

# ZAMBIA ECONOMIC BRIEF

## RAISING REVENUE FOR ECONOMIC RECOVERY

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**8<sup>th</sup> ZAMBIA ECONOMIC BRIEF**

**RAISING REVENUE  
FOR ECONOMIC RECOVERY**



December 2016

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# IACRONYMS

BoZ	Bank of Zambia
CIT	Corporate Income Tax
CSO	Central Statistical Office
DfID	Department for International Development
EFD	Electronic Fiscal Devices
FDI	Foreign Direct Investment
FSIP	Farmers Input Support Program
GDP	Gross Domestic Product
IFF	Illicit Financial Flows
IMF	International Monetary Fund
LCMS	Living Conditions Monitoring Survey
METR	Marginal Effective Tax Rates
MInGov	Mining Investment and Governance Review
MOSES	Mineral Output Statistical Evaluation System
MVCMP	Mineral Value Chain Monitoring Project
MW	Mega Watts
PAYE	Pay As You Earn
PPP	Purchasing Power Parity
SACU	Southern African Customs Union
SSA	Sub-Saharan Africa
TADAT	Tax Administration Diagnostic Assessment Tool
US\$	United States Dollar
VAT	Value Added Tax
WBG	World Bank Group
ZDA	Zambia Development Agency
ZEITI	Zambia Extractives Industries Transparency Initiative
ZIPAR	Zambia Institute for Policy and Research
ZMW	Zambian Kwacha
ZTP	Zambia Tax Platform

# FOREWORD

I am pleased to share the eighth Zambia Economic Brief with a focus section on raising revenue for economic recovery. This Brief is part of a series of short economic updates produced twice a year by the World Bank.

Each Brief includes two sections: the World Bank's assessment of recent economic developments and the outlook in the short to medium term, and its analysis of a specific development topic or theme. Previous Briefs covered opportunities for improving public expenditure, the power sector, mining, jobs, trade, and financial inclusion and can be found on the World Bank's Zambia website.

Zambia has continued to face tough economic conditions in 2016. Copper prices have improved this year, but they remain low when compared to their peak. Also, domestic challenges including power outages, tight liquidity, and limited appetite for economic reform during the first half of 2016 have put downward pressure on growth. Implementation of the 2016 budget has led to a substantial build-up of spending arrears that need to be addressed with a well-thought-out strategy.

We also see that the past decade of growth was not sufficiently pro-poor and the benefits have accrued

mainly to the richer segments of the population in urban areas. Poverty remains far higher for the rural population than their urban counterparts, and income growth between 2006 and 2015 was greatest among those with higher incomes and relatively weak for those with lower incomes.

There remains a need to look closely at ways to improve revenue collection so that economic recovery will be expedited, growth itself can be made more inclusive to support households' escape from poverty, and to ensure that prosperity is better shared in Zambia.

We hope that the findings of this Economic Brief will stimulate a healthy debate around these questions so that Zambia can beat the recent slowdown and shift to a path of more inclusive growth.



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Country Manager for Zambia  
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# EXECUTIVE SUMMARY

## **Regional economic developments**

Economic activity in the Sub-Saharan Africa (SSA) region continues to be subdued in 2016, with GDP expansion expected to stall to its slowest pace in over two decades. The region continues to confront tough global conditions; notably low global growth, weak global trade, and low commodity prices. Economic performances remained divergent across countries, with slowdown concentrated in the largest commodity exporters. For countries that have stronger fiscal and monetary policies, a better regulatory environment, a more diverse structure of exports, and more effective public institutions, growth remained resilient.

## **The state of the Zambian economy**

Zambia continued to face slower growth in 2016. Tough global conditions have combined with domestic challenges including power outages, tight liquidity, and limited appetite for economic reform during the first half of 2016. Implementation of the 2016 budget has been characterized by weak commitment control and deteriorating budget credibility. As revenues fell below target, Government did not make the necessary expenditure adjustments, resulting in a substantial build-up of arrears. Monetary policy has helped moderate inflation and supported exchange rate stability, but at the price of an increased cost of borrowing, a low availability of credit, and a drawdown in reserves, all of which have added an extra drag on growth. The 2017 national budget and Economic Recovery Program provide a good framework to support a return to faster and more inclusive growth.

## **Zambia's economic outlook**

Given the tough global conditions for growth and domestic challenges, GDP growth is forecast to remain close to 3.0% in 2016, before improving in 2017 (4.0%) and 2018 (4.2%). The 2017 forecast assumes progress with the economic recovery plan, a better electricity situation than in 2015/2016 and improved copper exports. For the medium term, it assumes even higher copper production, that copper prices will recover marginally, and that progress

is made with structural reforms identified in the 2017 budget.

## **Economic policy challenges**

To shift to faster and inclusive growth, efforts are needed to overcome a set of interlinked economic policy challenges – if progress is made on only some of them, and not on others, the desired outcomes will not be achieved. The sequencing and co-ordination of measures are key in 2017 and over the course of a medium-term economic recovery plan.

There remains a need for fiscal and monetary policy to work in tandem for faster growth. What remains critical is that any reduction in the fiscal deficit is planned and managed carefully. A disorderly and incomplete adjustment will not restore market confidence. A too severe or too quick adjustment will undermine growth.

Responses to the immediate policy challenges can be grouped as either fiscal measures or structural measures.

Fiscal measures include:

- i. the need to urgently set and publish medium-term fiscal targets;
- ii. the development of an arrears clearance strategy;
- iii. efforts to improve debt management; and
- v. enhanced revenue mobilization (the focus of Section II of this report).

Structural measures include the need to fast-track electricity sector reforms and ensure policies designed to boost the non-copper economy get implemented. The forthcoming National Development Plan should cement the reform direction, especially in agriculture – a leading non-copper sector. However, efforts are needed to remove constraints to the necessary structural reforms. For example, many legislative changes are required, but there is a bottle-neck in getting new laws passed.



## **Part II: Raising Revenue**

### **Revenue performance**

Both public spending and revenues have grown considerably since 2010, but in recent years the pace of expenditure has exceeded that of revenue. If current levels of government expenditure are to be maintained in a sustainable manner, then higher domestic revenue collections are essential. After ten years of rapid growth, Zambia has emerged from being a country with a high aid dependency to one where in 2015, grants provided just 1.4% of revenue compared to 98.6% from domestic revenues.

### **Mining revenue**

The absence of good data on mining companies has helped support a common perception that not much revenue is being collected from them in Zambia. The reality is that the mining sector (which includes quarrying and cement production) contributed ZMW 8.8 billion in 2014, equivalent to 28% of total domestic revenue, up from ZMW 7.7 billion in 2013 and ZMW 7.6 billion in 2012. There remains a pressing need for an improved flow of information and transparency to ensure the contribution of the sector is better understood. Efforts are also needed to improve the monitoring of the country's mineral value chain from exploration to export, and to ensure that at the given rates, Zambia collects the revenues it is due.

### **Planned revenue reforms and challenges**

There have been many revenue-related reforms over the past few years, and some are still ongoing or planned for the future. The reforms are aimed not only at increasing revenue collection, but also ensuring that collection is efficient and free from corruption. A recent assessment cites compliance as one of the weakest areas in Zambia's tax administration system. Key efforts to tackle this problem

include the TaxOnline system, more enforcement measures and audits, and the recent introduction of Electronic Fiscal Devices to link retailers directly with the Zambia Revenue Authority (ZRA).

### **Ideas to improve tax policy and revenue administration**

There are two key areas on which Government is working. The first is on improving tax policy, which falls under the responsibility of the Ministry of Finance, and the second is on improving tax administration, which falls under the responsibility of the ZRA.

