REVIEW OF THE PERFORMANCE OF THE FIRST QUARTER OF THE 2019 BUDGET ESTIMATES

Submitted by

The Zambia Institute for Policy Analysis and Research

to

The Parliamentary Budget Committee

on

24th April 2019

This memorandum is in response to the request made by the Parliamentary Budget Committee to the Zambia Institute for Policy Analysis and Research (ZIPAR). The report provides a review of the performance of the first quarter of the 2019 Budget. The paper provides budget tracking information by looking at both the revenue and expenditure trends as provided in the Ministry of Finance fiscal tables. In analysing the 2019 Budget, the first quarter preliminary outturns are compared to the approved Budget for 2019, the projected performance for the first quarter as well as the first quarter of 2018.

1 OVERVIEW

As part of the macroeconomic objectives and targets, the Government intends to reduce the fiscal deficit to 6.5% of GDP in 2019 from an outturn of 7.2% of GDP in 2018. To achieve that target, it intends to increase domestic revenues to no less than 18% of GDP; control the growth in the wage bill by restricting recruitment to 3,500 frontline personnel; achieve significant reductions on the administrative parts of the public service so as to prioritise allocation to key service delivery expenditures such as drugs; scaling down domestically financed capital expenditure; and curtailing domestic borrowing from 4% to 1.4% of GDP[1]. In this paper, we review the fiscal performance of the first quarter of the 2019 Budget estimates to determine if the Government is on track to achieve these and other fiscal targets.

2 REVENUE PERFORMANCE

During the first quarter of 2019, revenues overperformed compared to targets; though grants continued to underperform as was the case in the first quarter of 2018. On the surface, tax revenues overperformed by 4%. The overperformance is largely due to higher than planned increases of the soon-to-be-abolished Value Added Tax (VAT). The continued good performance of VAT is no accident - it emanates from measures that started in 2017 which include having VAT registered suppliers using electronic fiscal devices which enable real-time monitoring of business transactions and appointing of companies and government agencies to serve as VAT withholding agents at source. However, the Government has accumulated a backlog in VAT refunds which stood at K17.9 billion at the beginning of the year[2]. The main motivation for the introduction of the Sales Tax is to offset some of these VAT arrears, which are more than the K15.1 billion in revenues and grants collected during the first quarter of 2019. A once-off higher than planned dividend amounting to K1.3 billion in March boosted non-tax revenues. As a result, non-tax revenues overperformed by 66%.

However, the collection of mineral royalties underperformed by 8% compared to an underperformance of 2% in the first quarter of 2018. This is in spite of copper prices increasing to

[1] Ministry of Finance, 2018. *2019 Budget Address*
[2] Ministry of Finance, 2019. *Economic and Treasury Brief: Highlights on the Performance of the Economy in 2018,* Lusaka: Ministry of Finance [Zambia]

about US$6,400 per metric tonne in March from about US$6,000 per metric tonne at the beginning of the year. In its 2019 Budget Analysis, ZIPAR warned of loss of income for the mining companies due to the increases in the mineral royalty rates. Depending on the significance of these losses, the mining companies could defer their capital investments decision, thereby impacting production and subsequently reduce the Government's revenue collection[3].

Table 1: Revenue performance, Q1 2018 and Q1 2019

	2018				2019			
	Approved 2018	Jan - March Proj.	Jan - March Prelim.	Jan - March deviation%	Approved 2019	Jan - March Proj.	Jan - March Prelim.	Jan - March deviation%
TOTAL REVENUE AND GRANTS	51,525	12,041	12,154	1%	58,011	13,544	15,146	12%
DOMESTIC REVENUE	49,087	11,432	12,040	5%	56,087	13,062	15,000	15%
Tax Revenue	40,874	9,403	10,213	9%	46,673	10,852	11,334	4%
VAT	12,369	2,708	4,215	56%	14,862	3,649	4,368	20%
Non-Tax Revenue	8,213	2,028	1,827	-10%	9,414	2,211	3,665	66%
Mineral Royalty	3,528	901	884	-2%	4,888	1,097	1,009	-8%
GRANTS	2,438	610	114	-81%	1,924	481	146	-70%
	% of GDP							
TOTAL REVENUE AND GRANTS	18.4%	4.3%	4.4%	0.0%	19.3%	4.5%	5.0%	0.5%
DOMESTIC REVENUE	17.6%	4.1%	4.3%	0.2%	18.7%	4.4%	5.0%	0.6%
Tax Revenue	14.6%	3.4%	3.7%	0.3%	15.5%	3.6%	3.8%	0.2%
VAT	4.4%	1.0%	1.5%	0.5%	5.0%	1.2%	1.5%	0.2%
Non-Tax Revenue	2.9%	0.7%	0.7%	-0.1%	3.1%	0.7%	1.2%	0.5%
Mineral Royalty	1.3%	0.3%	0.3%	0.0%	1.6%	0.4%	0.3%	0.0%
GRANTS	0.9%	0.2%	0.0%	-0.2%	0.6%	0.2%	0.0%	-0.1%

