair importation or potential trade injury. It is also prudent that Government should follow procedures established under the trade treaties and must notify other members to avoid resistance and retaliation.

Previously in the 2016 budget, excise duty on plastic bags was increased from 10% to 20%. For the 2017 fiscal year, customs duty has been raised from 25% to 40%. While these measures remain important for raising revenue, they are likely to have positive environmental impacts. In order to maximise the environmental effects, it should be mandatory that stores pass on the cost to consumers to discourage their use by making shoppers pay an extra amount for each bag. Better still, businesses could be mandated to make available, paper bags which are environmentally friendly materials.

Increasing customs duty on semi-processed edible oils and spare parts from 5% to 15% is meant to encourage local manufacture of edible oils, but also recognises that spare parts are more appropriately classified as intermediate goods and thus the realignment. This should encourage value addition on edible oils and discourage importation of semi-finished goods such as spares. The two measures will also increase revenue.

Furthermore, the inelastic nature of consumption of airtime and cigarettes has driven the decision to increase excise duty from 15% to 17.5% and ZMW 200 to ZMW 240 per mille, respectively. The fact that the amount of these items consumed does not necessarily reduce despite the tax increase makes these two items good candidates for the hike.

The introduction of export duties on maize will work to minimise the usage of export bans in 2017. This measure will not only allow for free flow of trade in the maize sector but also for some revenues to be raised. The export ban on maize in 2016 led to a foregoing of US$210 million dollars in export earnings (Indaba Agricultural Policy Research Institute, 2016). Therefore, a 10% export tax on maize would lead to approximately ZMW 210 million[3] of additional revenue.

Overall, the 2017 revenue target is realistic but the cloth could have been widened by being more ambitious particularly in terms of broadening the base of existing taxes as well as improving on compliance and administration. The relatively conservative approach to tax revenue could reflect an attempt to encourage a recovery process which remains largely uncertain and fragile. Going forward, government should ensure that it continues to reform the administration of non-tax revenue as this is a necessary and easy tax handle to administer. The mineral royalty regime in its current state lacks automatic stabilisers to ensure that revenue corresponds to price movements and leaves the temptation of frequent reforms that may potentially damage investor confidence and trust of citizens.

3 ($210*K10/$)*10%=K210million

Kicking the can down the road

Constantly rising public debt has been one of the most contentious issues in recent times in the fiscal management of the Zambian economy. Debt has grown at an average of 23% since 2006 but the most rapid growth has been from 2011 to date. Government has time and again raised the public debt ceiling on external debt to create fiscal space for infrastructure projects spending. In February 2016, Parliament approved another raise of the foreign debt ceiling from K60 billion to K160 billion which is about 90% of the 2015 GDP. Concerns about debt sustainability have increased, with many calling for an updated Debt Sustainability Assessment (DSA) and shopping for an IMF-supported programme to help address the deep fiscal imbalances that have emerged since 2015.

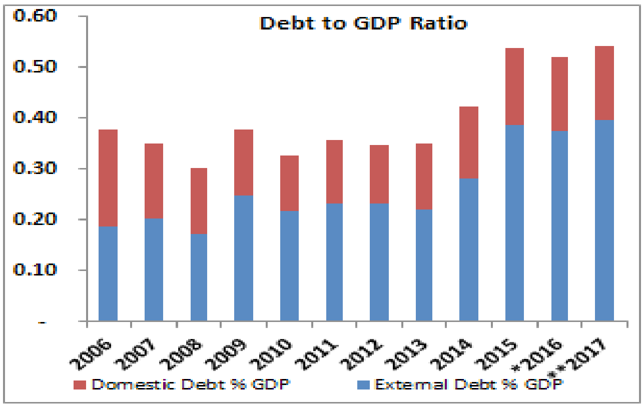
The preliminary estimate of total public debt as a percentage of GDP for 2016 as submitted by the Minister of Finance in the 2017 budget stands at 47%. However, this estimate is at variance with ZIPAR's own calculation at 52% (based on 2016 preliminary GDP estimates and debt figures from the Ministry of Finance) and the IMF projection[1] of 58% for the same period. What is of concern is that there could be so many variations of this fundamental fiscal indicator at a time when debt sustainability should be a priority given the hostile economic environment. This points to the need for a more transparent and robust debt management system.