Three important studies for 2017 to inform tax policy are:

- i. a tax gap study;
- ii. a tax exemptions analysis; and
- iii. a Marginal Effective Tax Rates (METR) study, aimed at understanding whether the revenue gains from a marginal tax increase would outweigh the potential loss of revenue.

Four ideas for improving tax administration are as follows:

- i. develop a strategy to increase tax compliance;
- ii. scaling up taxpayer-focused public education campaigns;
- iii. design and build an effective system for property tax; and
- v. further support efforts to improve monitoring of the country's mineral value chain from exploration to export

# SECTION 1 RECENT ECONOMIC DEVELOPMENTS

## A. REGIONAL ECONOMIC DEVELOPMENTS

Economic activity in the SSA region continues to be subdued in 2016, with GDP expansion expected to stall to its slowest pace in over two decades. The region continues to confront tough global conditions; notably low global growth, weak global trade, and low commodity prices. Economic performances remained divergent across countries, with slowdown concentrated in the largest commodity exporters. For countries that have stronger fiscal and monetary policies, a better regulatory environment, a more diverse structure of exports, and more effective public institutions, growth remained resilient.

*Economic activity in Sub-Saharan Africa has stalled significantly, with GDP growth projected to decline to 1.6% in 2016.*

The World Bank's *Africa's Pulse* highlights the continued fragility of the global economic environment facing SSA<sup>1</sup>. Global GDP growth is projected to decline to 2.3% in 2016 from 2.6% in 2015 on the back of weak global trade, poor productivity performance and raising policy uncertainty. As a result, economic activity in SSA has stalled significantly, with GDP growth projected to decline to 1.6% in 2016, from 3.0% percent in 2015; the slowest growth rate of the region in over two decades.

Weak global growth affects SSA through three channels; notably low commodity prices, reduced trade, and rising costs of borrowing. This has been the case since 2015, and the region's commodity-exporting countries and countries that depend on external borrowing and capital flows have been hit hardest. The situation has been exacerbated by domestic headwinds from policy uncertainty, droughts, weak policy buffers, and political and security concerns which continued to weigh on activity across the region. The slowdown in growth implies that GDP per capita will contract by 0.7% in 2016, further complicating the challenge of accelerating poverty reduction in the region.

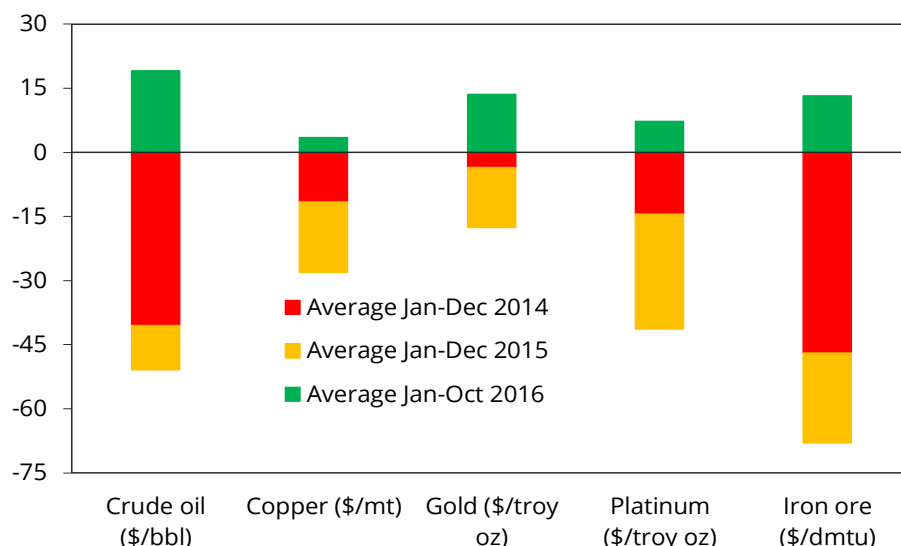
*Commodity prices have experienced some recovery but remain well below their previous peak.*

In the first nine months of 2016, commodity prices have recovered some ground although they remain far below their recent peak (figure 1). Oil prices rose by 36.9% in Q2 2016 relative to Q1 on the back of supply disruptions, and then a further 2.6% between July and October 2016. Meanwhile, copper prices rose by 1.3% in Q2 2016 and a further 0.9% between July and October 2016. However, they climbed 14% to US\$5,549 per ton in the first three weeks of November 2016, buoyed by speculation about increased infrastructure spending in the USA, improved manufacturing production numbers from China, and speculative buying. Non-energy commodity prices rose 7% in Q2, led by agriculture. Despite recent improvements, the average prices of all commodities in 2016 remain below those for the corresponding period in 2015, except for gold.

*Nigeria and South Africa, the region's two largest economies, have been the key drivers of the growth slowdown.*

**Figure 1** Commodity prices remain well below their 2011 peak

1 Cumulative % Change to Index, 2010 = 100



Source: World Bank Commodity Markets Data

*Countries that remained resilient to a weak global growth environment have stronger fiscal and monetary policies.*

Regional aggregates disguise divergent economic and growth performance across African countries. Nigeria and South Africa, the region's two largest economies, which jointly account for 50% of its GDP, have been the key drivers of the growth slowdown. Nigeria, the region's largest oil exporter, fell into recession in the first half of 2016. GDP contracted by 0.4% (year-on-year) in Q1 2016, followed by a further contraction of 2.1% in Q2 2016. Furthermore, the composite Purchasing Managers Index (PMI) fell to a record low of 46.3 in August 2016, remaining below the 50-mark and suggesting that the contraction will continue through the second half of 2016. In South Africa, a declining mining sector and poor rains led to a GDP contraction of 0.1% in Q1 2016, although growth since then has picked up following improved performance in manufacturing and financial services.

Elsewhere, growth continued to stall in oil-exporting countries (e.g. Angola, Chad, Gabon, and Equatorial Guinea). Non-energy mineral exporting economies, including Botswana, the Democratic Republic of Congo, Guinea, Liberia, Sierra Leone, and Zambia have also continued to struggle, despite benefiting from lower oil prices. In some countries domestic challenges amplified the impact of external headwinds. For example, El Niño-related poor rainfall in the 2014-15 and 2015-16 seasons curtailed agricultural production and hydroelectricity generation across the Southern African region.

Despite a slowdown of the regional economy, some countries continued to experience robust GDP growth. These include Cote d'Ivoire, Ethiopia, Rwanda, Uganda, Tanzania, and Senegal. According to the World Bank's *Africa's Pulse* (October 2016), most countries that remained resilient to a weak global growth environment have stronger fiscal and monetary policies, a better regulatory environment, a more diverse structure of exports, and more effective public institutions.

Recent improvements in commodity prices have not been large enough for commodity exporters to rebuild their eroded policy buffers. Consequently, internal and external imbalances are expected to remain elevated in most commodity-exporting economies. Furthermore, capital inflows into the region have stalled, indicating tightening external financing conditions. This has put pressure on the balance of payments. With tight financing conditions, increased external strains have been met, in part, by reserve draw-downs to support currencies. This has substantially weakened the reserve positions across commodity-exporting economies.

