

Are Interest Payments on Debt Derailing Fiscal Consolidation?

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1 About this policy brief

This policy brief provides a review of the performance of the first quarter of the 2018 National Budget. The paper provides context by looking at both the revenue and expenditure trends during the last three years when Government instituted some fiscal adjustment measures to bring the country back to a path of fiscal fitness. In analysing the 2018 Budget, the first quarter preliminary outturns are compared to the approved Budget for 2018, the projected performance for the first quarter as well as the first quarter of 2017. We assess fiscal fitness over the last three years and determine that fiscal consolidation had begun. While fiscal performance was generally high, budget credibility and sustainability were low. In the first quarter of 2018, revenues were higher than planned and most expenditures were within the projected amounts. Nonetheless, interest payments were much higher than expected and are likely to be a major source of spending overruns in 2018.

2 Has fiscal fitness kicked in?

Government's promise to bring back the country's fiscal fitness was first mentioned in the 2016 National Budget Address, with an aspiration of reducing the deficit from 9.4% in 2015 to 3.8% of Gross Domestic Product (GDP) in 2016. Our assessment is that a realistic timeline to assess the fiscal consolidation measures is 2-3 years. Our review of the last three years shows

that generally fiscal consolidation has started manifesting itself in fiscal outcomes. Driven by spending reductions and the slowdown in debt accumulation, the overall fiscal deficit and the primary deficit have declined during the last three years.

However, revenues and grants are a weak link. Overall spending significantly declined from 29.2% of GDP in 2015 to 24.4% of GDP in 2017. Revenues and grants – which were expected to increase considering the rebound in economic growth from 2.9% of GDP in 2015 to 4.1% of GDP in 2017 – have equally declined by 1.3 percentage-points of GDP. Table 1 shows the fiscal performance during the last three years.

Table 1: Fiscal indicators as % of GDP, 2015-2017

| | 2015 | 2016 | 2017 | %-point change 2017/2015 |
|----------------------------------|---------|---------|---------|--------------------------------|
| Total domestic revenue & grants | 18.8% | 18.2% | 17.5% | -1.3% |
| Expenditure (incl. amortisation) | 29.2% | 27.1% | 24.4% | -4.8% |
| Fiscal deficit | 9.4% | 5.7% | 6.0% | -3.4% |
| Primary deficit | 6.6% | 2.3% | 2.0% | -4.6% |
| Public Debt | 47.4% | 56.9% | 59.0% | 11.3% |
| GDP (K million) | 183,381 | 216,098 | 245,686 | |

Source: Ministry of Finance and ZIPAR's own calculations

In order to achieve fiscal consolidation, we measure the fiscal performance of the economy by analyzing the trends in the revenue, expenditure, deficit and financing of the deficit since 2015. Achieving fiscal consolidation is not just about the budget performance or execution; it is also about building budget credibility as well as fiscal and debt sustainability. ZIPAR has produced an experimental **Fiscal Fitness Index** to determine the country's fiscal health using three dimensions, namely: performance (trend analysis), credibility (effectiveness) and sustainability (ability to meet debt obligations).

Fiscal performance is a framework within which fiscal policy is conducted. Analysing the trends helps to determine if fiscal policy objectives, such as reducing the fiscal deficit, are being met. A credible budget is a requirement for effective public financial management. Equally, fiscal and debt sustainability enables Government to meet its short- to long-term debt obligations. The index is, similar to the Human Development Index (HDI), based on relative distance methodology. Like the HDI, we define very high performance as an index higher than 0.800, high performance as an index between 0.700 and 0.799, medium performance as an index between 0.550 and 0.699, and low performance as an index below 0.550.

The Fiscal Fitness Index quantitatively depicts that generally fiscal performance, credibility and sustainability have improved in the last three years, 2015-2017. Zambia's overall

fiscal fitness improved from low performance in 2015 (0.249) and 2016 (0.476) to medium performance in 2017 (0.578).

All **fiscal performance** indicators generally improved during this period from a low to a medium level. Revenue performance which declined in 2016 rebounded in 2017. Further, significant improvements were recorded by reducing spending, resulting in a reduced fiscal balance and deficit financing.

