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Zambia Institute for Policy Analysis & Research

ANALYSIS OF THE 2018 NATIONAL BUDGET

"Accelerating Fiscal Fitness for Sustained Inclusive Growth, Without Leaving Anyone Behind"

Submitted by
The Zambia Institute for Policy Analysis and Research

To

The Expanded Committee on Estimates, National Assembly

On
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KEY HIGHLIGHTS FROM THE 2018 NATIONAL BUDGET

Macroeconomic Objectives and Policies

One objective related to jobs in 2017 has been dropped whereas three others have been introduced and they do not have clear cut specific targets. The targets for 2018 include:

- Achieve real GDP growth of at least 5.0 %;
- Maintain single digit inflation in the range of 6.0 - 8.0%;
- Maintain international reserves of at least 3 months of import cover;
- Attain domestic revenue mobilisation of at least 17.7% of GDP;
- Limit the fiscal deficit on a cash basis to 6.1% of GDP;
- Limit domestic financing to no more than 4% of GDP;
- Accelerate implementation of measures towards diversification of the economy;
- Reduce the stock of arrears and curtail the accumulation of new arrears; and New targets
- Slow down the contraction of new debt to ensure debt sustainability.

Fiscal Framework

- The Government has proposed to increase spending by K7.2 billion to K71.7 billion in 2018 compared to K64.5 billion in 2017. As a share of GDP, spending is set to decline to 25.9% in 2018 from 27.7% in 2017.
- Domestic revenues are anticipated to increase to K49 billion in 2018 from K42 billion in 2017. This is due to a whole range of measures across many tax categories. However, as a percent of GDP, the revenue target has reduced from 18.4% in 2017 to 17.7% in 2018.
- Against domestic revenues of 17.7% of GDP, the Government's spending plans amounting to 25.9% of GDP will result in a fiscal deficit of about 8.2% of GDP on a commitment basis. This deficit is lower than the 9.3% of GDP projected for 2017.

Key Integrated Multi-Sectoral Policies and Interventions

The 2018 budget departs from sectoral budgeting to introduce a multi-sectoral approach in line with the Seventh National Development Plan (7NDP) and will be aligned to five pillars:

i) economic diversification and job creation;
ii) poverty and vulnerability reduction;
iii) reducing development inequalities;
iv) enhancing human development; and
v) creating a conducive governance environment for a diversified and inclusive economy.

Pillar I: Economic Diversification and Job Creation

Agriculture

- Introduction and development of a farm block model – three pioneers in Copperbelt, Muchinga and Northern Provinces.

- Facilitate a US$100 million public-private sector investment into a tractor and agricultural equipment assembly plant in the Lusaka South Multi-Facility Economic Zone.
- Financing of US$40 million from EXIM Bank of India that will be used for agriculture mechanisation.
- Fully migrate to the e-voucher system to cover one million beneficiaries
- Construct 18 artificial insemination centres to improve livestock production and breeds.
- Construction of 200 dip tanks will continue. In addition, construction of 4 regional laboratories will be completed by the end of 2018
- Promote cage fish farming on lakes Mweru, Kariba, Tanganyika and Bangweulu as well as along Kafue River at Kasaka and in water bodies in Western Province.
- Continue with the implementation of the US$50 million Zambia Aquaculture Enterprise Development Project in 2018.
- Currently undertaking a comprehensive livestock and aquaculture census which will be finalised in 2018.
- Recruit 750 extension service workers for agriculture, fisheries and livestock.

Industrialisation

- Set up the Kafue Iron and Steel, Kalumbila and the Chembe multi-facility economic zones
- Use the Agricultural and Industrial Credit Guarantee Scheme to facilitate access to affordable credit to Small and Medium Enterprises
- The Government will engage financial institutions to increase credit to Small and Medium Enterprises using movable assets as collateral in line with the provisions of the Movable Assets Act.
- The Government will include the use of securities and stocks as collateral to further enhance access to finance for Small and Medium Enterprises.

Tourism

- Government will together with the Business Regulatory Review Agency establish and operationalise a Single Licensing System.
- Facilitate development of requisite infrastructure to ease access to tourist sites, rehabilitate heritage sites and strengthen wildlife protection.
- Prioritise major roads, bridges and air strips leading to tourism destinations.

Pillar II: Reducing Poverty and Vulnerability

- Government is implementing the electronic Single Registry of Beneficiaries for all social protection programmes piloted in 5 districts and will be rolled out to 36 districts in 2018.
- The number of Social Cash Transfer beneficiary households will be further increased from 590,000 to 700,000 and the Government will fully migrate to an electronic social cash transfer platform.
- To enable more vulnerable people access education and healthcare, the Government will increase access to the Public Welfare Assistance Scheme from 134,000 to 200,000.

- The Government will increase the number of household beneficiaries to 80,000 from 40,000 in the 2017/2018 farming season, to support vulnerable but viable farmers.
- Increase the number of learners on the Home Grown School Feeding program to 1.5 million from 1.2 million.
- Enhance access to productive resources and entrepreneurship skills by empowering 30,000 women with productive grants and micro credit countrywide
- With support from the World Bank provide educational support to 16,000 girls from extremely poor households in 16 districts and provide grants to 75,000 women in 51,000 districts.
- Rollout the implementation of the Pilot Project for Climate Change Resilience currently being undertaken in Western, Southern and Central provinces to Northern, Muchinga and Luapula provinces.
- To address deforestation, Government will undertake the US$32.8 million Integrated Forestry Landscape project in Eastern province with the support of our cooperating partners.

Pillar III: Reducing Development Inequalities

- Increase access to social services and completion of on-going education, health and water and sanitation infrastructure in rural areas.
- *Feeder roads*: Government has secured US$200 million from the World Bank for feeder roads under the rural connectivity project to enhance the connectivity of rural areas to markets.
- *Decentralisation*: Finances required to provide front-line public services and infrastructure projects at provincial and district level will be deconcentrated to provincial administration.
- The Government will devolve powers from central government to lower levels to ensure participation of the citizenry in project identification, planning monitoring and evaluation
- Rating Act to be repealed and replaced to ensure that councils gain buoyancy and adequacy from property rates as part of the efforts towards establishing a sound financial base for local authorities

Pillar IV: Enhancing Human Development

Health

- To strengthen health systems, priority will be on completion of on-going construction of health infrastructure, ensuring availability and timely supply of drugs, procurement of medical equipment, recruitment of health personnel and promotion of innovative health financing.
- Strengthen local manufacturing of drugs thereby assuring security of supply of drugs.
- Recruit 1,000 health personnel to add to the 7,400 recruited this year.
- Establish a Social Health Insurance Scheme to increase the resource envelop and enhance universal health coverage.
- Introduce *e*–health services starting with University Teaching Hospital (UTH)

Education and Skills Development

- Infrastructure development in the primary education sub-sector will focus on completion of schools under construction, and rehabilitation of classrooms.