In 2016, currencies in the region have continued to perform differently. The currencies of Angola, Mozambique, and Nigeria weakened substantially, while South Africa and Zambia have strengthened. Exchange rate pass-through to prices is high in the SSA region.<sup>2</sup> Consequently, inflation has increased in countries where currencies weakened,

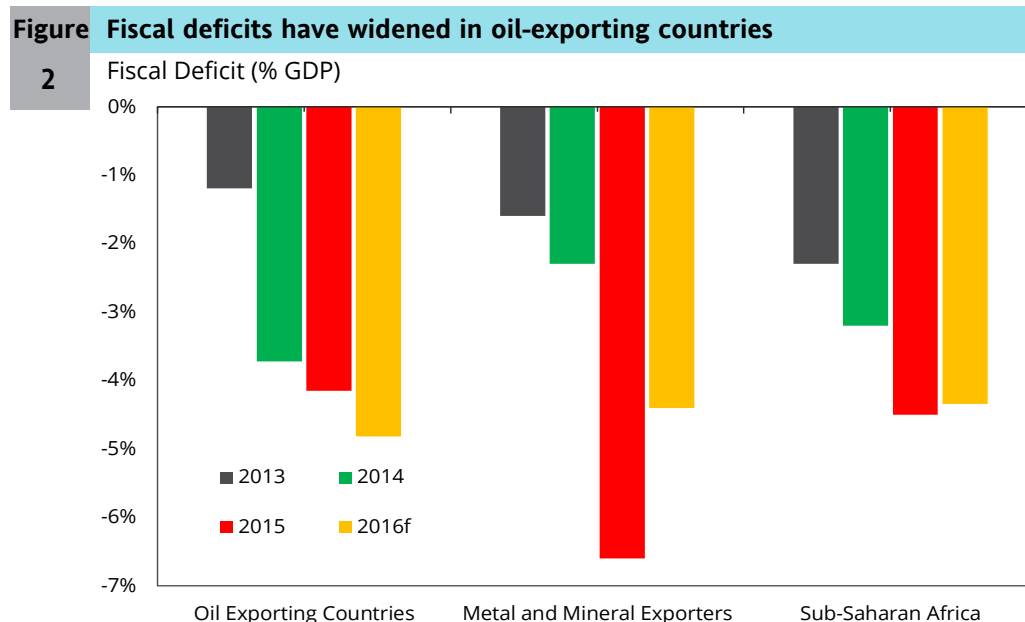
and declined in countries where currencies appreciated or remained stable (including Ghana, Kenya, South Africa, Uganda, and Zambia).

*Compounding the external pressures, fiscal positions continued to be weak across the region.*

Compounding the external pressures, fiscal positions continued to be weak across the region. This is particularly so in oil exporters where the fiscal deficit is expected to widen to 4.8% of GDP in 2016 from 4.2% in 2015 on the back of declining revenues (figure 2). In Nigeria, the fiscal deficit is projected to widen by more than a third from the 2.8% of GDP recorded in 2015. In Angola, Chad, and Equatorial Guinea, fiscal consolidation reforms began in 2015, but were abandoned in 2016 leading to further fiscal slippage. In Cameroon, Chad, and South Sudan, no adjustments were made and public expenditure continued to rise despite falling revenues.

The fiscal deficit is expected to narrow to 4.4% of GDP in 2016 from 6.6% in 2015 in metal and mineral exporters (figure 2). This is because some countries undertook fiscal and structural reforms to cut expenditure and increase revenue. These include Benin, Botswana, Guinea, Namibia, Niger, Senegal, and South Africa. By contrast, in several commodity importers whose GDP growth remained strong, fiscal policies have not been sufficiently countercyclical, and as such, fiscal deficits have either remained high (Kenya, Zambia, and Togo) or widened (Ethiopia, Mali, Rwanda, and Uganda).

*The fiscal deficit is expected to narrow for metal and mineral exporters, because some countries undertook fiscal and structural reforms.*



Source: World Bank (2016): Africa's Pulse (October 2016)

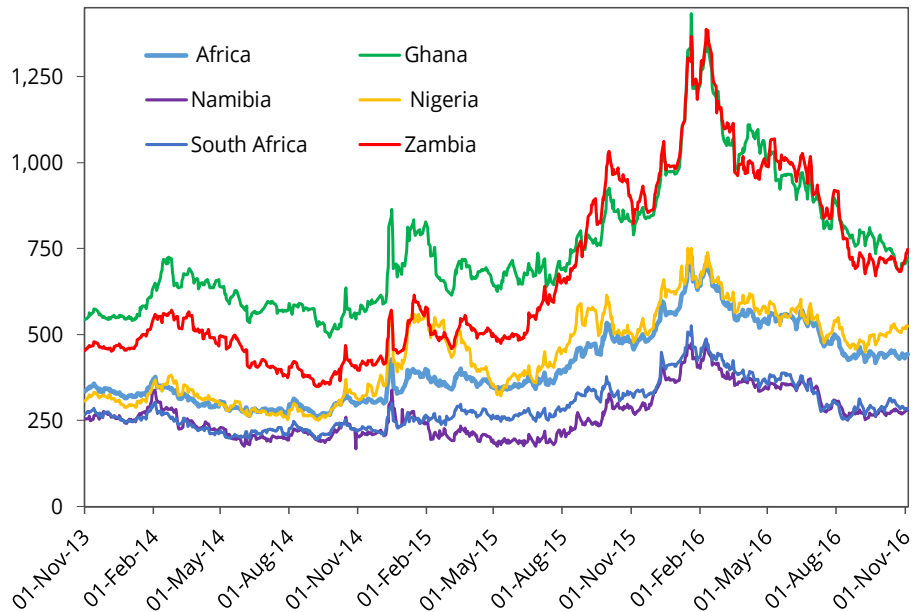
Large fiscal deficits, non-concessional borrowing, and weakened currencies have contributed to the rising debt levels, while debt ratios in 2015 were well above the levels in 2011–13. In 2016, debt ratios either remained elevated or further increased across many countries in the region, which has eroded fiscal space.

*In 2016, debt ratios either remained elevated or further increased across many countries.*

Market access has dropped significantly across the region in 2016. As of end-November 2016, only Ghana, Mozambique, and South Africa had tapped international debt markets. Low Eurobond issuance was, in part, due to the increased cost of borrowing for many sovereigns between July 2015 and January 2016, as a result of uncertainty about government policies and a slowdown in the economies. However, sovereign spreads have declined (especially in Ghana and Zambia) since February 2016 (figure 3). The decline is on account of improved conditions in global financial markets since March 2016 and better prospects for domestic reform.

**Figure 3** Zambia's Eurobond spreads have improved in 2016<sup>3</sup>

Daily Sovereign Spreads



Source: Bloomberg

Market access has dropped significantly across the region in 2016.

### Outlook for Sub-Saharan Africa

The outlook for 2016 is expected to remain somber, reflecting the effects of weak global growth, low commodity prices, and tough domestic conditions. The growth projection for 2016 has been halved to 1.6% from 3.2% since the March 2016 issue of the World Bank's *Africa's Pulse* (figure 4). Beyond 2016, GDP expansion is expected to improve in 2017 (2.9%) and 2018 (3.6%). Growth rates will continue to be divergent across the region.

After contracting in 2016, Nigeria's economy is expected to improve moderately in 2017 and 2018 on account of fiscal expansion, increased oil production, and improved Foreign Direct Investment (FDI) inflow following a shift to a flexible exchange rate regime. South Africa is expected to encounter a sluggish medium-term recovery due to policy uncertainty, structural issues, and an unstable power supply.

Beyond these two of Africa's biggest economies, recovery is expected to be slow in oil-exporting economies due to low oil prices and declining oil production resulting from maturing oil fields. For oil importers such as Kenya, Rwanda, Senegal, and Tanzania, growth is expected to remain robust, supported by public investment. Sources of financing for these public investments have varied from public-private partnerships (Rwanda) to donor aid (Rwanda and Tanzania) and Chinese entities (Ethiopia). Political uncertainty in the Democratic Republic of Congo, Burundi, Comoros, and Zimbabwe, and political instability in South Sudan, are expected to exert a drag on growth in the medium term.