While **budget credibility** has generally improved from low to medium performance, it is only spending and the fiscal deficit performance that improved; the performance of revenue and deficit financing declined. This means that the differences between revenue and deficit financing targets and the actual outturn have widened. Enhancing domestic resource mobilisation will help improve the credibility of deficit financing.

Sustainability still remains low and this is on account of debt sustainability issues. While fiscal sustainability performance has increased from low to medium, due to some reduction in the ratio of recurrent expenditure in general, and the wage bill in particular, to domestic revenues, as well as a reduction in the ratio of capital expenditure to domestic revenue, debt sustainability remains low. This is consistent with the concerns that have been expressed recently about debt sustainability. These findings are shown in Table 2.

Table 2: Experimental Fiscal Fitness Index, 2015-2017

| | | 2015 | 2016 | 2017 | 2017/2015 |
|------------------------------|-------------------|--------------|--------------|--------------|----------------|
| Overall Fiscal Fitness Index | | 0.249 | 0.476 | 0.578 | +0.329 |
| Fiscal performance Index | | 0.144 | 0.418 | 0.640 | +0.496 |
| | Revenue | 0.454 | 0.129 | 0.512 | +0.057 |
| | Spending | 0.000 | 0.237 | 0.377 | +0.377 |
| | Fiscal Balance | 0.000 | 0.557 | 0.717 | +0.717 |
| | Deficit Financing | 0.121 | 0.749 | 0.955 | +0.834 |
| Budget Credibility Index | | 0.319 | 0.584 | 0.623 | +0.303 |
| | Revenue | 0.981 | 0.499 | 0.774 | (0.207) |
| | Spending | 0.000 | 0.923 | 0.646 | +0.646 |
| | Fiscal Balance | 0.000 | 0.501 | 0.870 | +0.870 |
| | Deficit Financing | 0.296 | 0.413 | 0.201 | (0.095) |
| Sustainability Index | | 0.337 | 0.441 | 0.485 | +0.148 |
| | Fiscal | 0.372 | 0.516 | 0.603 | 0.231 |
| | Debt | 0.303 | 0.367 | 0.368 | 0.065 |

This index does not take into account the revised 2017 fiscal figures.

3 Overview of the 2018 Budget

The 2018 Budget attempts to balance between meeting development aspirations as espoused in the Seventh National Development Plan (7NDP) and ensuring short- to medium-term health of public finances. However, the fiscal adjustments in 2018 are mixed. While Government proposes to increase domestic revenue and grants from 17.5% of GDP in 2017 to 18.6% of GDP in 2018, expenditures are expected to edge upwards from the realised 24.4% of GDP in 2017 to 25.9% of GDP in 2018. Growth in revenues is expected to be driven by increases in income tax and non-tax revenues which underperformed in 2017. Spending pressure is likely to come from an increase in the wage bill and capital spending.

Table 3: Budget Outturn for 2015-2017 and the 2018 Approved Budget

| | Outturn | | | Approved |
|----------------------------------|----------------|----------------|----------------|----------------|
| | 2015 | 2016 | 2017 | 2018 |
| Total domestic revenue & grants | 18.8% | 18.2% | 17.5% | 18.6% |
| Domestic Revenue | 18.6% | 18.0% | 17.3% | 17.7% |
| Total tax revenues | 14.4% | 13.0% | 14.9% | 14.8% |
| Income tax | 7.0% | 6.9% | 6.7% | 7.4% |
| VAT | 4.6% | 3.7% | 5.7% | 4.5% |
| Non-tax revenues | 4.2% | 5.0% | 2.5% | 3.0% |
| Mineral royalties | 2.0% | 1.4% | 1.0% | 1.3% |
| Grants | 0.2% | 0.2% | 0.2% | 0.9% |
| Expenditure (incl. amortisation) | 29.2% | 27.1% | 24.4% | 25.9% |
| Expenditure | 28.2% | 24.0% | 23.5% | 24.7% |
| EXPENSES | 20.8% | 20.1% | 19.2% | 19.0% |
| Personal Emoluments | 8.8% | 8.7% | 8.1% | 8.4% |
| Use of Goods and Services | 2.8% | 2.2% | 2.0% | 2.7% |
| Interest Payments | 2.8% | 3.4% | 4.0% | 3.9% |
| Domestic debt | 1.8% | 1.9% | 2.1% | 2.4% |
| External debt | 1.1% | 1.6% | 1.9% | 1.5% |
| Grants and Other Payments | 4.9% | 5.0% | 3.7% | 2.9% |
| Social Benefits | 0.5% | 0.2% | 0.8% | 0.6% |
| Other Expenses | 1.0% | 0.4% | 0.4% | 0.4% |
| ASSETS | 7.2% | 3.9% | 3.6% | 5.3% |
| Non-Financial Assets | 7.0% | 3.8% | 3.5% | 5.1% |
| Financial Assets | 0.2% | 0.1% | 0.1% | 0.2% |
| LIABILITIES | 0.2% | 0.1% | 0.8% | 0.5% |
| FISCAL DEFICIT | 9.4% | 5.7% | 6.0% | 6.1% |
| Primary deficit | 6.6% | 2.3% | 2.0% | 2.2% |
| Public Debt | 47.4% | 56.9% | 59% | |
| GDP | 183,381 | 216,098 | 245,686 | 276,689 |