Source: Ministry of Finance and ZIPAR's own calculations

Having underperformed by 70%, Grants continue to be the Achilles heel of the revenue performance. If the performance of last year is anything to go by (i.e. 81% underperformance in Q1 2018), it is unlikely that the under-collection from grants will improve, unless the Government clinches a deal with the International Monetary Fund (IMF) and improves its management of donated funds – a move likely to unlock the disbursement of foreign grants.

3 EXPENDITURE PERFORMANCE

At K20.3 billion, total expenditure (including amortisation) was 5% lower than the projected expenditure of K21.5 billion. Excluding amortisation, expenditure was 11% lower than planned. The lower than projected outturn was mainly due to lower than projected domestically financed expenditure.

[3] ZIPAR, 2018. *Budget Analysis 2019: Taking the Road Less Travelled – In Pursuit of Fiscal Consolidation*, Lusaka: Zambia Institute for Policy Analysis and Research

Against a target of K6.2 billion, the Government spent K4.8 billion on personal emoluments in the first quarter of 2019. The Government's intentions to restrict the growth in the wage bill by restricting recruitments to only 3,500 frontline personnel levelled out the headcount in the civil service, thereby relieving some of the upward pressure on the wage bill. However, delayed payments of salaries in February 2019 suggest an emerging budget financing challenge that is likely to bring in a new problem of salary arrears.

Table 2: Expenditure Performance, Q1 2018 and Q1 2019

	2018				2019			
	Approved 2018	Jan - March Proj	Jan - March Prelim	Jan - March deviation %	Approved 2019	Jan - March Proj	Jan - March Prelim	Jan - March deviation %
TOTAL EXPENDITURE (Incl Amortisation)	71,662	16,789	23,674	41%	86,808	21,474	20,348	-5%
TOTAL EXPENDITURE (Excl. Amortisation)	68,445	16,027	22,687	42%	77,418	19,127	17,045	-11%
o/w: Domestically financed	58,448	13,528	14,021	4%	58,686	14,444	,614	-13%
Foreign financed	9,997	2,499	8,666	247%	18,732	4,683	4,431	-5%
EXPENSES	52,452	12,233	12,901	5%	56,319	13,927	12,129	-13%
Personal Emoluments	23,104	5,686	5,248	-8%	25,244	6,197	4,788	-23%
Use of Goods and Services	7,420	953	1,168	22%	6,113	1,289	796	-38%
Interest Payments	10,923	3,036	3,979	31%	14,183	4,352	5,054	16%
Domestic Debt	6,764	1,792	2,181	22%	7,965	2,642	2,346	-11%
External Debt	4,159	1,245	1,798	44%	6,219	1,710	2,708	58%
Transfers and Other Payments	7,993	2,057	2,086	1%	8,246	1,581	1,325	-16%
Social Benefits	1,782	445	292	-35%	1,760	316	87	-72%
Pension Fund	1,061	265	200	-25%	1,061	199	22	-89%
Social Cash Transfer	721	180	92	-49%	699	117	65	-44%
Other Expenses	1,230	55	129	135%	773	193	77	-60%
ASSETS	14,663	3,548	9,756	175%	20,610	5,078	4,875	-4%
Non-Financial Assets	14,201	3,495	9,696	177%	20,458	5,040	4,875	-3%
Roads	3,517	1,131	885	-22%	2,056	514	638	24%
Water and Sanitation	479	212	112	-47%	410	102	-	-100%
Financial Assets	462	52	60	15%	153	38	-	-100%
Empowerment Funds	152	-	-		133	33	-	-100%
LIABILITIES	1,330	246	30	-88%	488	122	41	-66%
PRIMARY BALANCE: Surplus (+)/Deficit (-)	(5,996)	(949)	(6,554)	590%	(5,224)	(1,232)	3,155	-356%
FISCAL BALANCE: Surplus (+)/Deficit (-)	(16,919)	(3,985)	(10,533)	164%	(19,407)	(5,583)	(1,899)	-66%