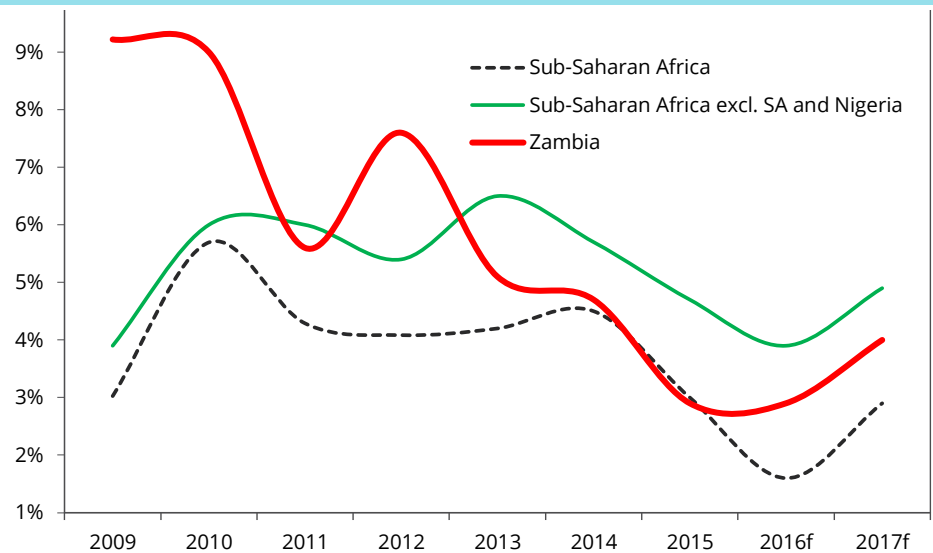
Net exports are expected to make a negative contribution to real GDP growth in the near term. Commodity prices at current levels will keep export receipts depressed, especially among oil exporters, even as export volumes rise in some countries. Moreover, balance of payments, reserves and fiscal revenue of commodity exporters will remain under pressure from low commodity prices.

Reflecting on these challenges, and given the increased cost of external private financing, commodity exporters may need to make further fiscal adjustments, notably cutting inefficient expenditure and undertaking structural reforms to boost non-commodity fiscal revenue. In the event that the recovery of commodity prices is faster than expected, these countries should prioritize on building their eroded policy buffers before any further fiscal expansion.

Beyond 2016, GDP expansion is expected to improve in 2017 (2.9%) and 2018 (3.6%).

**Figure 4 Growth in SSA countries has slowed**

*Balance of payments, reserves and fiscal revenue of commodity exporters will remain under pressure from low commodity prices.*



Source: World Bank (2016): Africa's Pulse (October 2016) and World Bank projections. Note: f= forecast.

The balance of risks to the outlook remains slightly tilted to the downside. The global risks include:

- i. a sharper than expected slowdown in China (as the country rebalances growth to ward consumption and services),
- ii. political uncertainty following Brexit and the results of the USA election, and
- iii. an earlier-than-anticipated tightening cycle in the USA and the Euro Area which could trigger a strong decline in capital flows to emerging and frontier markets of SSA, leading to increased sovereign spreads and the volatility of heavily traded currencies.

On the domestic front, delays in adjustment to external shocks in affected countries would create policy uncertainties that could weigh on investor sentiment and weaken the recovery. For most countries in the region, adjusting to the low commodity prices will need to include stronger efforts to strengthen domestic resource mobilization to reduce the overdependence on revenue from the resource sector.

## B. THE STATE OF THE ZAMBIAN ECONOMY

Zambia continued to face slower growth in 2016. Tough global conditions have combined with domestic challenges including power outages, tight liquidity, and limited appetite for economic reform during the first half of 2016. Implementation of the 2016 budget has been characterized by weak commitment control and deteriorating budget credibility. As revenues fell below target, Government did not make the necessary expenditure adjustments, resulting in a substantial build-up of arrears. Monetary policy has helped moderate inflation and supported exchange rate stability, but at the price of an increased cost of borrowing, low availability of credit, and a drawdown in reserves, all of which have added an extra drag on growth. The 2017 budget and Economic Recovery Program provide a framework to support a return to faster and more inclusive growth.

### *Slower growth has persisted in 2016*

Zambia has faced tough global and domestic conditions for growth since mid-2015. Real GDP grew at a lackluster 2.9% in 2015 (figure 5), well below the average growth of 7.4% experienced between 2004 and 2014. This recent rate of expansion is also just above population growth, meaning that on average, Zambia's per capita income growth has been flat. The tough conditions have continued in 2016 and real GDP growth is expected to remain close to 3.0% (figure 5) as both external headwinds and domestic pressures remain.

*The tough conditions have continued in 2016 and real GDP growth is expected to remain close to 3.0%.*

The external headwinds include slower regional and global growth, and volatility in the US dollar (US\$) and investor appetite for emerging and frontier market investment. The free fall in the copper market has stabilized in 2016, but prices remain far below their 2011 peak. Domestic pressures relate to a lack of liquidity and confidence in the economy, low availability of credit, and high costs of borrowing.

The impact of the power crisis moderated in mid-2016, as emergency power was imported at a high cost and hydroelectric reservoirs recovered after late rains. However, in October 2016, power outages of 8 hours per day returned, reducing the productivity and output of businesses in all sectors. Double digit inflation and the rapid depreciation of the kwacha in 2015 have now been stemmed, but they have left the cost of many domestic and imported goods high and subject to lower demand.

For a deeper understanding of the 2015 and 2016 economic pressures in Zambia see: *'Beating the Slowdown: Reducing Fiscal Vulnerabilities for Economic Recovery'* (September 2016)<sup>4</sup>.

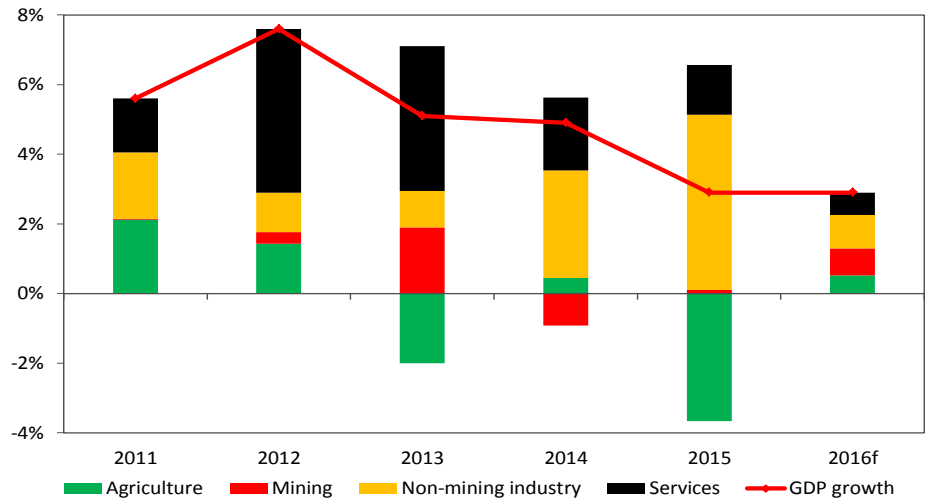
Despite the lower copper prices, copper production picked up slightly during the first three quarters of 2016, due to an easing in electricity supply constraints and scaled-up production at the Sentinel copper mine (opened in August 2015). In this period however, growth in the services and non-mining industries stalled following tough credit conditions imposed by a tight monetary policy and an erratic electricity supply. A slowdown in services and non-mining industries has a significant impact on overall growth because these two industries jointly contribute 80% to GDP.