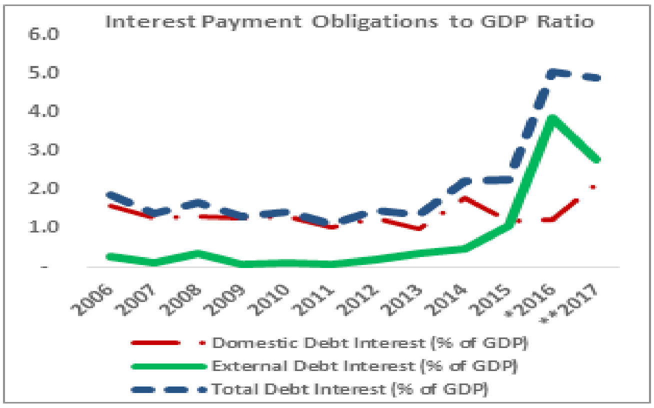
Although Government did not go back to international markets to borrow in 2016, external debt increased by 6.3%, from US $6.3 billion as at August 2015 to about US$6.7 billion as at September 2016. Indications from the 2017 budget are that the ratio may rise to as much as 54% of GDP, only 2 percentage points shy of breaching the sustainability threshold of 56% as shown in Figure 1[2] below.

The risk of the mounting debt scenario lies in the rising interest payment obligations. Interest obligations are projected to rise by 60% between 2016 and 2017; that is form K7.1 billion to K11.5 billion. The fiscal risk of the debt becomes more obvious when the interest payments are expressed as percentage of GDP thus threatening our capacity to service debt obligations. From around 2013 these figures have been on the rise. In view of this, the budget should have been more resolute by resisting the urge to allocate more resources on activities that have widened the fiscal deficit.

The dominant expenditure components that have previously put excessive pressure on

Figure 3: Debt and Interest Payment Obligations





Source: Compiled from Annual Economic Reports and Budget Speeches

1 IMF (2016), 2016 Fiscal Monitor

2 2016 figures are preliminary estimate and 2017 figures are projections

the fiscal balance and are still appearing in the 2017 include foreign financed non-financial assets, road construction projects, and farmer input support subsidies. Most of these spending components could be capped without significantly risking economic recovery. More offsetting is the fact that the allocation for road infrastructure has increased from K6.6 billion in the 2016 budget to K8.6 billion in the 2017 budget. Likewise the allocation for FISP has also increased from K1.0 billion to nearly K2.9 billion.

As part of the measures to finance the 2017 budget, Government projects a higher level of borrowing as well as a higher level of grant assistance from cooperating partners. Whereas in 2016 Government had planned for K0.54 billion in terms of project grants, in 2017 these are projected in the region of K2.23 billion. This represents a 309% increase on the 2016 estimates and about 100% increase on an average for the last 5 years. However, project grants have often had low levels of realization as they are usually conditional on commitment to public sector reforms, fiscal prudence, transparency and accountability among others. Based on the recent fiscal management performance of Government and the slight materialization of project grants in the past, it is difficult to picture how the 2017 projections may pan out. Should these proposed project grants underperform, there are chances that Government may resort to increased domestic borrowing. This would then cause yields to rise and lead to further crowding out of the private sector who are already constrained to borrow at high interest rates.