- In secondary education, the Government will focus on the implementation of the two-tier system which offers learners the opportunity to follow an academic or vocational career path way.
- At tertiary level, the Government will operationalise the Higher Education Loans and Scholarships Scheme.
- Construction of universities, and university colleges specialised in the fields of science, technology, mathematics and performing arts.

Pillar V: Creating a Conducive Governance Environment for a Diversified and Inclusive Economy

- Revisions to the Public Finance Act of 2004 will be undertaken to strengthen its legal and regulatory power and make it more punitive to abusers.
- The Planning and Budgeting Bill to ensure adherence to planned programmes will be tabled to the National Assembly.
- Zambia Public Procurement Authority to finalise and implement a price benchmarking framework; additionally Government will pilot an e-Government Procurement System.
- Roll out the national land titling programme with the aim of issuing titles for at least 300,000 parcels of land in the nation.

Selected Tax Proposals

Direct Taxes

- remove 5-year income tax holiday
- introduce 5% property transfer tax on intellectual assets such as trademarks and Zambian assets abroad
- increase presumptive tax on public service vehicles by 50%
- increase specific rates on base tax from K150 to K365
- Remove the insurance premium levy on reinsurance
- Maintain exempt PAYE threshold at K3,300
- Maintain PAYE rate for income above K6200 at 37.5%

Customs and Excise

- align excise duty to 125% on methylated spirits, denatured alcohol and undenatured alcohol
- increase customs duty to 25% from 15% on unmanufactured tobacco
- Remove customs duty on inputs used in the manufacture of stock feed
- Reduce customs duty on bricks used in the formation of furnaces from 15% to 5%
- Increase customs duty on electric geysers and stoves to 40% from 25%

Value Added Tax

- Exempt unprocessed and semi-processed tobacco from VAT
- Introduce penalties in the VAT Act for failure to furnish documents upon request
- Change due dates for submission of the VAT returns from the 16th to the 18th of every month.

Non-Tax Revenue

- Introduce landing rights charge at the rate of K3,150 per channel for tv channels with less than 35% local content
- Migrate all motor vehicles to the electronic number place system at a reduced fee of K500 from K975
- Increase TV levy to K5 per month
- Revise upwards various fees and charges

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1 Introduction

The reading of the 2018 Budget Speech by the Hon. Minister of Finance Felix Mutati on 29th September 2017 signaled that the country has now come off a tight rope to economic recovery and may well be on its way to a path of fiscal fitness. The theme of the 2018 budget is "Accelerating Fiscal Fitness for Sustained Inclusive Growth, Without Leaving Anyone Behind". Indeed, Zambia now needs to hasten its efforts to lock in fiscal fitness and stay the course of fiscal fitness as the country implements the 2018 Budget.

The Seventh National development Plan (7NDP) has been taken as an anchor for key policies and strategies for the 2018 Budget. The policy and structural interventions announced in the Speech have been aligned to the five pillars of the Development Plan namely:

- Economic diversification and job creation;
- Poverty and vulnerability reduction;
- Reducing developmental inequalities;
- Enhancing human development; and
- Creating a conducive governance environment for a diversified and inclusive economy.

In order to create a supportive environment for the effective implementation of the 7NDP and the Budget, the Minister further announced continuation of implementation of policy and structural reforms as outlined in the Economic Stabilisation and Growth Programme (ESGP) dubbed Zambia Plus.

The 2018 Budget will seek to accelerate and lock in fiscal fitness, among other things, narrowing the deficit modestly to 6.1% of GDP in 2018 and to a prudent level of 2.6% of GDP by 2020 in the medium term (Figure 3.1). This ambitious fiscal consolidation outlook is feasible provided the Government stays the course of fiscal fitness, applying the revenue and expenditure measure pronounced in the 2018 Budget Statement (the revenue measures are revisited in Section 6).

The 2018 Budget proposes a whole slew of tax measures across many of the tax categories in a bid to raise sufficient revenue to meet expenditure demands. This will result in additional revenue of K6.1 billion.

On the expenditure side, overall spending is expected to increase by K7.2 billion in 2018, considerably lower in nominal terms than the K11.4 billion increase seen in 2017. Similarly, debt interest repayment expenditure is expected to increase by only K2.8 billion in 2018 compared to K4.3 billion in 2017. Generally a notable relative slowdown in spending is expected in 2018 compared to 2017, especially when viewed from the anticipated higher level of economic activity (5% in 2018 compared to the 3.5% projection for 2017).

2 Macroeconomic Framework

Zambia's macroeconomic framework is configured as a set of policy statements and targets, and aggregate indicators and variables that are used to track and review past and present macroeconomic developments. The framework also provides an outlook for the economy. It is a key basis upon which recommendations for the future course of fiscal, monetary and external sector policy are made.

The framework has three time dimension. These are: (a) the short-term, which refers to a period of one year, usually in line with the fiscal year and annual budget calendar; (b) medium term, which is a three-year period in line with medium term policy instruments (mainly the Medium Term Expenditure Framework (MTEF)); and (c) the long-term, a five-year period, in keeping with five-year development policy, strategy and planning frameworks like the National Development Plans (NDPs).

2.1 Key Structural Elements of the Macroeconomic Framework

The macroeconomic framework in the Annual Budget reflects the short-term version of the macroeconomic framework. Every budget contains a section (usually Part II) on *Macroeconomic Objectives, Policies and Strategies*. Zambia's current framework in the 2018 Budget Address is presented in Table 2.1.