Source: Ministry of Finance and ZIPAR's own calculations

At K5.0 billion, spending on interest payments in the first quarter was 16% above budget and higher than the K4.8 billion spending on personal emoluments. An average of K1.7 billion in interest payments was paid out every month during the first three months of the year, easily outpacing spending on personal emoluments and a myriad of other programmes. Already the fastest growing major government expense, the cost of interest is on track to hit K20 billion by the end of 2019.

With more money going toward interest payments, the Government will find it harder to address pressing needs like paying the civil service, paying for the use of goods and services, social benefits, paying for bridges or meeting its obligations to grant-aided institutions. Spending towards the use of goods and services underperformed by 38%, transfers and other payments underperformed by 16% while social benefits were 72% below target during the first quarter of 2019.

Table 3: Expenditure Performance, Q1 2018 and Q1 2019, % GDP

	2018				2019			
	Approved 2018	Jan - March Proj	Jan - March Prelim	Jan - March deviation %	Approved 2019	Jan - March Proj	Jan - March Prelim	Jan - March deviation %
TOTAL EXPENDITURE (Incl Amortisation)	25.6%	6.0%	8.5%	2.5%	28.9%	7.2%	6.8%	-0.4%
TOTAL EXPENDITURE (Excl. Amortisation)	24.5%	5.7%	8.1%	2.4%	25.8%	6.4%	5.7%	-0.7%
o/w: Domestically financed	20.9%	4.8%	5.0%	0.2%	19.6%	4.8%	4.2%	-0.6%
Foreign financed	3.6%	0.9%	3.1%	2.2%	6.2%	1.6%	1.5%	-0.1%
EXPENSES	18.8%	4.4%	4.6%	0.2%	18.8%	4.6%	4.0%	-0.6%
Personal Emoluments	8.3%	2.0%	1.9%	-0.2%	8.4%	2.1%	1.6%	-0.5%
Use of Goods and Services	2.7%	0.3%	0.4%	0.1%	2.0%	0.4%	0.3%	-0.2%
Interest Payments	3.9%	1.1%	1.4%	0.3%	4.7%	1.4%	1.7%	0.2%
Domestic Debt	2.4%	0.6%	0.8%	0.1%	2.7%	0.9%	0.8%	-0.1%
External Debt	1.5%	0.4%	0.6%	0.2%	2.1%	0.6%	0.9%	0.3%
Transfers and Other Payments	2.9%	0.7%	0.7%	0.0%	2.7%	0.5%	0.4%	-0.1%
Social Benefits	0.6%	0.2%	0.1%	-0.1%	0.6%	0.1%	0.0%	-0.1%
Pension Fund	0.4%	0.1%	0.1%	0.0%	0.4%	0.1%	0.0%	-0.1%
Social Cash Transfer	0.3%	0.1%	0.0%	0.0%	0.2%	0.0%	0.0%	0.0%
Other Expenses	0.4%	0.0%	0.0%	0.0%	0.3%	0.1%	0.0%	0.0%
ASSETS	5.2%	1.3%	3.5%	2.2%	6.9%	1.7%	1.6%	-0.1%
Non-Financial Assets	5.1%	1.3%	3.5%	2.2%	6.8%	1.7%	1.6%	-0.1%
Roads	1.3%	0.4%	0.3%	-0.1%	0.7%	0.2%	0.2%	0.0%
Water and Sanitation	0.2%	0.1%	0.0%	0.0%	0.1%	0.0%		0.0%
Financial Assets	0.2%	0.0%	0.0%	0.0%	0.1%	0.0%		0.0%
Empowerment Funds	0.1%			0.0%	0.0%	0.0%		0.0%
LIABILITIES	0.5%	0.1%	0.0%	-0.1%	0.2%	0.0%	0.0%	0.0%
PRIMARY BALANCE: Surplus (+)/Deficit (-)	-2.1%	-0.3%	-2.3%	-2.0%	-1.7%	-0.4%	1.1%	1.5%
FISCAL BALANCE: Surplus (+)/Deficit (-)	-6.1%	-1.4%	-3.8%	-2.3%	-6.5%	-1.9%	-0.6%	1.2%