In the 2016 budget Government targeted a fiscal deficit 3.8% of GDP but is now off course, and expected in the region of 10% of GDP. The fiscal deficit on cash basis is projected to close at 3% of GDP. For 2017 Government proposes to limit the overall fiscal deficit to no more than 7% of GDP on cash basis. However, the summary of revenue estimates and financing shows that the overall budget deficit is expected around 9.3%. It is currently difficult to see where the budget derives the assurance that the overall deficit for 2017 will be contained below the expected level for 2016. This is particularly because the pace for fiscal consolidation appears to be painstakingly slow. Government therefore looks set to continue kicking the can down the road by avoiding the obvious decision to put a rein on spending.

In view of the above, we can only therefore hope that the increase in debt, factors in the expected credit facility from the IMF and other partners expected under Zambia Plus Economic Recovery Programme, and thus is not all from non-concessional or other high cost sources. This is so considering that the 3 bullet repayments for the Eurobonds are due in 2022 and 2024 for the first 2, respectively and over a 3 year spread – from 2025 to 2027 – for the third one. Otherwise maintaining high levels of debt amidst subdued economic growth would significantly increase the country's fiscal risk. However, even if borrowing on concessional basis has already been factored in the 2017 estimates, expectations were that allocations of these resources would be biased towards investments with high financial returns in the energy and manufacturing sectors. This is with the view to increase capacity to generate revenue and pay outstanding obligations.

We therefore stress the need for Government to further improve its debt management framework and keeping its debt contraction within its capacity to repay. Government needs to finalise and adopt the Debt Management Strategy which includes an adequate risk management tools. This is in order to minimise the trade-offs between the debt cost and risk of default. In addition, Government must ensure that a DSA is conducted to ascertain whether the current debt levels are within sustainable thresholds.

In order to reduce the dependence on debt, Government must consider developing robust legal and regulatory framework for alternative sources of finance such the proposed Public Private Partnerships (PPPs) and venture financing. Weak institutional arrangements, lack of capacity and lack of defined strategies for PPPs and venture finance limit private investment. Government's move to table the Loans and Guarantees (Authorisation) Act for revision is a welcome move as it will help provide more oversight to parliament through the legislative arm and thus prevent the accumulation of debt.

On the economic diversification story

At a time when economic growth outlook is subdued and the country is struggling to dismantle accumulated debt arrears, it is difficult to accelerate the pace of achieving economic diversification. The biggest challenge is to increase the range of commodities produced and exported in agriculture beyond maize and also build industries to manufacture equipment, machinery, chemicals, wood and process agriculture products into finished goods for domestic consumption and exports.

In the 2017 budget, Government is proposing the following measures to boost production in agriculture beyond maize and support local production among industries away from mining of base metals:

1. Introduction of import surtax at 5% for all imported items that are also produced locally;

2. Introduction of customs duty on semi-processed edible oils and on spare parts for various machinery and equipment is proposed to increase from 5% to 15%;

3. Imposing specific rates on the export of unprocessed and semi-processed timber products at the rate of K10 per kg and K5 per kg respectively;

4. Levying export duty on exports of maize at 10% to encourage exports of value added maize meal, maize bran and other maize processed products over the export of raw maize grain.

5. Suspension of customs duty on aquaculture implements for a period of three years and the removal of 25% customs duty on fittings used for irrigation; and,

6. Removal of 15% customs duty on lifting, handling and loading machinery in the shoe industry.

Government is also proposing a Cashew Nut Infrastructure Support Programme valued at US$55.4 million is expected in Western Province as part of its diversification towards cash crops in agriculture that include cotton, soya beans, cassava and rice. In terms of industrial development, Government has committed to develop the newly created Kafue Iron and Steel Economic Facility Zone. The private sector led Kalumbila Multi Facility Economic Zone is expected to attractt US$100 million. Small and Medium Enterprises (SMEs) are expected to benefit US$50 million credit facility. Government has further pledged to channel pension and other investible funds to support industrialisation led by the Industrial Development Corporation (IDC) which focuses on agriculture, manufacturing, tourism and infrastructure.