Source: Ministry of Finance

4 First Quarter Preliminary Outturn

4.1 Revenues in Q1 2018 were higher than planned

Revenues and grants in the first quarter were on target at 23% of the 2018 approved budget. As shown in Table 4, revenues and grants amounted to K12.0 billion, which is 29% higher than the collections in Q1 2017. Taxes were 9% higher than planned, due to better collections in Value Added Tax (VAT) and Mining Company Income Tax (CIT). This is largely on account of increased compliance in VAT owing to measures to withhold the tax at source by appointed agents, as well as the favourable copper prices. However, non-tax revenues were 18% lower than projected.

Table 4: Highlights of revenue budget performance and credibility

| K million | PERFORMANCE | | | | | CREDIBILITY | | |
|---------------------------------|----------------------|----------------|----------------|--------------------------|------------------------|-------------------|----------------|-------------|
| | Approved Budget 2018 | Actual Q1 2017 | Actual Q1 2018 | % change Q1 2018/Q1 2017 | % of total 2018 Budget | Projected Q1 2018 | Actual Q1 2018 | % Share |
| Total domestic revenue & grants | 51,525 | 9,270 | 12,004 | 29% | 23% | 12,041 | 12,004 | 100% |
| Domestic Revenue | 49,087 | 9,131 | 11,425 | 25% | 23% | 11,432 | 11,425 | 100% |
| Total tax revenues | 40,874 | 7,548 | 10,213 | 35% | 25% | 9,403 | 10,213 | 109% |
| VAT | 12,369 | 2,309 | 4,312 | 87% | 35% | 2,708 | 4,312 | 159% |
| Non-tax revenues | 8,213 | 1,538 | 1,668 | 5% | 20% | 2,028 | 1,668 | 82% |
| Mineral Royalties | 3,528 | 771 | 884 | 15% | 25% | 901 | 884 | 98% |
| Grants | 2,438 | 139 | 123 | -12% | 5% | 610 | 123 | 20% |

Source: Ministry of Finance and ZIPAR's own calculations

4.2 Overall expenditure is well within the projected levels

Expenditure (including amortisation), at K16.4 billion, was lower than the quarter's target of K17.1 billion, which was only 4% higher than the spending in Q1 2017. This is mainly due to reduced spending on everything but interest payments. Personal emoluments were lower than projected, well within the projected annual rate of inflation of 6-8%. The restricting of recruitments to frontline staff (mostly teachers and nurses), coupled with a payroll clean-up exercise has resulted in keeping the wage bill in check. The wage bill reduced from 54% of domestic revenues in Q1 2017 to 46% of domestic revenues in Q1 2018. Capital spending was 29% lower than projected. These and other findings are shown in Table 5.