Table 2.1: Summary Macroeconomic Framework in 2018 Budget Statement

Macroeconomic Objectives in 2018 Budget	*Macroeconomic aggregate area*	*Analytical Comment*
i) achieve real GDP growth of at least 5.0 percent;	Growth	SMART, traditional, routine
ii) maintain single digit inflation in the range of 6.0 to 8.0 percent;	Stability (monetary)	SMART, traditional, routine
iii) maintain international reserves of at least 3 months of import cover;	External (monetary)	SMART, traditional, routine
iv) attain domestic revenue mobilization of at least 17.7 percent of GDP;	Stability (fiscal)	SMART, traditional, routine
v) limit the fiscal deficit, on a cash basis, to 6.1 percent of GDP;	Stability (fiscal)	SMART, traditional, routine
vi) limit domestic financing to no more than 4.0 percent of GDP;	Stability (fiscal)	SMART, traditional, routine
vii) accelerate implementation of measures towards diversification of the economy;	Growth (multi-sectoral)	Not SMART, new, not routine
viii) reduce the stock of arrears and curtail the accumulation of new arrears; and	Stability (fiscal)	Not SMART, new, not routine
ix) Slow down the contraction of new debt to ensure debt sustainability.	Stability (fiscal)	Not SMART, new, not routine
Notes: SMART = Specific, Measurable, Accepted, Relevant or Time bound		

Traditional = arrears traditionally as part of the budget and has appeared in last three budgets Routine = progress is routinely reported on in the Budget Statement

Source: constructed from 2018 Budget Address

This assessment categorizes the macroeconomic framework in the 2018 Budget Statement into three sub-groups, namely: *prominent, routinely reported elements* in the Annual Budget; *new elements* introduced in the 2018 Statement; and *missing elements* from the 2018 Budget.

a) Routinely Reported Elements

Indicators (i)-to-(vi) in the macroeconomic framework in Table 2.1 are traditionally and routinely presented in each budget, both in terms of progress-to-date and fiscal year targets. They are well specified and SMART (Specific, Measurable, Accepted, Relevant or Time bound).

b) New Elements

Indicators (vii)-to-(ix) in the macroeconomic framework in Table 2.1 are new. Although it is within the Finance Minister's mandate to set macroeconomic policy objectives, the proliferation of objectives, which are now raised to nine, raises the risks that the new indicators will be lost to follow-up in 2018 or beyond. They may quickly disappear like others before them. The risk of disappearance is heightened by the fact that these new objectives are not quite SMART; in particular, they are not specific, measurable or time-bound. This increases the temptation for the Ministry of Finance to simply ignore them (or "sweep them under the carpet").

c) Missing Element in 2018

This refers to elements that, for one reason or another, do not appear in the 2018 macroeconomic objectives. They are not so closely watched or are neglected. A good example of this is that the 2017 Budget pledged to "support the creation of at least 100,000 decent jobs." Despite the importance of this employment commitment, the 2018 Budget neither offers any explicit target for the 2018 fiscal year nor does it even refer to the progress made against the 2017 target.

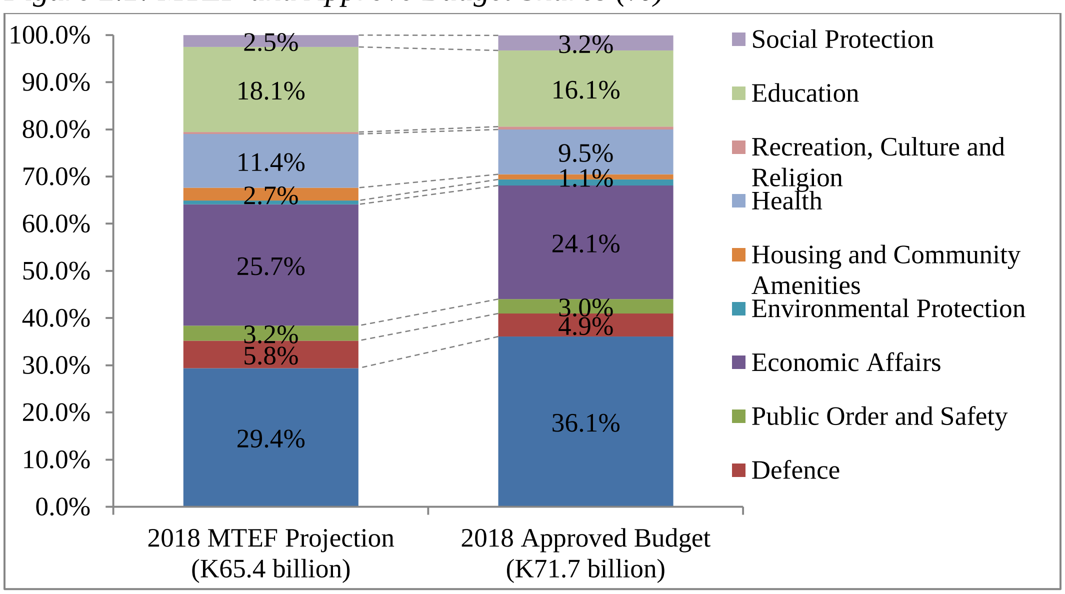
Similarly, the 2017 Mid-Year Economic Review published by the Ministry of Finance in September 2016 (same month of the 2018 Budget reading) makes no mention of the mid-year progress in creating the 100,000 new jobs. Indeed, the words "jobs" and "employment" are not mentioned even once in the mid-year review. Going a few years back in Zambia's economic history, it is disquieting to note that the jobs target, which has now vanished, was shifted around a few times before, before it finally vanished in 2018. In 2013, the Industrialization and Job Creation Strategy (published in July of that year) pledged to "create 1,000,000 new formal sector jobs over the next five years" (presumably over 2013-2017). In line with this, the 2013 and 2014 Budget Statements committed to support the creation of at least 200,000 decent new jobs in each fiscal year. None of these targets were ever accounted for or even partially reported on in subsequent Budget Statements or in annual or mid-year economic reports. They have now simply vanished, leaving the country wondering what happened to the 1,000,000 new formal sector jobs that were promised by 2017.

2.2 Time Dimensions of the Macroeconomic Framework

Recalling that the macroeconomic framework forms a key basis upon which recommendations for the future course of fiscal, monetary and external sector policy are made, challenges in the framework often reveal themselves as mismatches or misalignments on budgetary instrument when the (earlier defined) time dimension is taken into account. The nexus of the annual budget (short-term instrument) to the medium-term instrument – the Medium Term Expenditure Framework (MTEF) 2018-2020 – offers a good example. The comparative analysis finds some disquieting disparities between the two, particularly in relation to the fiscal (revenue and expenditure) projections. This is despite that the 2018 Budget Statement and the MTEF 2018-2020 were both published in September 2017. A major issue is that the total proposed budget for 2018, at K71.7 billion, was nominally 9.5% larger than the MTEF projected budget for the same year (K65.4 billion). The proposed 2018 Budget was also larger than the projected 2019 MTEF budget (K69.1 billion). Thus, MTEF projections are not good predictors of final budget allocations, even over time horizons that are as short as one month.

Furthermore, the composition of the budget by function diverged markedly between the proposed budget and the MTEF (Figure 2.1).