Government acknowledges that lack of access to affordable and adequate finance is a major obstacle to accelerating the pace of economic diversification especially among SMEs in Zambia. The 2017 budget provides a modest K20million for the creation of the agriculture and industrial credit guarantee fund. This measure is designed to mitigate the problem of small and medium enterprises (SMEs) low access to bank finance due to inadequate collateral and the failure by banks to understand the SMEs risk.

This is not the first time that Government is implementing a credit guarantee scheme. In 2009, DBZ managed a credit guarantee scheme for SMEs valued at US$2.1million as part of the Private Sector Development Reform Programme for 3 years. The lesson from a few published studies including one by ZIPAR is that the scheme failed to post satisfactory results due to the weaknesses in the institutional design and tenuous administrative procedures. As a result, commercial banks failed to utilize this opportunity and increase lending to SMEs. This is an area Government needs to do an assessment so that the likelihood of success for the new scheme is enhanced.

These specific measures are more progressive when compared to the diversification measures in 2015 were agriculture only had a single measure of customs duty reduction from 15 to 5 percent on greenhouses and rose seedlings. However the measures are still dominant in agriculture, mining and forestry sectors.

A series of analyses performed by ZIPAR on customs data collected by ZRA and compiled by CSO show that the country suffers from huge chronic deficits in the trade of products classified under machinery, electronics and transportation equipment; petroleum oils and processed mineral elements; chemicals, plastics and rubber mineral and iron and steel. This is caused by overdependence on imports as local heavy industries that are capable of manufacturing some of these products are nonexistence. These are sectors that are crucial and successive budgets should start to prioritize these areas so that economic diversification can start to bear tangible results over the medium to long term.

Facing the energy challenges head on

Since 2015, the country has been experiencing a severe electricity supply crisis. This arose due to the drop in the water levels particularly in the Kariba Dam. Arising from the supply deficit, ZESCO commenced a stringent load shedding regime in order to preserve water in the dams and avoid a complete shutdown of the power generation plants. ZESCO also embarked on some short-term measures that resulted in the importation of emergency power.

The importation of emergency power has come at a great cost. It is reported that the cost of this power was pegged at 18c/kw while ZESCO has had to sell it to its customers at an average cost of 5c/kw. To help ZESCO carry this burden, Government has spent ZMW1 billion or 3% of total expenditure between January 2016 to August 2016 on electricity subsidies. This is equal to the FISP budget for 2016. Going forward, Government has indicated that it is not ready to continue subsidizing power in view of the need to implement fiscal consolidation measures. There is now a strong inclination towards migrating to full cost reflective tariffs sooner rather than later.

The challenges in the electricity sector goes beyond the issues of tariffs and subsidies. They touch on generation capacity, private sector participation, market structure rigidities, the inefficiencies of the power utility company (ZESCO) as well as the change in weather pattern that has affected water levels. The expectation of the budget, therefore, was that Government would deal decisively with these issues. This entail putting in place measures that will deal with the short-term challenges like the importation of emergency power and medium to long-term measures that will increase generation capacity in light of the climate changes realities. Indeed, the Minister did not mince his words regarding the above issues.

The budget outlined a number of important measures aimed at addressing the electricity sub-sector challenges. The measures touched on moving to cost reflective tariffs by the end of 2017; maintaining the life line tariff to protect poorer households; dealing with inefficiency in the sector; increasing electricity generation capacity; moving to a better energy mix, and the review of the overall market structure – including review of ZESCO.

The budget speech has indeed taken a good direction in addressing the electricity sub-sector challenges. Regarding the issue of moving to cost reflective tariffs, it is expected that a new cost of service study is already on the cards to enable stakeholders understand the full cost of ZESCO's supply of power. This is more so important due to the fact that being a Government monopoly there are lot of inefficiencies embedded in the system that increase the cost of operations. If this is not properly understood, electricity tariffs may end up unnecessarily higher than they should be. In addition, since the bulk of ZESCO's major generation assets are already amortized, it will be important to extend the benefit of lower generation costs to the consumers.