Source: Ministry of Finance and ZIPAR's own calculations

The major consequence of the lower spending is the Government's inability to meet its payment obligations thereby accumulating further arrears – the stock of domestic arrears (excluding VAT arrears) stood at K15.6 billion in 2018.

The chronic and persistent accumulation of arrears by the Government has had severe economic consequences including the following[4]:

[4] International Monetary Fund (IMF) (2014). Public Expenditure Review Study on the Prevention and Management of Payment Arrears

- Reduced economic growth: In Zambia, most businesses are dependent on government contracts. Therefore, payment arrears have led to reduced business activities as a result of payment delays. The delays have imposed difficulties in businesses accessing credit from commercial banks, due to a liquidity problem in the economy resulting in a reduced pace of economic activity. Since 2015, Zambia's economic growth averaged 3.6% during 2016-2018, a far-cry from the average of 5.9% per annum in the five years before the 2015 economic crisis.
- Reduced or interrupted public service delivery: increased costs and diversion of resources to settle previous arrears forced the Government to reduce the amount of supplies purchased or volume of services delivered. Some public services/projects halted where providers of essential services/materials suspended supplies.
- Increased interest rates: illiquid suppliers bridged the delay in payment by borrowing from banks and other financial institutions, and this led to a significant increase in the portion of non-performing loans (NPLs), adding pressure to credit markets and driving up interest rates with adverse consequences for monetary policy.
- Impact on the banking system: as banks provided credit to companies owed by the Government, they bore the brunt of the problem. The rise in NPLs left banks unable to extend credit to new customers. Credit growth to private sector contracted in real terms because of tightened credit conditions arising from the rise in NPLs. To offset the risks of non-recovery, banks passed the cost of arrears onto other private borrowers by adding a premium to their lending rates.
- Second-round fiscal costs: as government suppliers suffered from liquidity shortages there were knock-on effects from lower profits, resulting into reduced employment; suppliers reduced or withheld payments of taxes and social security payments to offset the delays in receiving amounts owed to them by Government.

4 FISCAL DEFICIT

Zambia's fiscal deficit at the end of the first quarter of 2019 was 10% of the budgeted target for 2019, better than 62% of the first quarter of 2018. This is on account of higher than projected revenues and lower than projected spending in the first quarter of 2019. Revenues and grants were 12% higher than targeted, while expenditure (excluding amortisation) was 11% lower than targeted. If the Government sticks to this revenue and expenditure pattern, it is likely to meet its fiscal deficit target of 6.5% of GDP for the year. However, it remains uncertain whether the budgeted targets for the soon-to-be introduced Sales Tax would be realised. Further, the early indications of higher than planned interest payments on external debt could also derail the achievement of the deficit target.

The growing problem of payment arrears, including VAT arrears, presents a significant challenge and the need to report the fiscal deficit, not only on a cash basis, but on a commitment basis as well. The true stock of arrears at the end of 2018 grew to K33.5 billion, when the K17.9 billion VAT arrears are added, which is equivalent to 11.2% of GDP. Therefore, the fiscal deficit on a commitment basis is likely to be north of 17% of GDP by the end of 2019.

5 FINANCING THE DEFICIT

To finance the deficit, the Government borrowed both domestically and externally. The higher domestic borrowing of the last two years resulted in the crowding out of private sector investment and heightened commercial bank interest rates. Therefore, the Government planned to limit domestic borrowing in 2019 to 1.6% of GDP from 4.0% of GDP in 2018. Net domestic financing in the first quarter of 2019 underperformed by 103%. This is due to under-subscription of government securities. While project financing has been up-to-date, no funds came in for programme financing during the first quarter.