Figure 2.1: MTEF and Approve Budget Shares (%)



Source: constructed from 2018 Budget Speech and MTEF (2018-2020)

For instance the budgetary allocation to General Public Services was projected at 29.4% of the 2018 MTEF budget but this was increased to 36.1% in the 2018 Budget. On the other hand, the shares of Health and Education in the Budget were reduced from 11.4% to 9.5% and from 18.1% to 16.1%, respectively. These unexplained shifts limit the effectiveness of the MTEF as a strict constraint on the Annual Budget, eroding integrity and credibility of budgeting and planning. Similarly, a look at Zambia's ESGP and the MTEF show some striking disparities in fiscal revenue and expenditure projections for instance. This is irrespective of the fact that these documents overlap in terms of the time periods they cover.

The MTEF generally has higher estimates of revenue and expenditure than the ESGP. The percentage increase in revenue projections from the ESGP to the MTEF is 10% is 2018 and 13% in 2019. This increase in revenue, if achieved, would be fairly welcomed because it would place the country in a more favorable position since more revenue is better than less revenue. Unfortunately, the same pattern is observed on the expenditure side of things. The percentage increase in expenditure projections from the ESGP to the MTEF is 16% in 2018 and 21% in 2019. The larger disparities in expenditure are quite worrying because they pose a threat on the possibility of a larger than projected budget deficit in the ESGP. Taking 2018 as an example, this turns out to be the case as the deficit projection in the ESGP is 5.1% of GDP and 6.3% of GDP in the MTEF.

The above two scenarios both represent situations where there is a deviation in estimated figures in different documentation that should at least speak the same language. These unexplained inconsistencies limit the effectiveness of the MTEF as a strict constraint on the Annual Budget, as well as that of Zambia's much spoken of Zambia Plus' integrity and credibility.

3 Fiscal Policy Framework

This section looks at two aspects of the fiscal policy framework, namely: the past and prospective future performance of fiscal policy in influencing key fiscal aggregates; and the on-going legal and systems reforms of the fiscal framework

3.1 Past Fiscal Performance and Outlook

Retrospectively, the 2015 and 2016 Budget Addresses report that Zambia set itself on an expansionary fiscal path around 2012. Over time, fiscal performance deteriorated markedly. In large measure, this can be traced back to the economic malaise of 2015. After achieving 15 years of sustained economic growth that average at 6.9% per year over 1999-2014, in 2015, Zambia's real GDP growth rate slowed down dramatically to 2.9%, with a modest rebound to 3.6% in 2016 (MOF, 2017[1]). The 2015 slowdown was mainly a result of two problems, namely: external shocks; and domestic policy misalignments and failures.

[1] MOF (2017) "Economic Stabilization and Growth Programme – Zambia Plus", Ministry of Finance, Republic of Zambia

The external shocks included:

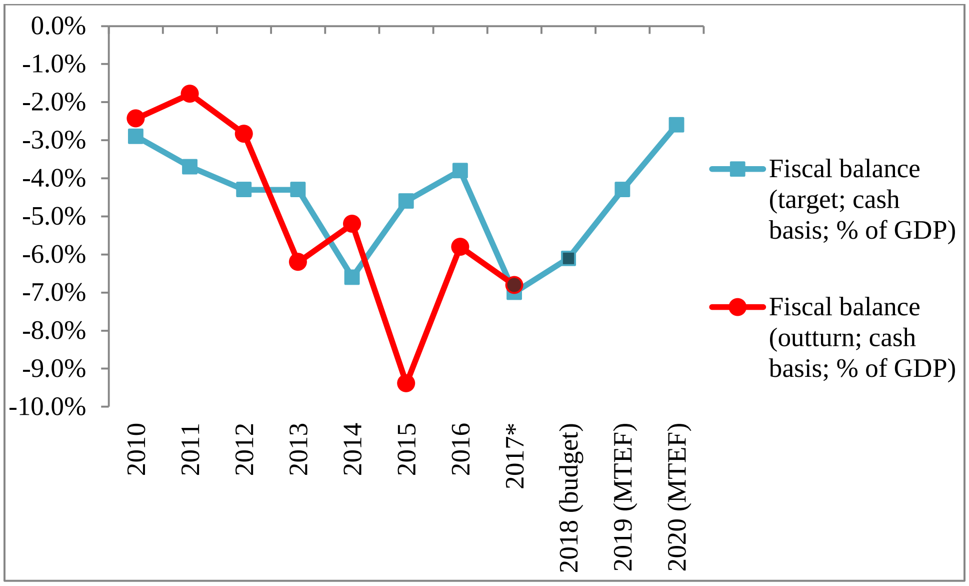
- A drastic fall in international copper prices, which had been steadily declining since 2011; in 2015, they fell by about 35%.
- Severe electricity shortages that set in in July 2015 due to reduced water levels in Zambia's main reservoirs for hydroelectric power generation during the 2014/2015 rainy season. Industrial productivity in manufacturing and agro-processing reportedly reduced by around 30-70% between June and October 2015 and resulting in an estimated nominal GDP loss of US$4.3 billion in by the end of 2015.
- A sizable collapse of the Kwacha: the Kwacha depreciated by 26% in nominal terms in September 2015 (and by 60% on average during the year); and the inflation rate increased from 7.7% in September to 21.1% by December, driven by high imported inflation due to the drastic exchange rate depreciation.

The main domestic policy challenges included the following:

- Monetary policy became severely tight or contractionary in an attempt to curb the escalating inflation and exchange rate depreciation while fiscal policy remained overly loose as the public sector's appetite to borrow could not be reduced despite the economic downturn. This resulted in misalignment between monetary policy and fiscal policy.
- The contractionary monetary policy – working jointly with extensive domestic borrowing through the issuance of Government securities (Treasury Bills and Government bonds) – increased to domestic cost of credit and drained liquidity from the market. This severely reducing credit to the private sector, crowded out private sector spending, suppressed firm productivity, and ultimately limited the private sector's contributions to GDP.
- On the other hand, fiscal policy, which was quite expansionary over 2011–2014 remained loose in 2015, with very few adjustments in the wake of the crisis. For instance the fiscal balance (cash-basis), which had been targeted at 4.6% of GDP, deteriorated to 9.4% of GDP by the end of the year (Figure 3.1). With a rapidly mounting public debt overhang, concerns about the sustainability of Zambia's debt position emerged.

Economic fortunes improved in 2016 as fiscal policy was tightened moderately. The Fiscal deficit narrowed to 5.8% of GDP (although it was still considerably deeper than the budget target). The 2018 Budget Statement anticipates that the 2017 fiscal deficit outturn, projected at 6.8% of GDP, will be better than the target of 7% of GDP.