Perhaps an area the budget did not touch but would be important to point out here is the implementation of short-term energy efficiency measures to reduce demand for electricity. For example, behavioural change in domestic energy use could help to reduce electricity demand. One such policy option would be to encourage households to use alternative energy sources such as Lignified Petroleum Gas (LPG) to meet their cooking energy needs. This however requires deliberate policy interventions on aspects such as education, regulation, and incentives to stimulate supply and competition in the sub-sector.

An interesting twist to the budget is the pronouncement that the procurement of finished petroleum products will be undertaken by the private sector from 1st March 2017. This is being done with a view to ensure efficiency and disengage Government from the sector. The Minister further indicated that Government is in the meantime examining the viability of Indeni and TAZAMA pipeline. If it is Government's intention to completely disengage from the sector, then this proposition is laudable. This will be in line with ZIPAR's recommendations in 2011 (ZIPAR Working Paper No. 11) urging Government to consider the direct importation of finished products by Oil Marketing Companies (OMCs). Instead of just buying products from Indeni for internal distribution, OMCs would be free to procure fuel on the world market and transport it from Indian Ocean ports to Zambia by road, rail or both. This is also how GRZ has responded when Indeni has been shut down for extended periods.

The ZIPAR paper also highlighted potential advantages of such a move relative to current arrangements. The most obvious one is the introduction of competition into a sector where it is sorely needed. There would be competition both between OMCs themselves and between different ports and transport routes. The other obvious benefit of competition is that it would eliminate the country wide fuel crises that currently result from unplanned shutdowns at Indeni. Securing fuel from multiple sources is a much safer risk strategy than relying solely on Indeni.

However, to implement such a policy effectively there will be need to ensure that adequate measures are put in place to guarantee sufficient strategic reserves. Pricing of the commodity would also pose serious challenges given the possibility that the finished products could be imported from different sources. This would require a very strong regulator to effectively regulate private sector profit motives. Further, Government will need to deal with the 25% import duty on petrol and diesel which currently is the major deterrent for direct imports of finished products by OMCs.

Tasting the pudding of economic recovery

The 2017 National Budget speech establishes a clear link to the medium-term Economic Recovery Programme dubbed "Zambia Plus". In this regard, the budget will be as a key instrument for establishing a foundation for economic recovery and eventual sustained and inclusive growth over 3-5 years. It describes Zambia Plus as a home grown programme for soliciting external or development partner support, hence the *plus* component. The budget and Zambia Plus are both consistent with a key tenet of International Monetary Fund (IMF) assistance, which provides that support to member States will be for three-year periods.

The five pillars of Zambia Plus have been treated to varying degrees in different parts of this analysis so far. Here, we look specifically at Pillars Three and Five with a view to emphasizing the imperative of implementing key measures for putting Zambia on the path to economic recovery.

Pillar Three focuses on improving economic and fiscal governance by raising the levels of accountability and transparency in the allocation and use of public finances. This will involve the following key measures, which we hope the Government will remain steadfast in implementing in 2017 and beyond: (i) proposed revisions to the Public Finance Act of 2004 to enhance punitive measures; (ii) Planning and Budgeting Bill to improve adherence to planned programmes; (iii) roll out of the Integrated Financial Management Information System (IFMIS) by end 2017 to prohibit spending outside the system and curb arrears; (iv) roll out of the Treasury Single Account to major Ministries by end 2017 to restrict short-term borrowing; and (v) automation of major revenue collection processes by June 2017. These are commendable and promising measures. However, many of them have been variously forwarded before in previous budgets. The test of how well they will be implemented will only be established ex post or after the event of implementing the budget; *the taste of the puddling will be in eating*.

