

Creating and wasting fiscal space

Zambian fiscal performance 2002–2011

Based on the ZIPAR report *Creating and wasting fiscal space: Zambian fiscal performance, 2002–2011* by Alan Whitworth

Following three decades of economic mismanagement and decline, Zambia has experienced sustained economic growth since the turn of the century. The combination of rapid growth, reduced public expenditure, increased mining taxation and debt relief helped the Government establish fiscal discipline and reduce fiscal deficits and debt to sustainable levels. As a result, fiscal space has grown significantly and Zambia is no longer aid dependent. In addition, lower domestic public borrowing has helped cut inflation and interest rates and has reduced crowding out of private sector borrowing. These developments would normally be expected to lead to significant poverty reduction. However, by 2010 there had been little improvement in poverty. This is partly due to fiscal space being wasted on ill-designed agriculture policies and uneconomic road paving projects of little benefit to the poor.

Between the 1970s and 1990s Zambia's economy was one of the most badly mismanaged in Africa. At the macro level this is perhaps best illustrated by the scale of fiscal deficits, which averaged 12.3% of gross domestic product (GDP) during the 1970s, 13.8% in the 1980s and 6% in the 1990s. With fiscal deficits and debt at unsustainable levels and copper production and prices in decline, per capita income fell substantially. But since the turn of the century, Zambia's macro economy has been transformed. This brief explains how this has been achieved, then explores the worrying signs that the potential benefits for poverty reduction are being lost through poor micro-economic policies.

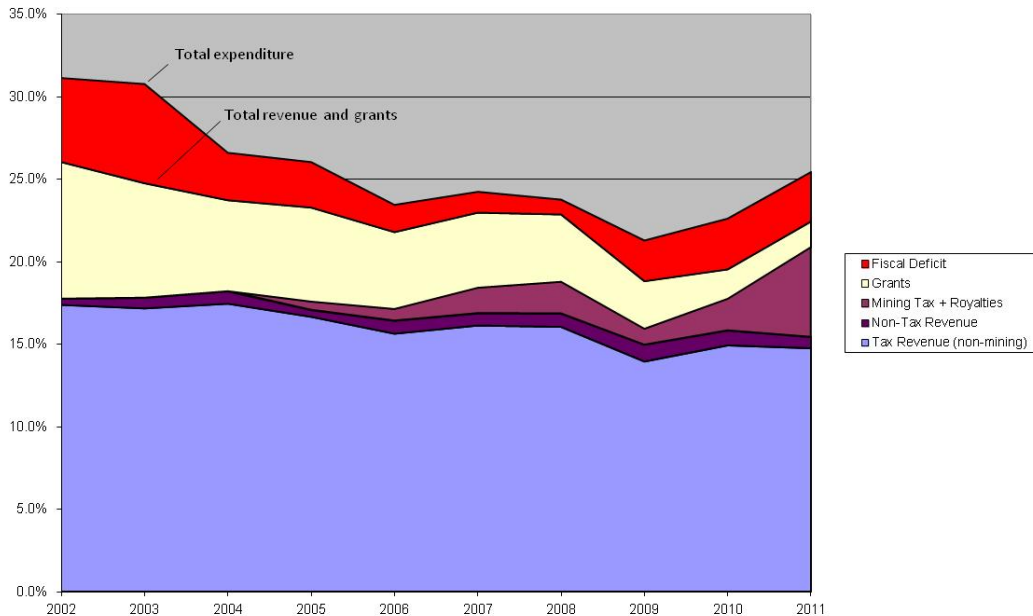
FISCAL TRENDS 2002–2011

The chart on page 2 of this brief shows that Zambia's total revenue was fairly stable (at around 17–18% of GDP) between 2002 and 2008, dropped to 16% in 2009 following the global financial crisis, then rebounded to 20.9% in 2011. To understand

this pattern it is useful to examine the contrasting trends in non-mining and mining revenue.

Non-mining revenue (tax and non-tax) has been declining. Some of this is a result of Zambia honouring its commitments to reduce import taxes under regional trading agreements such as the SADC Trade Protocol. More of it is due to the increased use of tax exemptions to attract investment (e.g. Multi Facility Economic Zones) or to meet short-term political objectives. An example of the latter was the cut in September 2008 of excise duties on petrol and diesel to offset the impact of rising world prices.

This decline is more than offset by the increase in mining revenue. After a long period when it contributed little, total mining revenue (the combined value of mining tax and royalties) jumped sharply from 1.9% of GDP in 2010 to 5.5% in 2011. As a result, total revenue jumped from 17.8% of GDP in 2010 to 20.9% – the highest level this century. Although the 2011 figure is distorted



by a 'one off' payment of arrears (1.9% of GDP), the doubling of the royalty rate on base metals to 6% in the 2012 Budget means that total mining revenue is unlikely to return to the previous low levels. While there is still controversy over the appropriate mineral tax regime for Zambia, a decade after privatisation the mining sector has finally become a significant source of GRZ revenue.