Table 4: Deficit Financing, Q1 2018 and Q1 2019

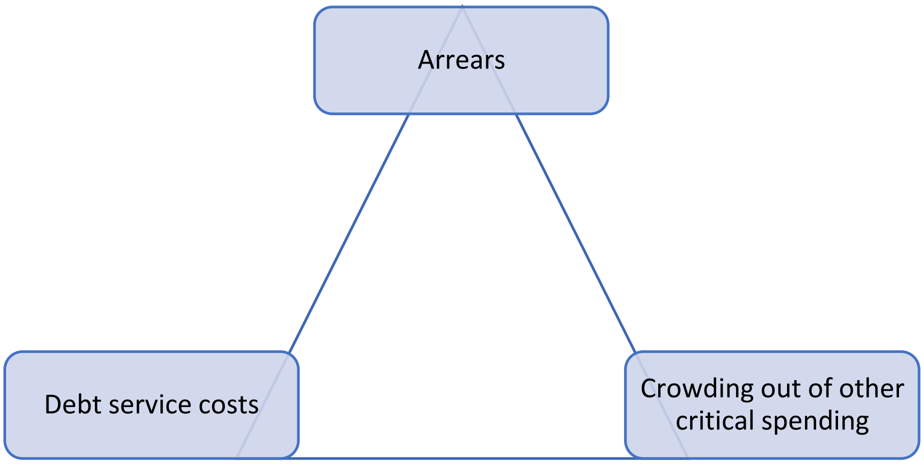
	2018				**2019**			
	Approved	Jan – March Proj	Jan – March Prelim	Jan - March	Approved 2019	Jan - March Proj	Jan - March Prelim	Jan - March deviation %
FINANCING	16,919	3,985	10,949	175%	19,407	5,589	2,274	-59%
Net Domestic Financing	10,945	3,440	3,242	-6%	3,503	1,791	(59)	-103%
Domestic Financing	11,153	3,440	3,343	-3%	4,164	1,957	1,375	-30%
Amortisation	(208)	2,911	2,840	-2%	(662)	(165)	(1,434)	767%
Net External Financing	5,974	529	7,707	1356%	15,904	3,798	2,332	-39%
Programme	1,425	-	-		7,825	1,778	-	-100%
Project	7,559	1,307	8,594	557%	16,808	4,202	4,202	0%
Amortisation	(3,009)	(762)	-887	16%	(8,728)	(2,182)	(1,869)	-14%

Source: Ministry of Finance and ZIPAR's own calculations

6 CONCLUSIONS AND RECOMMENDATIONS

In a nutshell, the Government is presently faced with a three-pronged challenge:

i) large fiscal imbalances over the last few years have led to escalating debt service costs;
ii) large debt service costs have led to the crowding out of other critical spending with the Government struggling to meet its wage bill obligations and the delivery of other services;
iii) low spending in other critical areas of the economy has led to the growing problem of payment arrears which reduces liquidity in the economy and slows down economic activity. Slow economic activity reduces economic growth and hampers the collection of revenues and without enough revenues we may experience debt distress.



The Government must restore budget credibility. Debt is the accumulated deficits of all past years, so persistently running deficits means that at some point the dreaded default trigger will be reached and the government will default on its debt service payments. Therefore, the Government must restore budget credibility as espoused in the Economic Stabilisation and Growth Programme by observing fiscal discipline and avoid breaching the deficit targets.

The Government should improve the quality of infrastructure spending to speed up the rate of economic return. ZIPAR's Analysis of the 2019 National Budget (published October 2018) found, among other things, that the Incremental Capital-Output Ratio (ICOR) values were significantly higher in 2015-2017 than any other period since 2010, suggesting declining productivity of capital (with capital accumulation being mainly public sector financed).

The Government should devise a systematic and comprehensive framework for paying off arrears. To address the problem of arrears from the roots, the Government needs to devise and publish a medium-term arrears payment strategy that could be embedded in the Medium-Term Debt Management Strategy, which is currently silent on the issue of arrears. This will also inform the deficit financing policies and strategies.

Running a primary surplus is critical for the much-needed revenues to pay for the debt. The Government recorded a primary surplus in the first quarter of 2019 amounting to K3.2 billion or 1.1% of 2019 estimated GDP. But it remains unclear if this is sustainable because the surplus is as a result of spending cuts to critical social and economic programmes which may depress economic activity and revenues still further.