Figure 3.1: Fiscal balance, cash-basis (% of GDP)



Source: constructed from Budget Speeches and Annual Economic Reports

Growth in the first half of 2017 averaged 3.1%, driven by favourable performance in agriculture and the energy sector. The favourable performance of the agriculture sector is attributed to a good supply of rains, quick response to threats such as army worms, the provision of inputs and extension workers as well as better targeting of farmers under the farmer input support programme. The performance of the energy sector in the first half of 2017 was favourable evidenced by the increase in electricity generation and the stable supply of petroleum products. Total electricity generation in the period increased by 25.3% to 6,913,887 MWh compared to 5,519,162 MWh generated in the previous year. Consequently, exports of electricity increased by 59.9%. In the same vein, electricity consumption increased by 9.3% to 5.9 million KWh compared to 5.4 million KWh in the corresponding period in 2016. Feed stock imports of petroleum declined by 25.7% on account of a late delivery in 2016 that was consumed in 2017, with the wholesale and retail sector being the largest consumers of petroleum products followed by the mining sector.

3.2 Legal and Systems Reforms of the Fiscal Framework

The planned legal reforms for enhancing fiscal accountability, transparency and overall governance have been very slow. The revision of Public Finance Act has been promised since the 2016 Budget Address and the revision is still being promised again in the 2018 Budget Address. Revisions to the Loans and Guarantees Act and the Public Procurement Act, have also been added to the list in 2018. The issue of a Planning and Budgeting Bill first appeared in the 2015 Budget Statement, which announced the publishing of the National Planning and Budgeting Policy in 2015. Against this, three successive Budget Statements (2016, 2017 and 2018) promised to table a Planning and Budgeting Bill before Parliament. A check of the Bills archive on the National Assembly website (http://www.parliament.gov.zm/publications/bills-list?page=4) indicates that between 2014 and September 2017, no bills or amendment bills were submitted to Parliament in relation to any of the above legal instrument. If the fiscal measures pronounced in the 2018 Budget Address are to be sufficiently backed by the law, the legal reforms must be undertaken with much more urgency.

Similarly, the pace of implementing systems strengthening reforms to improve the performance of key operational elements in the fiscal framework has been worryingly slow over the past three years.

For example, the 2015 Budget Statement reported that a key milestone achieved so far was "the rolling out of the Integrated Financial Management and Information System (IFMIS) to more sites". By 2017, the Budget Speech promised that: "With the expected full rollout of Integrated Financial Management Information System by end 2017, no Ministry, Province or Spending Agency shall be allowed to spend outside the system". However, in 2017 the Ministry of Local Government went outside the system to procure 42 fire tenders at a reported cost of US$42 million (approximately K390 million) or US$1 million each, against a 2017 budgetary allocation of K12.6 million (US$1.4 million) to Fire Safety and Services (the programme where the procurement of fire tenders falls). The off-budget spending was therefore 2,959% above budget.

This was during a year when Zambia is anticipated to accumulate sizable arrears in relation to the Farmer Input Support Programme (FISP) and Strategic Food Reserves under the Food Reserve Agency (FRA). The anticipated overdue payments prompted the Finance Minister to propose the allocation of K440 million to dismantling of these arrears. One cannot help but think that these arrears would have only amounted to K50 million had IFMIS prevented the Ministry of Local Government from overspending by 2,959% in arguable lower national priority fire tenders.

4 Monetary Policy Framework

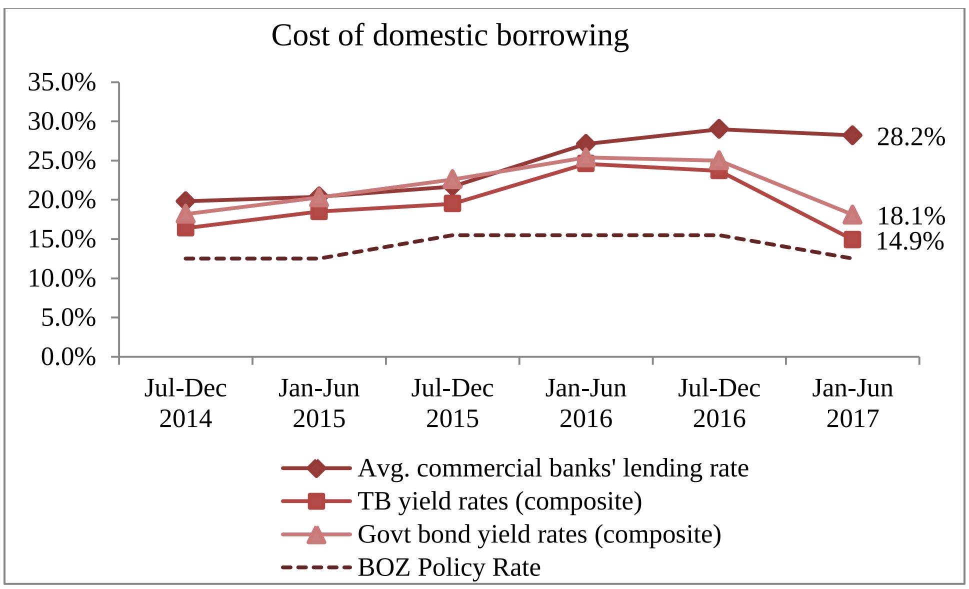
This section presents an analysis of the conduct and performance of monetary policy during the year 2017 and presents insights into the likely policy direction during the upcoming 2018 budget cycle and its implications.

Monetary policy involves the actions of the central bank in relation to the short-term supply of money and level of interest rates. This is in order to support the primary policy objective of price stability which the Bank of Zambia ((BOZ) has defined as being an inflation rate in the range of 6 to 8% as measured by the Consumer Price Index (CPI). The BOZ has equally committed to ensuring financial system stability as a major objective. Hence, in its day-to-day operations, the two objectives are primary. Other secondary objectives of monetary policy as announced in the Monetary Policy Committee's (MPC) statements are economic diversification and economic growth (MPC Monetary Policy Statement, August 2017).

4.1 Monetary Policy Performance and Implications

The year 2017 saw a somewhat loosened monetary policy stance. This arose from the improved macroeconomic conditions in which the rate of inflation declined significantly. Compared to February 2016 when inflation was highest at 22.9%, inflation was 6.8% in the same month in 2017. Furthermore, the exchange rate stabilised and the kwacha appreciated against major currencies and is now trading below K10 per US dollar. These developments have necessitated a lowering of the Bank of Zambia (BOZ) policy rate from 15.5% to the current 11% so as to improve liquidity which had dried up significantly due to Bank open market operations which essentially mopped up the kwacha from the domestic money markets when market volatility was high as exemplified by an unstable exchange rate beginning in September/October, 2016. Furthermore, the reserve requirement ratio was lowered from 18% to 9.5%. This has resulted in general borrowing costs trending downwards as shown in Figure 4.1 below.