The end of aid dependency

For much of its history Zambia has been dependent on foreign aid to supplement GRZ revenue. During the 1980s and 1990s it was one of the most aid dependent countries in the world. However, aid's fiscal significance has diminished in recent years.

Locally collected data is poor, but according to OECD figures, aid's share of GDP declined sharply from 21.9% in 2002 to 5.4% in 2011. This largely reflects the rapid growth in GDP since the turn of the century and is exaggerated by the sharp appreciation of the kwacha-US dollar exchange rate in 2006. With GDP expected to continue growing faster than aid over the medium term, the ratio is likely to continue to fall. In short, Zambia is no longer aid dependent.

The end of unsustainable deficits

Between 2002 and 2004 there was a serious effort to reduce expenditure and the deficit, which dropped from 6% of GDP in 2003 to 2.9% in 2004. The deficit continued to decline, reaching a healthy 1.6% of GDP in 2006. So, by reducing expenditure – and assisted by rapid growth in GDP (the denominator) – it took just three years for the GRZ to bring an end to decades of unsustainable deficits.

Debt and interest

While public attention has focused on the reduction in foreign debt as a result of Zambia reaching HIPC Completion Point in 2005, domestic interest was much larger than foreign interest throughout the period, and reductions in this domestic debt have been more significant in cutting the GRZ interest bill.

Foreign interest fell from 1.3% of GDP in 2002 to 0.1% in 2011. Domestic interest fell even more, from 2.8% of GDP in 2002 to 1.1% in 2011.

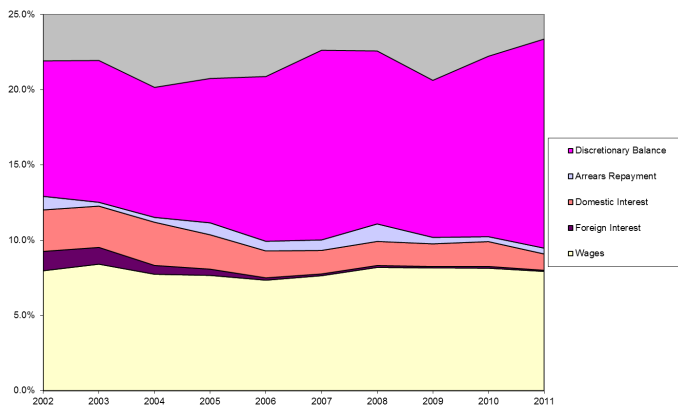
While the reduction in foreign interest is almost entirely attributable to debt relief, domestic interest savings are due to three distinct factors: (1) lower borrowing resulting from improved fiscal management from 2004, (2) GDP growth, and (3) falling interest rates. Zambia has experienced a 'virtuous circle' of lower borrowing facilitating lower interest rates, leading to a reduction in the interest bill which in turn facilitates further reductions in borrowing, inflation and interest rates, and so on.

Another important benefit of reduced GRZ borrowing is the impact on "crowding out" of the private sector. When governments borrow domestically to finance fiscal deficits they both reduce the supply of finance available to the private sector and increase its cost (the interest rate). This discourages private investment and growth. Conversely, when government borrowing is reduced interest rates are likely to fall and private sector borrowing increase.

Fiscal space and the discretionary balance

By showing trends in total domestic expenditure as a share of GDP, the chart below illustrates the increase in the GRZ “discretionary balance” – i.e. that part of the budget over which GRZ can exercise real control, or the part not represented by wages, interest and repayment of arrears. It is a useful indicator of “fiscal space”.

Taking the discretionary balance as an approximation of fiscal space, fiscal space increased by 4.9% of GDP between 2002 and 2011. Given that real GDP itself grew by 75% over the period, this represents a substantial increase in resources available to GRZ. Following some 30 years during which it had negligible control over its own expenditure, GRZ finally has significant fiscal space at its disposal.



HOW HAS FISCAL SPACE BEEN USED?

Now it is in a position to make real decisions on resources, how has it chosen to allocate them?

As a backdrop, it should be noted that Zambia’s impressive growth performance in recent years has had relatively little impact on poverty. “The proportion of the population falling below the poverty line reduced from 62.8% in 2006 to 60.5% in 2010” (GRZ 2012).

While analysis of fiscal space is an imprecise science and should be treated with caution, the figures suggest that most of the fiscal space created in recent years has been spent on three programmes, each of which represents an inefficient use of resources with little impact on poverty reduction: (1) fertiliser subsidies, (2) maize purchase, and (3) paving roads.