*Despite the lower copper prices, copper production picked up slightly during the first three quarters of 2016.*

The agriculture sector has contributed positively to growth in 2016, albeit marginally. During the 2015-16 farming season, rains came later than expected but were above average in early 2016, leading to improved production for several crops. Maize production increased by 9.7%, soya beans by 8.7%, sunflowers by 75.9%, and sorghum by 73.7%. Meanwhile, in the fisheries sector, aquaculture production went up by 12.1% due to the adoption of better methods of fish production (e.g. cage commercial fish farming).<sup>5</sup>

**Figure 5 Drivers of growth**

5



Source: Ministry of Finance

*During the 2015-16 farming season, rains came later than expected but were above average in early 2016, leading to improved production of several crops.*

*The construction sector is expected to expand much slower than last year, thereby dragging down the contribution of non-mining industry to growth.*

Much slower growth in non-mining output in 2016 relates to domestic challenges such as power outages, reduced demand, and low availability of credit. Non-mining industry consists of construction, manufacturing, electricity and gas, and water and sewerage management. The construction sector constitutes half of non-mining industry GDP, and in 2015, the sector grew by 18.0% as a result of increased public sector infrastructure investments. However, public infrastructure investments have shrunk by half over the first three quarters of 2016, relative to the corresponding period in 2015. Furthermore, Government has not yet paid many construction contractors for projects completed last year. As a result, the construction sector is expected to grow much more slowly than last year, thereby dragging down the contribution of non-mining industry to economic growth.

Meanwhile, the electricity and gas sector, which contributes almost 10% to non-mining industry output, contracted in 2016. During the first half of 2016, electricity production was just 75% of the level produced in the same period the previous year. This expected contraction is in spite of the launch of new power generation at Maamba Colliers (150 MW output so far from a possible 300MW) and the Itezhi-Tezhi hydro-power plant (capable of generating 120 MW). Reduced electricity production is linked to low hydro-electric generation from the country's main hydro-reservoirs, where 90% of electricity is generated. Lower rainfall in the 2014-15 season exacerbated the situation, but faster water use following the installation of peak turbines at Kariba Dam in 2014 has been a key factor leading to the lower water levels<sup>6</sup>.

*The services sector has struggled in 2016 following increased costs of borrowing, the electricity crisis, and slower consumption growth combined with high inflation.*

To manage the electricity deficit, Government continued 8-hour rolling daily power cuts between July 2015 and May 2016. This was reduced to 4 hours per day following improved water inflows to hydro-power reservoirs and increased electricity imports. However, since October 2016, 8 hours per day load-shedding returned following maintenance work aimed at upgrading transmission lines, issues with the 48 MW generation plant operated by Ndola Energy Company Limited, and reductions in generation from Kafue Gorge and Kariba Dam to prevent the water from falling below critical levels.

The services sector has been an important driver of growth over the past ten years, and the greatest contributor to national income. The sector has struggled in 2016 following increased costs of borrowing, the electricity crisis, and slower consumption growth combined with high inflation. For example, the wholesale and retail trade sector contributes 40% to the services sector's output, but has experienced a decline in sales in 2016. A recent monetary policy update by the Bank of Zambia (BoZ) suggests that consumer spending declined by 6% in Q3 2016 on account of tight credit conditions.<sup>7</sup> Growth of the financial sector has been constrained by a tight monetary policy. Similarly, the transport sector declined following weak economic performance across other sectors of the economy.



**Copper production picked up by 8.3% to 575,014 metric tons in the first three quarters of 2016.**

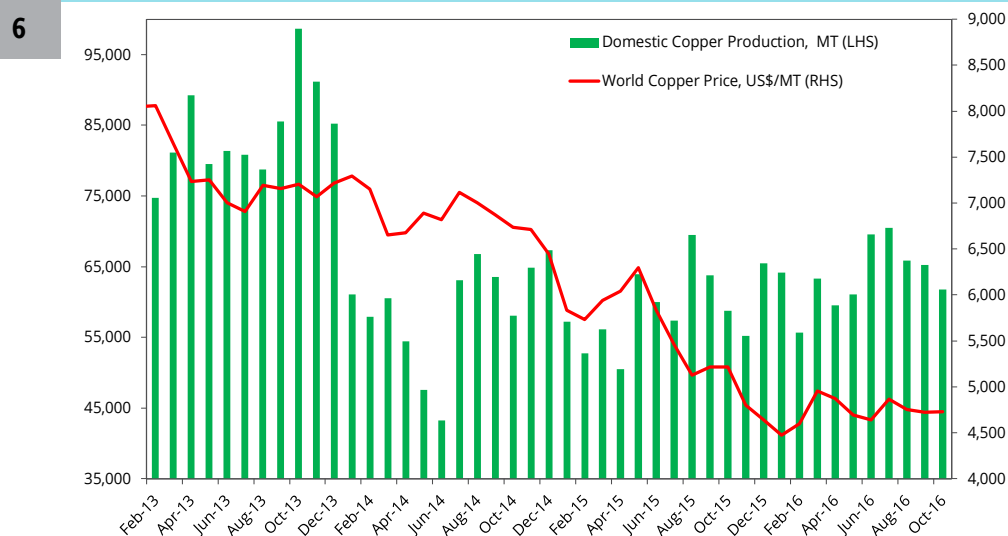
Some sectors of the services industry have continued to grow. This was the case for the information and communication sector, where the number of mobile subscribers and internet users increased by 6.6% and 22%, respectively. Moreover, tourism received a boost from various international conferences held in Zambia, leading to a 4.7% increase in international passenger movements during the first nine months of 2016<sup>8</sup>.

Copper production picked up by 8.3% to 575,014 metric tons (mt) in the first three quarters of 2016, from 531,140 mt in the corresponding period in 2015. This was on the back of improved production at the Kalumbila, Kansanshi, Konkola and Lumwana copper mines<sup>9</sup> (figure 6). However, production declined at the Mopani copper mine following the suspension of activities from 2015 to allow for refurbishment and the completion of expansion projects. The improved performance of the mining sector followed an easing of domestic constraints, particularly electricity. Electricity plays a strategic role in mining, while the sector consumes 54% of power supply in Zambia.

The improved copper production came in spite of copper prices remaining well below their 2011 peak. In January 2016, copper prices were at US\$4,471 per mt, 54.7% lower than their peak in February 2011 (their lowest since April 2009). However, since February 2016, copper prices have recovered to US\$4,726 per mt in October 2016 (figure 6). Copper prices also experienced rapid gains in November 2016 with the rally following speculative buying after the outcome of the US elections and better manufacturing data from China. Despite the 2016 gains however, average copper prices have in 2016 remained below the corresponding period in 2015. Consequently, the US\$ value of copper exports in the first three quarters of 2016 was 10.4% lower than the same period in 2015, despite higher production.

**Between January and end-November 2016, the kwacha has appreciated by 12.3% against the US\$.**

**Figure 6 Copper production has recently held up despite lower prices**



Source: Central Statistical Office and World Bank Pink Sheets

A key recent development has been the publication of a quarterly GDP series that provides insight into past economic sectoral trends and will in future provide an in-year measure of economic performance, if it is calculated and published without too much of a lag (table 1).