Table 5: Expenditure execution, credibility and sustainability

| | PERFORMANCE | | | | | CREDIBILITY | | | SUSTAINABILITY | |
|---|----------------------|----------------|----------------|---------------------------|-------------------|-------------------|----------------|----------|----------------|------------------------|
| | Approved Budget 2018 | Actual Q1 2017 | Actual Q1 2018 | % change Q1 2018/ Q1 2017 | % of total budget | Projected Q1 2018 | Actual Q1 2018 | % Change | Actual Q1 2018 | % of domestic revenues |
| Expenditure (incl. amortisation) | 71,662 | 15,689 | 16,377 | 4% | 23% | 17,140 | 16,377 | 96% | 16,377 | 143% |
| Expenditure | 68,445 | 15,092 | 15,490 | 3% | 23% | 16,377 | 15,490 | 95% | 15,490 | 136% |
| CURRENT EXPENDITURE | 52,452 | 11,906 | 12,991 | 9% | 25% | 12,703 | 12,991 | 102% | 12,991 | 114% |
| Personal Emoluments | 23,104 | 4,944 | 5,235 | 6% | 23% | 5,686 | 5,235 | 92% | 5,235 | 46% |
| Use of Goods and Services | 7,340 | 1,332 | 1,163 | -13% | 16% | 1,410 | 1,163 | 82% | 1,163 | 10% |
| Interest Payments | 10,923 | 2,382 | 4,079 | 71% | 37% | 3,036 | 4,079 | 134% | 4,079 | 36% |
| Domestic debt | 6,764 | 1,385 | 2,282 | 65% | 34% | 1,792 | 2,282 | 127% | 2,282 | 20% |
| External debt | 4,159 | 997 | 1,798 | 80% | 43% | 1,245 | 1,798 | 144% | 1,798 | 16% |
| Grants and Other Payments | 8,073 | 2,482 | 2,093 | -16% | 26% | 2,070 | 2,093 | 101% | 2,093 | 18% |
| Social Benefits | 1,782 | 385 | 292 | -24% | 16% | 445 | 292 | 65% | 292 | 3% |
| Other Expenses | 1,230 | 150 | 129 | -14% | 11% | 55 | 129 | 235% | 129 | 1% |
| CAPITAL EXPENDITURE | 14,663 | 3,025 | 2,470 | -18% | 17% | 3,428 | 2,470 | 72% | 2,470 | 22% |
| LIABILITIES | 1,330 | 393 | 30 | -92% | 2% | 246 | 30 | 12% | 30 | 0% |
| Primary Balance | (5,996) | (3,439) | (593) | -117% | 10% | (1,300) | (593) | 46% | (593) | -5% |
| Overall Balance (cash) | (16,919) | (5,822) | (3,486) | -40% | 21% | (4,336) | (3,486) | 80% | (3,486) | -31% |

Source: Ministry of Finance and ZIPAR's own calculations

4.3 Threats to fiscal consolidation

As revealed by the Fiscal Fitness Index, debt sustainability performance, at 0.368 in 2017, is low, and therefore requires the most attention. The indicators used for gauging debt sustainability are the following:

- Public debt as a % of GDP
- Interest payments as a % of domestic revenues
- The debt spread, which is the difference between the growth rate of GDP and the growth in the stock of public debt; and
- The rate spread, which is the difference between the growth in the rate of GDP growth and the average cost of borrowing¹

The issue of Zambia's public debt stock has recently come under a lot of scrutiny. By the end of 2017, public debt was estimated at 59% of GDP. This has prompted Government to institute a number of measures to curtail the growth of interest payments and ensure fiscal and debt sustainability. These are the boldest measures yet and Government needs to be commended. However, **recurrent expenditure continues to outpace domestic revenue**. Zambia's recurrent expenditures in Q1 2018 amounted to K13.0 billion, which was 14% higher than the K12.0 billion domestic revenues collected. This means that at the very least, 14% of recurrent expenditure has to be financed from borrowed resources as the recurrent spending could not be completely covered from domestic revenues. This is borrowing for consumption and is not fiscally sustainable.

¹ Average cost of borrowing = Interest Payments (t) / Average (Debt Stock (t), Debt Stock (t-1))

Within recurrent spending interest payments continue to be the fastest-growing element of the Budget. The increased portion of interest payments is diverting critical resources from frontline services such as health and education. Considering that 36% of this budget line in the approved 2018 Budget was spent in the first three months, interest payments are likely to be a major source of spending overruns in 2018 as was the case in 2017. For every K1 of domestic revenues collected in Q1 2018, 36 ngwee was allocated to interest payments during the first quarter.