Pillar Five focused on *ensuring greater economic stability, growth and job creation through policy consistency to raise confidence for sustained private sector investment*. The fifth pillar therefore links to the growth, stability and job creation macroeconomic objective in the budget. That is, according to the budget, in 2017, Zambia will aim to: (i) achieve 3.4% real GDP growth; (ii) attain at most 9% end-year inflation; (iii) mobilize 18% of GDP as domestic revenue ; (iv) limit the (cash-basis) overall fiscal deficit to 7% of GDP; (v) limit domestic borrowing to 2% of GDP or less; (vi) build up foreign exchange reserves to at least 3 months of import cover by end 2017; and (vii) support the creation of at least 100,000 decent jobs. Objectives (iii), (iv) and (v) are dealt with elsewhere in this paper. On the other hand, Objectives (i), (ii), (vi) and (vii) are worth a closer look.

The short-term stability objective is mainly reflected through the inflation and gross international reserves targets. On this, in 2017, monetary policy "will remain focused on maintenance of price and financial system stability in order to support restoration of macroeconomic stability and growth". Beyond this, monetary policy adjustments will only be made in order to re-align it in accordance with the fiscal consolidation drive. This holds some promise for re-introducing consistency and coherence between fiscal and monetary policy.

However, a notable concern of monetary policy being predominantly led by fiscal policy – except in the areas of stabilizing or smoothening foreign exchange rate only when short-term volatility occurs, stabilizing domestic prices and building international reserves – is that it offer no explicit scope for unilaterally loosened the policy stance. Should monetary policy remain tight on account that the pace of fiscal consolidation remains slow, the current liquidity constraints in the financial markets will persist and private sector borrowing, investments productivity and production will remain subdues with possible adverse implications for the 3.4% growth objective.

Regarding the objective on GDP growth the 2017 budget offers a fighting chance for recovery in the medium term. This is because economic restructuring of some key services sectors will be initiated, starting with key public institutions in the telecommunications (i.e., review of Zamtel) and energy (reviews of ZESCO in the electricity subsector and Indeni in the fuel subsector), among others. These reviews should however be comprehensive or sector-wide industrial organization reviews that are turned into time-bound reforms. In relation to the fuel subsector reforms, the withdrawal of the Government from the business of doing business in order to pave way for the private sector should be cautious and gradual, ensuring that the Government continues to hold strategic fuel reserves and uses them to smoothen supply should market failures or disruptions emerge. Other sectors or industries in need of reform, which are not fully address in the 2017 budget, include: finance, particularly commercial banking and transportation. Such reforms will enhance the efficiency, competitiveness of key services and reduce production and trade cost reductions; this will ultimately promote sustained and inclusive growth, and expand trade.

Finally, the 2017 budget re-introduces an explicit jobs target, aiming to create 100,000 decent jobs in 2017. This is commendable, and the target is smartly modest (not over-ambitious). However, in order to ensure the credibility that the 2017 budget seeks to establish for Zambia Plus, it will be imperative for the Government to set up a mechanism for monitoring job creation and for the Minister of Finance to commit through the 2017 budget to report on this target both in the Mid-Year Economic Review for 2017 and in the 2018 National Budget Address.

Another issue is the jobs target for 2017 in relation to the President's Speech to the National Assembly to create 1,000,000 new decent jobs in the next five years; this essentially means the creation of jobs will be back-loaded to the end of the Zambia Plus period, with risks of failure to achieve the overall objective in the last legs of the programme.

Ultimately the *taste of the pudding of economic recovery will be in the eating;* setting Zambia on the path to recovery will depend on how well the authorities stick to the budget execution plan. ZIPAR therefore looks forward to the mid-Year Economic Review around June/July 2017, taking into account the salient issues highlighted above. Although it will not be an easy feat, the Government will have to muster the political will and stewardship that keeps it steadfastly walking the tight rope. The Government should remain steadfast in walking the tight rope to recovery.

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