*Tight monetary policy measures contributed to the strengthening and stability of the kwacha.*

Table 1	Quarterly Growth Rates									
	2014				2015				2016e	
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1e	
Agriculture, forestry and fishing	1.7	-0.6	-0.2	2.5	-8.5	-7.8	-6.1	-7.7	3.0	
Mining and quarrying	3.5	-10.1	-0.7	-2.4	-4.7	17.1	-2.0	-6.1	7.9	
Manufacturing	9.4	11.6	0.4	5.3	5.2	1.8	8.7	6.2	1.1	
Electricity	4.1	1.4	0.7	1.7	8.8	7.2	-2.9	-18.9	-15.4	
Construction	-6.5	15.3	10.7	22.2	37.4	20.5	3.8	15.4	9.1	
Wholesale and retail trade	0.3	5.6	8.1	-0.1	1.0	-0.6	5.2	0.1	0.4	
Financial and insurance activities	7.2	19.3	14.2	20.0	4.0	7.1	21.2	15.4	5.1	
<b>GDP Growth</b>	<b>2.7</b>	<b>5.3</b>	<b>5.3</b>	<b>5.5</b>	<b>3.9</b>	<b>2.8</b>	<b>4.2</b>	<b>0.9</b>	<b>3.1</b>	

Source: Central Statistical Office

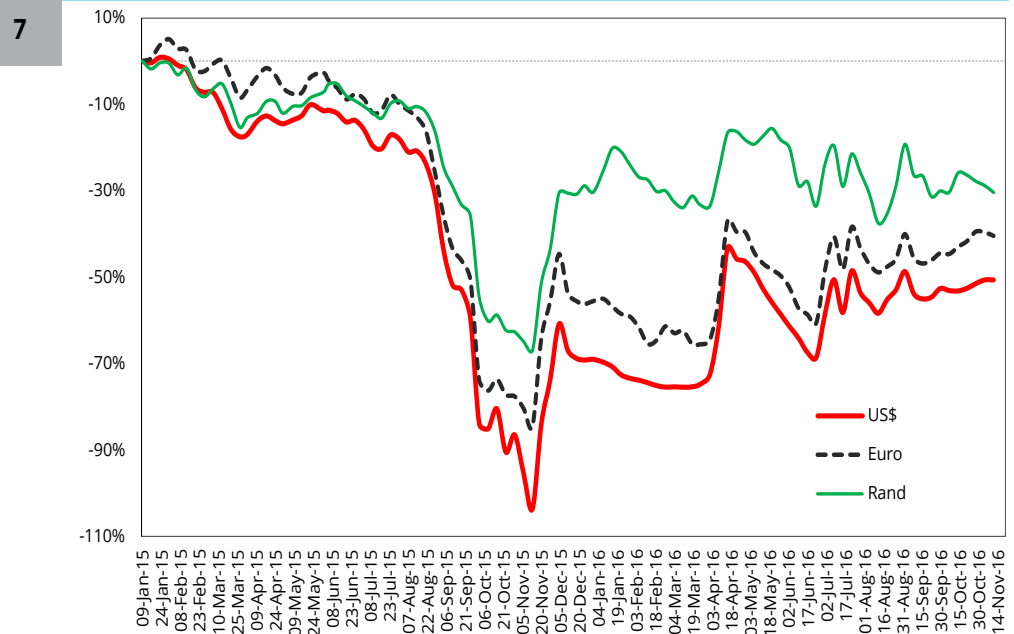
### *The kwacha has stabilized and slightly appreciated in recent months*

The kwacha has continued to fluctuate against its major trading currencies, but was stronger and less volatile in the first nine months of 2016 compared to 2015 (figure 7). Between January and end-November 2016, the kwacha has appreciated by 10.4% against the US\$, 13.2% against the Euro, and 2.1% against the South African Rand.

Four factors have contributed to the strengthening and relative stability of the kwacha. First is tight monetary policy measures introduced by the BoZ in November 2015, which continued to have an impact on the market during 2016. Second is reduced demand for imported goods, resulting in less demand for foreign currency. Foreign currency inflows in the first half of 2016 were US\$397 million, 20.3% less than the level in the same period in 2015<sup>10</sup>. Third is the return of foreign interest in kwacha-denominated bonds at the August 2016 auction. Fourth is a perception that the economy has weathered the toughest part of the shocks and that an IMF-supported economic recovery plan is likely.

*After reaching a peak of 22.9% in February 2016, inflation declined each subsequent month until it reached 8.8% in November 2016.*

**Figure 7 The kwacha has been more stable in 2016**



Source: Bank of Zambia

*Food inflation has been the main driver of overall inflation.*

### *Tight monetary policy has tamed inflation to near single digits*

After reaching a peak of 22.9% in February 2016, annual inflation declined each subsequent month until it reached 8.8% in November 2016 (figure 8). Although monthly inflation increased to 1.5% in November 2016, following the increase in fuel prices in October 2016.

Food inflation has been the main driver of overall inflation. It remained above 20% between November 2015 and September 2016, but also declined to single digits in

*While tight monetary policy has helped to reduce exchange rate volatility and moderate inflation in 2016, it has not been without cost.*

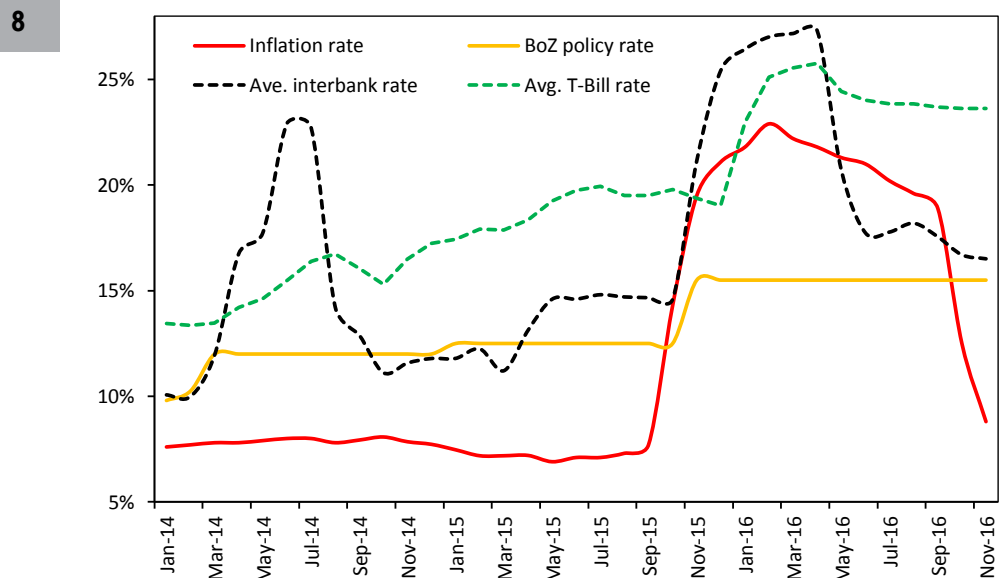
*Real interest rates fell sharply following the increase in inflation, dropping from 13.1% in September 2015 to 2.7% in December 2015.*

*Underperformance in domestic revenues was driven by VAT (below target by 22%) and customs and excise (below target by 18%).*

November 2016 (9.2% year-on-year). Unlike food inflation, non-food inflation never breached the 20% mark. Its peak was 19.1% in February 2016, and it has since declined to reach single digits, namely 8.3% in November 2016.

Lower inflation means that prices in Q4 2016 are increasing at a slower rate. However, many basic household and food items remain expensive, following the recent bout of higher inflation, tightening the budget constraints faced by households, particularly the poorest. During the year to November 2016, the price of breakfast maize meal increased by 16.7%, roller maize meal by 19.5%, tomatoes by 49.5%, onions by 25.5%, and sugar by 31.7%<sup>11</sup>.

**Figure 8 Inflation has moderated in 2016**



Source: Bank of Zambia

While tight monetary policy has helped to reduce exchange rate volatility and moderate inflation in 2016, it has not been without cost. Low liquidity has made it difficult to borrow at a time when the growth of the economy is slowing and firms are facing other domestic challenges (e.g. the power crisis). Total credit extension was US\$8.0 billion in the first three quarters of 2016, compared to US\$8.5 billion in the same period in 2015<sup>12</sup>. Meanwhile, the ratio of non-performing loans to total loans increased to 11% in June 2016 from 10% in March 2016. The most severe impact of the liquidity squeeze has reportedly been on small and medium size firms<sup>13</sup>.

The BoZ has in November 2016 responded to falling inflation by introducing some measures to ease liquidity, but has kept the reserve ratio, and policy and overnight lending rates unchanged. The liquidity measures include removing a once-a-week limit on commercial banks' access to the BoZ's overnight lending facility, ensuring that any intra-day credit automatically becomes an overnight loan, thus allowing banks to calculate their reserve ratio using weekly and not daily averages. These measures will help alleviate pressures on firms, reduce financial sector risks, and increase appetites for domestic paper.