Figure 4.1: Trends in interest rates (cost of borrowing)



Source: BOZ data

The figure shows that interest have exhibited a decline since the beginning of 2017 and positive steps on the monetary policy side could nudge them further downwards.

There are some risks, however, that require close monitoring to ensure that there is no resurgence of high interest rates going forward. Firstly, the Government in the 2018 Budget has indicated that it will increase participation in the domestic money markets by issuing more Government securities. In the Budget, these will rise from a targeted 2% of GDP in 2017 to 4% of GDP in 2017. With fairly underdeveloped financial markets, such a surge in the Government's domestic borrowing will put upward pressure on the cost of borrowing. Secondly, partly due to poor economic conditions in general, the asset quality of loans in the banking system has deteriorated and the rate of non-performing loans stood at 12.2% by June 2017. This represents higher risks for lenders who would naturally expect greater compensation in form of higher interest rates.

This would be detrimental to the private sector which has had to borrow at a high cost in order to invest and is only beginning to see an improvement in lending conditions. Therefore, if the quality of assets does not improve significantly, credit growth will be curtailed with adverse consequences for economic growth. Thirdly, changes in the BOZ policy rate upwards have the effect of raising general interest rates higher as well. In this respect, inflationary pressures and possible exchange rate volatility are factors worth noting. However, given favourable projections in the near-term[2], it is unlikely that there will be significant shifts in the Policy Rate in the year 2018 as monetary policy is expected to remain fairly benign.

5 Social and Economic Sector Budgets

5.1 Social Sectors

In 2018, the relative share of the Social Sector Budget to the National Budget has remained static at 32%. The allocation to this sector has in absolute terms increased nominally from K20.9 billion in 2017 to K22.8 billion in 2018. This translates to an increase of 10% (3% in real terms with year-end inflation projected at 7%).

a) Social Sector Budget by function

The Social Protection Budget has decreased nominally by 15% from the K2.7 billion in 2017 to K2.3 billion in the proposed 2018 Budget on account of the 33% reduction in the allocation to the Public Service Pension Fund (PSPF). The decrease in SP spending seems contradictory to national aspirations and commitments the Government announced both through the 7NDP and the Economic Stabilisation and Growth Programme (ESGP) to reduce vulnerabilities on the extreme poor.

The PSPF still accounts for a dominant share of the SP budget at 46% compared to the Social Cash Transfer (SCT) at 31% and other interventions at 17%. The SCT programme is expected to migrate to an electronic platform obviously in the hopes of better record keeping, improved coordination and beneficiary tracking. Nonetheless, with limited internet access in most of the rural areas, this will be a huge milestone to actualise. The Food Security Pack (FSP) has also been doubled and will now reach 80,000 households compared to 40,000 in the 2017 Budget.

[2] The BOZ projects inflation to range in the 6-8% range with a bias towards the lower bound in the medium term. Hence, the threat of an increase in the Policy rate next year is low especially that macroeconomic conditions are expected to continue improving in the coming fiscal year.

Similarly, the School Feeding Programme (SFP) is expected to increase coverage by 25% despite the level of allocation not having been stated in the budget speech.

b) Education Sector

In terms of resource allocation, the 2018 Budget seems to mirror the 2017 allocations as the share of the total Budget to the education sector declines from 16.5% to 16.1%. However, in absolute terms a marginal increase of 3% is observed. While spending on education infrastructure development has marginally increased as a share of the education sector budget from 6% to 6.3%, student loans and bursary scheme has marginally decreased from 3% in 2017 to 2.8% in 2018.

The 2018 Budget allocation to the education sector casts doubts on the ability of the country to achieve 7NDP aspirations, even though the policies outlined in the 2018 Budget Speech show promise. Furthermore, with the approved increase in the wages of civil servants, there is a risk that the increase in the allocation could be absorbed by personal emoluments in the sector. It is important to note that in previous Budgets, allocations have been skewed towards emoluments and have also shown bias towards primary education.

c) The Health Sector

The 2018 Budget allocation to the health sector has increased from 8.9% in 2017 to 9.5%. This allocation is still insufficient given the new policy pronouncement regarding the routine testing for HIV as part of diagnostic screening as well as already existing challenges in Zambia's health sector. The health sector still faces many challenges; lack of a clear health financing strategy, a human resource gap of 33% and high dependence on external funding which accounts for approximately 60% of total health expenditure; raising sustainability concerns. Further, the budget to health has continued to be low and has always fallen short of the Abuja declaration that Zambia signed many years ago obliging the country to allocate 15% of its national budgets to the health sector.

It is cardinal to note that the 2018 Budget has repeated Government's intention to implement the Social Health Insurance (SHI) as in earlier Budgets. However, this has never been followed with corresponding action.

d) Water and Sanitation Sector

In the 2018 Budget, 0.8% (K564.5m) of the total Budget is allocated to water and sanitation, a 0.2% increase from 0.6% in 2017. Nonetheless, disparities between urban and rural likely to escalate with 43% of the said water and sanitation Budget going to the Lusaka urban water project.

Over the past years, the focus of the water and sanitation Budget has been to improve access to safe and clean drinking water in rural areas. In 2017 the focus for the water and sanitation sector was to support the provision of safe and clean water to 600,000 households in rural areas. The focus of the 2018 Budget however, will be directed more towards urban and peri-urban areas. This inequitable focus could result in poor health and possible outbreaks of diseases in rural areas as constant access to a clean water supply and proper sanitation facilities are cardinal for good health and productivity. This defeats the very purpose of reducing developmental inequalities between rural and urban areas which is a priority under the 7NDP.

5.2 Economic Sectors

a) Agriculture

Agriculture has clearly emerged as the Government's sector of choice to advance Zambia's economic diversification agenda for obvious reasons and the 2018 Budget is a testament to the fact. This links well with the 7NDP which aims for a diversified and export-oriented agriculture sector. For all the six (6) strategies outlined in the 7NDP for improving agriculture, the 2018 Budget address has attempted to introduce and/or strengthen measures aimed at achieving the Development Plan's aspirations for the sector.

Broadly, the Budget introduced measures aimed at improving productivity (and production!), access to credit and enhancing agriculture value chains. Specifically, investment in a tractor and agriculture equipment assembly will promote mechanisation in the sector thereby increasing both production and productivity. In order to further incentivise and grow manufacturing and make the locally assembled equipment and tractors affordable to farmers, the suspension of import duty on machinery, equipment and capital goods for assembling of motor vehicles, trailers, motorcycles and bicycles should be extended to agriculture equipment assembly.