Compared to Q1 2017, interest payments have increased by 71.2%, while the wage bill grew by 5.9%. However, spending on goods and services, grants and subsidies, social benefits and capital expenditure declined. It is expected that the 'savings' from subsidies removal would have gone towards growth-enhancing investments and increased social spending. However, that was not the case as funds were clearly diverted towards interest payments. These findings are shown in Figures 1(a) and (b).

Figure 1(a): Interest payments 'eating up' domestic revenues

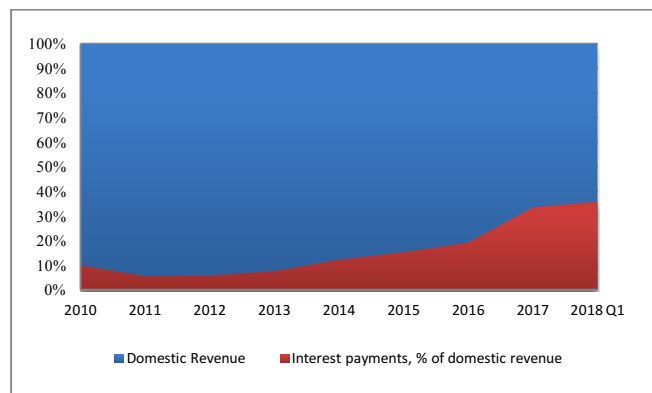
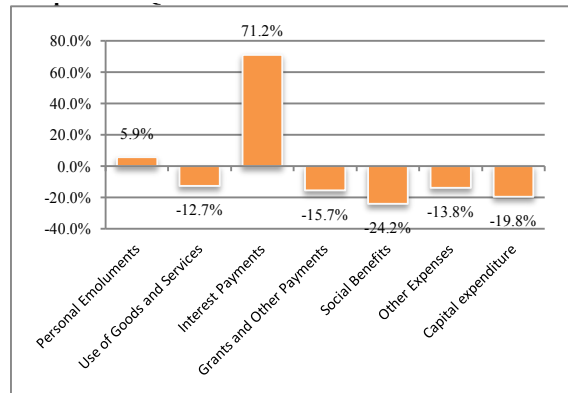


Figure 1(b): Interest payments had highest increased compared to Q1 2017



Interest payments are crowding out other critical spending. Higher than planned costs on interest payments have forced Government to cut spending from other critical budget lines or borrow more to make up the shortfall. While 36 ngwee in every Kwacha is used for debt interest payments, only 21 ngwee is used for infrastructure projects and 3 ngwee utilised on social benefits such as the pensions fund and the Social Cash Transfer.

The average cost of borrowing has surpassed economic growth and capital spending. Interest payments had historically constituted an insignificant part of the fiscal story, at least between 2010 and 2013. They grew at a pace lower than the real GDP growth rate and far below capital expenditures; moreover they were at an average of 1.1% of GDP before 2013. However, from 2013, the average cost of borrowing surpassed the economic growth rate. This reveals a high sustainability risk as economic growth rates that are below the average cost of borrowing show that the country is not generating enough resources to sustainably cover interest payments.

Additionally when interest payments as a percentage of GDP are compared to capital expenditure, interest payments surpassed investment into capital goods for the first time in 2017. Capital goods are the basis on which a country increases its production thus when more resources are directed towards paying out debt, returns to growth may not be achieved.

Interest payments constitute the largest part of the fiscal deficit. The composition of the fiscal deficit portrays worrying trends. As at 2015, interest payments had averaged 1.5% of GDP but in 2016 and 2017 interest payments constituted the largest part of the

fiscal deficit. For example, in 2017, had interest payments not taken up 5.8 % of GDP, the deficit would have been around 2% of GDP.