FISP

Since 2002 the Farmer Input Support Programme (FISP, formerly known as the Fertiliser Support Programme) has received the majority of the agricultural budget aimed at poverty reduction. GRZ procures fertiliser and seed and sells it to smallholder farmers at subsidised rates. However, the scheme has been plagued by a number of problems. First, the delivery of FISP inputs to farmers is frequently delayed. Second, FISP inputs are targeted at and disproportionately captured by a small minority of larger, wealthier farmers. Third, the standardised FISP input pack is not appropriate for many of Zambia’s diverse soil and agro-ecological systems. Subsidising inappropriate inputs leads to maize mono-cropping and low yields. Fourth, GRZ direct procurement of fertiliser has crowded out private agro-dealers in some regions.

Despite the lack of any evidence that it has helped reduce rural poverty, expenditure on FISP increased from 0.5% of GDP (2.4% of domestic expenditure) in 2005 to 1.0% of GDP (4.1% of expenditure) in 2011.

FRA maize purchase

The Food Reserve Agency (FRA) is mandated to maintain strategic food reserves to ensure food security in the event of poor harvests. It also purchases surplus maize at guaranteed prices from smallholder farmers. Until 2010 these operations cost between 0.1% and 0.4% of GDP (1%–2% of domestic expenditure), but the bill shot up in 2010 and 2011. Good rains saw a record harvest in 2010, which, combined with a guaranteed price way above market rates that meant the FRA ended up purchasing most of the marketed surplus, saw the maize bill balloon to 1.6% of GDP in 2010. Although the rains were less good in 2011, Zambia had a second successive record maize harvest, partly because farmers switched from other crops into maize in response to guaranteed above-market prices. With an election due in September 2011, the government was reluctant to reduce the guaranteed price or restrict FRA purchases. As a result, FRA’s maize purchase bill increased still further to 1.8% of GDP in 2011.

If these subsidies to maize producers were clearly benefitting the poor they might be justified despite the damage to GRZ finances and private traders. However, “the benefits of the FRA maize support prices are disproportionately enjoyed by the

relatively large farmers over 5 hectares, even though they constitute only 3.8% of the smallholder farm population”, while most Zambians who are net maize purchasers lose through paying higher prices (Jayne et al. 2011).

Paving roads

The third area to experience substantially increased expenditure in recent years is road upgrading. Following decades of neglect, Zambia has a large backlog of maintenance and rehabilitation, mainly on the unpaved road network. While funding for maintenance has increased somewhat, most additional GRZ funding has been addressed not at the backlog but at upgrading a small proportion of the unpaved network to fully engineered paved standard; upgrading expenditure increased from 0.1% of GDP in 2005 to 1.6% in 2011. Few of these projects have sufficient traffic potential to be economically viable. Decisions were taken at the political level with little, if any, technical/economic appraisal. Paving roads is of little benefit to the poor and is crowding out funding for maintenance and rehabilitation of the unpaved network – activities with much better economics and benefitting far more poor people.

The table below compares the growth in expenditure on the above three programmes (as shares of GDP) with growth in the discretionary balance for the periods 2005 to 2010 and 2005 to 2011. Over the former period their combined growth in expenditure accounted for 2.2% out of the 2.5% of GDP increase in the discretionary balance, while in the latter period they accounted for 3.6% out of 4.4%. This suggests that instead of utilising the fiscal space created in recent years to reduce poverty, GRZ has wasted most of it on programmes of little benefit to the poor.

Growth as % of GDP:

	2005–2010	2005–2011
Discretionary balance	2.5%	4.4%
<i>of which:</i>		
FISP	0.3%	0.5%
FRA	1.4%	1.6%
Road paving	0.5%	1.5%
Sub-total	2.2%	3.6%

CONCLUSION

The Zambian macro economy has been transformed since the turn of the century. Following decades as a macro-economic “pariah state”, Zambia has become a model of fiscal management.

The fiscal transformation is largely explained by three distinct developments: (1) mining revenues have begun to make a significant contribution, (2) economic growth has reduced the pain” required to bring down the debt-to-GDP and deficit-to-GDP ratios, and (3) reduced domestic borrowing, assisted by debt relief, has led to a reduction in interest by 2.9% of GDP over the period.

The combined effect of these developments was that GRZ’s “discretionary balance” (fiscal space) increased by 4.9% of GDP between 2002 and 2011. With real GDP growing by 75% over the period, this represents a substantial increase in resources.

In a context of sustained growth and macro-economic stability, the creation of substantial fiscal space means that GRZ has an unprecedented opportunity to use public expenditure to make inroads into poverty. Having had negligible fiscal space for decades, GRZ has little experience or expertise in the efficient allocation of public resources. It is perhaps not surprising, therefore, that recently created fiscal space appears so far to have been largely wasted on inefficient agriculture subsidies and uneconomic road paving projects which – while notionally aimed at poverty reduction – are of little benefit to the poor. Having finally mastered macro-economic management, if the rewards are not to be dissipated, GRZ needs to turn its attention to micro-economic policy and expenditure management.

Notes:

For full references and sources refer to the full-length paper: *Creating and wasting fiscal space: Zambian fiscal performance, 2002–2011* by Alan Whitworth