Furthermore, use of the farm block model will encourage investment in the sector where inadequate infrastructure is a concern. Farm blocks are an economic way of providing the needed infrastructure by concentrating investment in a designated area. However, given the resource constraints facing the Government, it is questionable as to whether the three farm blocks earmarked in 2018 Budget can be successfully developed simultaneously. We propose a phased approach to developing farm blocks as opposed to embarking on several at once as it may spread resources thinly and increase lead time to completion which in turn could delay expected investment to the detriment of the sector's growth.

There is emphasis in the 2018 Budget on improving market access by farmers especially in the livestock sub-sector where the Government has committed to facilitate the export of one million goats annually. This needs to be done sustainably, and therefore, the Livestock and Aquaculture Census alluded to in the Budget alongside the development of the agriculture information management system will help attend to the concern of whether there are sufficient stocks to cover both the domestic and export markets. Presently, Zambia is a net importer of fish which costs the country nearly K4 billion annually. The introduction of cage fish farming on lakes Mweru and Kariba, among others, and the US$50 million Aquaculture Enterprise Development Project will also increase fish production and have potential to not only replenish depleting fish stocks but to meet regional demand in the long term. Such measures are a plus for export-orientation of the agriculture sector. However, there should be measures put in place to improve access to information and support in relation to pricing and how small-holder farmers can take advantage of these emerging market opportunities.

b) Tourism

The Budget addresses two key issues affecting the tourism sector – administrative barriers and access to tourism sites. To address these issues a single licensing regime will be implemented by the Business Regulatory Review Agency (BRRA). In addition, the "Government will through an integrated approach, prioritise major roads, bridges and air strips leading to tourism destinations". The Government has also pledged to facilitate development of requisite infrastructure to ease access to tourist sites, rehabilitate heritage sites and strengthen wildlife protection.

The two interventions in the sector are laudable as they will contribute to making the sector competitive. However, related to the two issues is the aspect of developing saleable tourism products. This aspect is supposed to be taken care of by the Tourism Development Fund whose implementation was announced in the 2017 Budget. The 2018 speech is silent on this aspect. It could have been helpful if the speech reported on the progress in the implementation of the Fund.

c) Energy

In the energy sector, Government is continuing to push on some of the critical pronouncements that were made in the 2017 Budget. The 2017 Budget outlined a number of important measures aimed at addressing the electricity sub-sector challenges. The measures include 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 the review of ZESCO.

In 2017, we saw the implementation of the migration to cost reflective tariffs and the launch of the Cost of Service Study. There were also a number of electricity generation projects that were commissioned. The 2018 Budget Speech touched on a number of measures: The amendment to the Energy Regulation Bill to allow for enhanced supervision and regulation of the energy sector and the Electricity Bill to allow for participation of other players in the industry. It is however not clear whether these pieces of legislation will address both the market structure and ZESCO itself as was promised by the Minister. Related to this is the pronouncement that in 2018, the Government will implement the Renewable Energy Feed-In Tariff Regulatory Framework. The target is to add 200 megawatts through this initiative in the first phase. This is a shot in the arm to small scale electricity producers. Further, the Government has also taken a move to encourage households to use alternative energy sources such as Liquefied Petroleum Gas (LPG) and solar power. In this regard the Minister proposed to increase customs duty on electric geysers and stoves to 40% from 25%.

In the 2017 Budget, the Government had indicated that it would disengage from direct procurement of finished petroleum products by March, 2017. This was meant to remove the burden of oil procurement from the Treasury, attain efficiencies and promote private sector participation. It would appear that this pronouncement was prematurely included in the 2017 Budget Speech as the Ministry of Energy was far from being ready to implement this measure. The Minister has set a new deadline for first quarter of 2018.

As indicated in the 2017 ZIPAR Budget Analysis, this move has various positives; the most obvious one is the introduction of competition into a sector where it is greatly needed. There would be competition both between Oil Marketing Companies (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. 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 be challenging 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. We hope that the proposed amendment to the Energy Regulation Act will take these issues into consideration

6 Revenue Measures

In a bid to raise sufficient revenue to meet expenditure demands, the 2018 Budget proposes a number of tax measures across many of the tax categories. The Budget in its aim to accelerate fiscal fitness tries to balance between meeting the 7NDP development priorities and ensuring medium to long-term public financial health.

6.1 Composition of Key Contributions to Revenue in the 2018 Budget

The 2018 Budget in terms of the composition of contributions to revenue remains broadly similar to those of the 2017 Budget with the exception of notable increases in the share of Value Added Tax (VAT) and mineral royalties. As indicated in the table below, the proportion of VAT as a share of GDP is expected to increase from 4.1% in the 2017 Budget to 4.5% in 2018. Measures to be used to raise VAT build on those proposed in the 2017 Budget and will include the introduction of penalties in the VAT Act for taxpayers that fail to furnish records upon request.

Further, buoyed by higher copper prices, earnings from mineral royalties are expected to increase to 6.8% of GDP in 2018 compared to 4.2% in 2017. Additionally, it has been proposed that there will be a move to include non-traditional minerals such as gemstones and industrial minerals to broaden the tax base, as well as strengthening regulation and enforcement to control tax avoidance. Recently, the President announced the setting up of a ministerial committee to develop reforms aimed at putting the challenges of tax regulation in the mining sector to bed once and for all. However, given the past track record of poor implementation and enforcement, it is uncertain that this will be successful going forward.

Table 6.1: Comparison of 2016 and 2017 Budget Targets and Revenue Contributions

	2017 Approved Budget	*2018 Budget Speech*	*2017 % of Revenue*	*2018 % of Revenue*	*2017 % of GDP*	*2018 % of GDP*
Domestic Revenue	*42,939.8*	*49,087.0*	*95.1%*	*95.3%*	*18.4%*	*17.7%*
a. Tax Revenue	*35,266.3*	*41,139.8*	*78.1%*	*79.8%*	*15.1%*	*14.9%*
Income Tax	*17,757.0*	*20,337.6*	*39.3%*	*39.5%*	*7.6%*	*7.4%*
Value Added Tax (VAT)	*9,463.3*	*12,369.5*	*20.9%*	*24.0%*	*4.1%*	*4.5%*
Customs & Excise Duties	*7,924.2*	*8,098.7*	*17.5%*	*15.7%*	*3.4%*	*2.9%*
Export Duty	*68.4*	*51.6*	*0.2%*	*0.1%*	*0.0%*	*0.0%*
b. Non Tax Revenue	*7,673.5*	*7,947.2*	*17.0%*	*15.4%*	*3.3%*	*2.9%*
o/w: Mineral royalties	*1,890.9*	*3,527.7*	*0.8%*	*1.3%*	*4.2%*	*6.8%*