Real lending rates fell sharply following the increase in inflation, dropping from 13.1% in September 2015 to 2.7% in December 2015. They have been recovering since March 2016, but still remained below 10% in October 2016. Real deposit rates have been negative since 2011, and following the spike in inflation, they fell by a larger magnitude than the lending rate, leading to an increase in the lending spread. High lending spreads have been a disincentive for savings.

#### **The fiscal deficit has remained wide in 2016 and arrears have built-up**

The collection of domestic revenue reached ZMW 30.1 billion in the first three quarters of 2016, against a target of ZMW 31.6 billion. The slight underperformance in domestic revenues was driven by VAT (below target by 22%) and customs and excise (below tar-

*Implementation of the 2016 budget has been characterized by weak commitment control and deteriorating budget credibility.*

get by 18%). VAT was below target on account of lower collections and higher than projected refund claims, while customs and excise duties were below target due to lower imports. Contrastingly, income tax performed slightly above expectation (by 1.9%) due to improved compliance.

The 2016 national budget set an ambitious target for non-tax revenue. At first glance, non-tax revenues appear to have performed well, at 9% above target (January to September 2016). However, these figures include a one-off dividend of ZMW 4.1 billion from the BoZ to Government, linked to the 2015 Eurobond. If only 2016 revenue streams are considered, then the non-tax sources would have provided just 62% of their targeted revenue. Further information on revenues is provided in [Section II: Raising Revenue for Economic Recovery](#) of this Economic Brief.

While revenue collections were just a little below what was targeted in the 2016 budget, there has been considerable pressure on Government's cash flow. Implementation of the 2016 budget has been characterized by weak commitment control and deteriorating budget credibility. Although Government wage bill expenditures were only 88% of budgeted levels over the first nine months of the year, this could not prevent the need to make cuts to goods and services expenditure across spending agencies of 20% on average. Government's social cash transfer program, one of the key means in which it can support the poorest households, was also subject to severe cuts. After nine months of 2016, only 43% of budgeted resources had been received.

Furthermore, multi-year commitments to infrastructure spending, especially for the construction of roads, could not be honored and public investment expenditure fell to half the budgeted level between January and September 2016<sup>15</sup>. This has stalled many multi-year projects in 2016 and several contractors, especially in the road sector, are awaiting payment.

The expenditure pressures came in the form of election expenditures (budgeted for), an unbudgeted US\$350 million fuel subsidy that averaged US\$39 million per month in the first nine months of 2016, and an unbudgeted US\$100 million subsidy to keep the price of electricity constant as expensive emergency power was imported. With insufficient cash available to meet planned expenditures, there has also been a huge build-up of unpaid bills or arrears, as central systems to control commitments in line with cash availability have been lacking (box 1). The IMF in November estimated that the stock of arrears would increase by ZMW 10 billion in 2016 to approximately 9% of GDP<sup>16</sup>, although the Ministry of Finance followed this statement by suggesting that a verification process is required to ensure all payment claims are valid.

#### **Box 1 Large accumulation of spending arrears**

Arrears had previously been an issue in Zambia, but until recently the situation had improved. For example, arrears reached an average of 12% of annual expenditure between 2002 and 2004<sup>17</sup>, but were brought back under control and fell to just 1.9% of expenditure in 2009. Arrears increased again to 4.3% in 2011, and since then have re-emerged in large amounts.

By the end of 2015, the stock of arrears had increased to approximately ZMW 10 billion (equivalent to almost 20% of spending). In 2016, the stock is estimated to have doubled to ZMW 20 billion<sup>18</sup>. The arrears build-up in 2016 is largely due to the late payment of road contractors, Government's pension contributions, and delayed payments for imported fuel and electricity. There are also unpaid VAT refunds that have been excluded from the ZMW 20 billion estimate.

In addition, arrears attract interest costs, leading to Government paying increased interest bills. Arrears can also affect the broader economy by reducing the credit worthiness of government suppliers, which in turn imposes difficulties in accessing credit, thus reducing economic and employment growth.

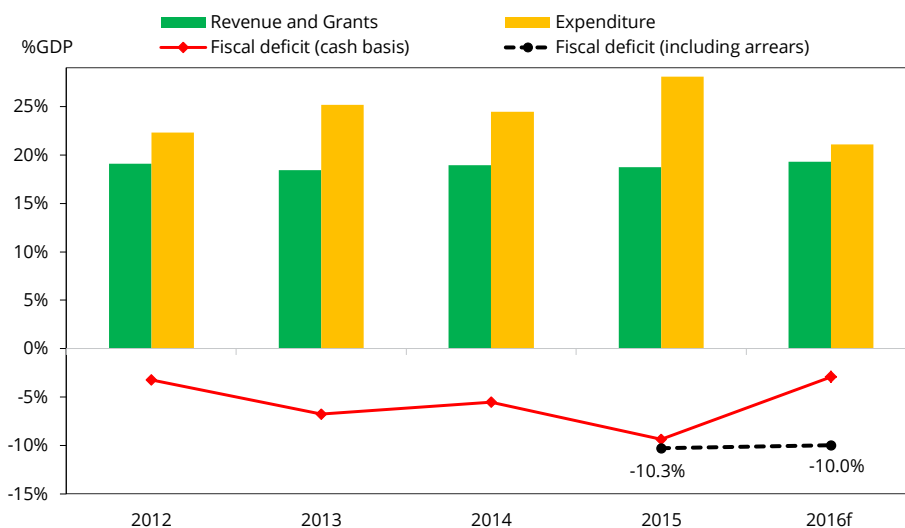
Zambia can work to reduce the accumulation of arrears by strengthening the legal and regulatory framework relating to commitment control, improving budget credibility, strengthening the oversight of state-owned enterprises, ensuring the full implementation of the IFMIS, and ensuring that the Treasury Single Account moves from being a statement to concrete action.<sup>19</sup>

*The fiscal deficit, on a commitment basis (cash plus arrears), is expected to end 2016 at around 10% of GDP.*

Government expects the fiscal deficit, on a cash basis, to end 2016 at around 3% of GDP<sup>20</sup>. To fill this gap between revenue and expenditure, Government has borrowed from the BoZ as it has faced difficulty in raising other domestic and external financing<sup>21</sup>. This appears to be a smaller deficit than in recent years (figure 10), but when the addition to arrears stock is also considered, the fiscal deficit, on a commitment basis (cash plus arrears), is expected to reach approximately 10% of GDP.

**Figure 9 Repeat fiscal deficits**

9



Source: Ministry of Finance and World Bank projections.

*The growth of expenditure has been accompanied by concerns about the quality of the expenditure.*

The growth of expenditure has been accompanied by concerns about the quality of the expenditure<sup>22</sup>. For example, there have been reports by the Auditor General’s department of increasing levels of wasteful expenditure (box 2), while public investment expenditure has been scaled up without building the necessary systems to manage public investment effectively. Systems for prioritizing and appraising projects are needed to ensure the best project proposals are being selected, taking economic and social – as well as political – returns into account. Further, financial planning and monitoring is needed to ensure that once active, projects are implemented at the expected cost, on time, and at the required quality.