Figure 2(a): Costs supersede economic growth

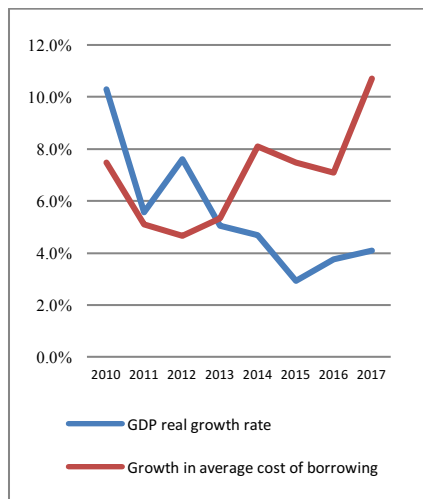


Figure 2(b): Interest higher than capital spending

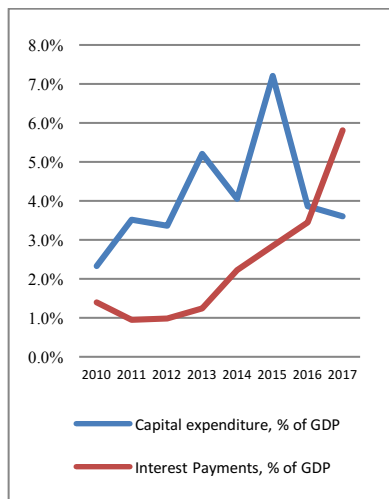
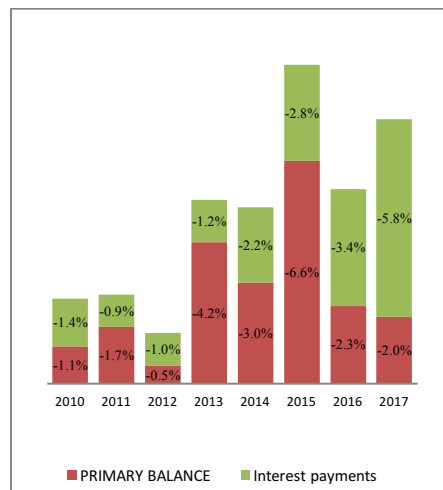


Figure 2(c): Interest costs take up most of the deficit



It is clear from the foregoing that interest payments are Government’s Achilles heel and a major source of spending overruns in 2018. Though Government has instituted a number of measures to curtail the growth of interest payments and ensure fiscal and debt sustainability, and we highly commend them for that, more needs to be done.

5 Recommendations

There is need to eliminate possible recording and reconciliation issues on interest payments. The discrepancy between the projected spending on interest payments and the outturn is too large and brings the credibility of these numbers into question. A nominal discrepancy based on the fluctuation of the exchange rate is acceptable. But the exchange rate has generally been stable. There is need to review the recording and reconciliation of interest payments on debt between Budget Office and Investment and Debt Management departments.

There is need to reduce/freeze external, non-concessional borrowing. Aside from possible recording issues, with 43% of the budget on interest payments on external debt spent in Q1 2018 alone, it is clear that there is need to reduce or freeze, non-concessional external borrowing. This is not only a major source of spending overruns, but it goes against the 2017-2019 Medium Term Debt Strategy which prioritises a higher share of domestic debt in the total debt portfolio and aims to increase longer-dated government securities. It also aims to maximise concessional and semi-concessional debt.

There is need to widen creditor sources. The financing shortfall created by reduced external borrowing could be filled up by widening domestic sources to reduce the appetite for non-concessional external borrowing. With the appetite for Treasury bills finally subsiding, suggesting that domestic lending markets are still too shallow to support the ambitions of the debt strategy and continued private lending, Government should develop a bond market for small investors. The government securities market is understandably

dominated by commercial banks and a few pension houses such as NAPSA. For the debt market footprint to expand, Government should put in place the necessary institutions and infrastructure to open up the market to other financial investors and the wider populace. Retail (individuals) and corporate bond participation in the debt market is almost non-existent at the moment. Encouraging participation of retail investors, primarily through mutual funds that pool money from many investors to purchase securities and/or selling securities in accessible environments such as over the Post Office counters would be a good start. There is need to set up a dedicated team of experts within the relevant institutions to facilitate development of the retail bond markets and follow up on relevant implementation initiatives.

There is need to rethink the announced project prioritisation plans. Government's recent measures include the finishing of only those projects with at least 80% completion rate. This will result in a massive slowdown of the infrastructure development programmes. There is need to evaluate the incomplete projects and ensure that the projects with the highest economic returns are completed, as opposed to just prioritizing those with a completion rate of at least 80%. This will ensure that projects that are able to pay back are prioritised.

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