6.2 Other Notable Revenue Measures

a) <u>The upward adjustment of the presumptive tax rate applicable to buses and taxis</u> This tax has not been adjusted in over 10 years; the argument used to explain the 50% upward adjustment across the board for all vehicle sitting capacities. However, implementation in the past has been a challenge and the Government will have to put in place stringent measures in order to be able to realise any benefits thereof.

b) <u>The discontinuing of the 5-year income tax holiday facilitated through the Zambia Development Agency (ZDA)</u>
While it is clear that any new entrant would not receive this incentive, it remains to be seen whether the removal will affect those that are already enjoying a tax holiday and how this will affect their operations. It is hoped that any investors that were already planning to come into the market remain undeterred.

c) <u>Increased customs duty on electric geysers and electric stoves from 25% to 40%</u> This is a shrewd measure to help deal with the electricity crisis that has faced the country in recent times by discouraging the use of appliances that are heavy on electricity consumption while simultaneously raising revenue.

d) Introduction of a charge of K2 per 50kg of cement

This capitalises on all the infrastructure development activity around the country to build an Infrastructure Development Fund. Considering the steady growth in the production of cement averaging 15% per annum between 2007 and 2016, this measure is envisaged to yield a significant amount of revenue in excess of K70 million to support infrastructure development. This is indicative of a good start in sustainable financing of infrastructure development. Cement production has steadily risen from an annual production of about 500, 000Mt in 2007 to over 1.7 million Mt in 2016 translating to 10.6 million bags in 2007 to 35.7 million bags in 2016.

What is not clear, however, is the mode of administration of this revenue, whether it will be ring-fenced to safeguard its purpose of establishment or aggregated with all other revenues in which case it may not have as much impact as expected. Additionally, this measure is expected to be most painful to the average Zambian as sellers are likely to pass on the burden to the consumers and in turn increasing the already high cost of construction. Thus, if not well appropriated to benefit the less advantaged, this may just become another retrogressive tax.

e) The removal of customs duty on Point of Sale machines, electronic fiscal devices, and sim cards:

It is well documented that any move to electronic transactions makes it easier to monitor compliance and thus increase revenue collections. In a similar vein, the introduction of a customs valuation referencing system to reduce undervaluation of imports is also a welcome initiative.

7 Effect of the Recent Set Price for Maize On Agriculture

The Food Reserve Agency (FRA) set the purchase price of a 50 kg bag of maize at K60 in the 2016/2017 agriculture season, a reduction of K25 from the K85 in the 2015/2016 season. This price has been considered unfavourable by most farmers who argue that the price by FRA does not take their input costs into consideration – it is below the cost of production. It is therefore likely to have a negative impact on the farmers.

Government has for a long time been subsidising maize by buying it at a higher price than it sold it to millers. As part of the reforms under the Economic Stabilisation and Growth Programme, Government has had to reduce subsidies (mainly in the agriculture and energy sectors). However, the true cost of FRA participation in the market when all factors such as logistics and transportation are considered remains high.

With Government's announced plans to transform FRA into a maize-exporting agency, it does not make business sense to continue subsidising millers as the case has been. Therefore, FRA has to source the maize from the market at a price that everyone else is getting. However, if Government wants to be buying at market prices, the question is whether they will keep changing the price as market prices change.

However, the price is likely to have a number of effects on the agriculture industry, including the following:

Holding out: Those with storage facilities have vowed to hold out their produce until the end of the year when the price is anticipated to go up. However, the majority of the maize farmers are small-scale and do not have storage facilities. These have no choice but to sell the maize at this reduced price.

Price distortions: IAPRI, a leading agriculture think-tank, has long contended that FRA's activities have undermined the competitiveness of the maize market and made it more vulnerable to supply and demand shocks than would otherwise have been the case without large FRA presence. The late setting of the maize price by FRA, 2-3 months after the maize marketing season began, has led to an upward distortion of the price. With maize production exceeding 3.6 million tonnes, thanks to good rainfall and favourable prices in the 2015/2016 season, the country is awash with maize and prices have been as low as K30 per 50kg bag in some places.

Substitution of maize for other crops: With an unfavourable maize price, farmers will be reluctant to grow maize during the 2017/2018 agriculture season. This is likely to threaten food security.

Budgetary implications

It is not good for economic players when FRA drastically reduces the price and or quantity of maize to be purchased as it affects the expectations and distorts the market. To minimise the fallout, Government is likely to compromise either on the price per tonne of maize itself or on the quantity that they will buy from the farmers by exceeding the 500, 000 metric tonnes that they have set, or both. Either way, this has budgetary implications. However, we do not have figures for purchases made thus far to be able to definitively estimate the full budgetary implications.

Suffice to say, in the 2018 Budget Address, a total of K1.0512 billion has been proposed as the allocation to Strategic Food Reserves "to facilitate maintenance of our country's strategic food reserves at 500,000 metric tonnes". If the full budgetary allocations is dedicated to maize purchases alone and taking into account transactional costs on transport, warehousing, pest control and other logistics), this will imply a price of K1.896 per kg or K94.8 per 50kg bag of maize in 2017/2018 agricultural season. This would be significantly higher than the 2016/2017 price of K60 per 50 kg bag (or K1.30 per kg). It is even higher than the upward price revision to K85 per 50kg bag (K1.70 per kg), which has been proposed in some circles.

The big question is will the money become available in the 2018 Budget to actually deliver on the commitment to secure 500,000 metric tonnes of maize? In the 2017 Budget, Strategic Food Reserves were allocated K952.5 million (with FISP getting K2.9 billion). Despite this, the 2018 Budget Address projects that a combined total of K440 million to dismantle arrears to FISP and Strategic Food Reserves, which will have been accrued by end of 2017. There are no fiscal safeguards in the 2018 Budget Address to offer confidence that the challenges that have led to the 2017 arrears will be properly mitigated in 2018. The risk of unmet expectations yet again in 2018 therefore cannot be ignored.

8 Conclusion

The proposed Budget places a very heavy burden on domestic revenue to perform. The goal of raising an additional K6.1 billion over the 2017 target is particularly ambitious given that the 2017 domestic revenue target is likely to be below target by 7%, according to the Budget speech. Additionally, despite all the proposed revenue raising measures, domestic revenue as a proportion of GDP will actually fall to 17.7% of GDP in 2018 compared to 18.4% in 2017.

Nonetheless, if the proposed revenue and expenditure measures are followed through and administered diligently, coupled with appropriate fiscal governance measures, it is possible that this Budget could set the country on the road to accelerated fiscal fitness.