**Box 2 Making every kwacha count**

According to the 2015 Auditor General’s report released in October 2016, wasteful spending increased by 59.6% (in nominal terms) to ZMW 879 million (or 2.0% of the total actual spending) from ZMW 550 million in 2014. The wasteful spending included government payments made without a payment voucher, irregular payments and payments where goods and services were not delivered, failure to account for revenue, failure to follow procurement procedures, wasteful payments, and overpayments. This is for a second successive year that wasteful spending has risen following a 102.6% increase in 2014. The report also points to issues including outstanding arrears, failure to meet revenue targets on individual tax types, failure to recover domestic tax debt and failure to collect ground rent among others.<sup>23</sup>

**The Economic Recovery Program and 2017 budget**

Large fiscal deficits and inefficiencies in government spending have persisted as sources of vulnerability for Zambia as the economy slowed down. In 2015, fiscal policy was too loose and monetary policy had to shoulder the burden of adjustment, putting a strain on the financial sector and business across the country<sup>24</sup>. A better balance between fiscal and monetary policy had been required for faster growth. Austerity measures had been announced in November 2015 to strengthen the fiscal position and help Government meet its targeted fiscal deficit, but they were either not put in place or were reversed. All the focus was on the August 2016 elections instead.

To support economic recovery, the Minister of Finance launched Government's economic recovery program on October 20, 2016. The plan was dubbed 'Zambia Plus' because it is being led by Zambia with support from cooperative partners (box 3). The first bold action was to remove the costly subsidy on fuel prices by increasing the pump prices for petrol, diesel and kerosene for the first time since July 2015. This subsidy was mostly of benefit to the richest segments of society, and had become a huge drain on resources, crowding developmental expenditure, including in key sectors such as health and education<sup>25</sup>.

### Box 3 Zambia Plus

The economic recovery program targets five pillars:

**Pillar I: Moving back to a sustainable fiscal path** by improving domestic resource mobilization (by strengthening tax policy and administration), and cutting (and reforming) expenditure on subsidies and reallocating it towards productive sectors as well as to poor households.

**Pillar II: Increasing allocation to social protection** including to pensioners to ensure a soft-landed transition to cost-reflective pricing.

**Pillar III: Cutting wastage through improved economic and fiscal governance** by improving transparency and enforcing more punitive measures to abusers of public funds.

**Pillar IV: Improving budget credibility:** Over the past few years, the variation of actual expenditures from the planned level has been as high as 25%, leading to over-spending in some budget lines, especially subsidies, and under-spending in others, particularly social protection.

**Pillar V: Promoting greater economic stability to boost market confidence and reduce constraints to private sector development,** for example, by investing in energy and transport infrastructure; reducing costs of doing business; facilitating better access to credit; clearing arrears and diversifying the economy.

*Despite new revenue measures to fund this expansion of expenditure, a fiscal deficit of 7% is planned for in 2017 (on a cash basis).*

The expectation was that the 2017 budget, guided by the 'Zambia Plus' plan, would be an austerity budget, where the amount of expenditure would be reduced<sup>26</sup>. However, 2017 expenditure is set to increase to ZMW 61.4 billion from ZMW 50.4 billion budgeted for in 2016. Despite new revenue measures to help fund this expenditure, a fiscal deficit of 7% is planned for in 2017 (on a cash basis) (tables 2 and 3).

If no new arrears are generated, this plan would see a reduction of the fiscal deficit on a commitment basis from the 10% of GDP expected in 2016. The pace of fiscal adjustment has been timed to limit any impact on growth in 2017, and to tackle the huge build-up of arrears.

The Minister of Finance stressed the need to curb the accumulation of arrears and to start dismantling the stock. It is for this reason that there will not be a larger reduction in the fiscal deficit in 2017 (on a cash basis). The plan hints at a move to 'fiscal fitness' over the medium term, but at end-November 2016, no details had been given for 2018 or 2019. Government typically issues a Green Paper or medium-term public expenditure framework prior to the budget, but this was not the case before the 2017 budget address.

*There is a need to curb the accumulation of arrears and to start dismantling the stock.*

Table 2	Fiscal Table			
	% GDP	2013 actual	2014 actual	2015 actual
<b>Revenue and Grants</b>	<b>18.4%</b>	<b>18.9%</b>	<b>18.7%</b>	<b>18.2%</b>
Domestic revenue	16.9%	18.2%	18.5%	17.9%
Tax revenue	14.7%	15.5%	14.4%	13.1%
Non-tax revenue	2.2%	2.7%	4.2%	4.8%*
Grants	1.5%	0.8%	0.2%	0.3%
<b>Expenditure</b>	<b>25.2%</b>	<b>24.5%</b>	<b>28.1%</b>	<b>21.9%</b>
Current expenditure	18.9%	19.1%	21.1%	19.5%
Wages and Salaries	8.2%	9.5%	8.8%	9.2%
Goods and Services	3.4%	3.1%	2.9%	1.9%
Interest Payments	1.5%	2.2%	2.8%	3.6%
Social Benefits	0.5%	0.4%	0.5%	0.3%
Subsidies	3.5%	2.0%	3.9%	2.7%
Intergovernmental transfers	1.8%	1.9%	2.3%	2.0%
Public investment (includes foreign projects)	6.3%	5.3%	7.0%	2.4%
Primary balance	-5.2%	-3.3%	-6.5%	0.7%
<b>Fiscal deficit (cash basis)</b>	<b>-6.8%</b>	<b>-5.5%</b>	<b>-9.4%</b>	<b>-3.7%</b>
Fiscal deficit (including new arrears)	-6.8%	-8.8%	-10.3%	-10.0%
<b>Financing</b>	<b>6.8%</b>	<b>5.5%</b>	<b>9.4%</b>	<b>3.7%</b>
Domestic financing	6.3%	0.8%	1.7%	1.9%
External financing	0.4%	4.7%	7.7%	1.8%
Stock of Arrears	-	2.4%	5.0%	11.3%
Public Sector Debt (2017 = forecast)	29.1%	35.2%	52.9%	55.4%
GDP (Current ZMW, millions)	151,331	167,053	183,381	209,162

Source: Ministry of Finance and World Bank projections

Note: 2016 Non-tax revenue\* = includes a ZMW 4.1 billion (2.1% of GDP) one-off dividend from the BoZ

*The macroeconomic targets set in the 2017 budget include a fiscal deficit of 7% (cash basis), end-year inflation of 9% and domestic revenue of at least 18%.*

Table 3	2016 and 2017 Budgets				
	ZMW '000	2016			2017
		budget	forecast	variance	budget
<b>Revenue and Grants</b>	<b>42,655</b>	<b>38,111</b>	<b>-10.7%</b>		<b>45,169</b>
Domestic revenue	42,109	37,533	-10.9%		42,938
Tax revenue	30,411	27,412	-9.9%		35,212
Non-tax revenue	11,698	10,121	-13.5%		7,726
Grants	546	578	5.9%		2,231
<b>Expenditure</b>	<b>50,410</b>	<b>45,845</b>	<b>-9.1%</b>		<b>61,421</b>
Current expenditure	40,645	40,732	0.2%		47,070
Wages and Salaries	20,394	19,251	-5.6%		20,055
Goods and Services	4,996	3,745	-25.0%		5,733
Interest Payments	7,098	7,546	6.3%		8,408
Social Benefits	1,130	621	-45.0%		2,207
Subsidies	2,910	5,428	86.5%		4,929
Intergovernmental transfers	4,117	4,141	0.6%		5,738
Public investment (includes foreign projects)	9,765	5,113	-47.6%		12,197
Liabilities	-	-	-		2,154
<b>Fiscal deficit (cash basis)</b>	<b>-7,755</b>	<b>-7,734</b>	<b>0.3%</b>		<b>-16,252</b>
Financing	7,757	6,018	-22.4%		16,260
Domestic Financing	1,750	3,395	94.0%		3,026
Foreign Financing	6,007	2,623	-56.3%		13,234

Source: Ministry of Finance and World Bank projections

The macroeconomic targets set in the 2017 budget include a fiscal deficit of 7% (cash basis), end-year inflation of 9% and domestic revenue of at least 18%. Further, Government plans to limit domestic borrowing to 2% of GDP and increase foreign exchange reserves to three months of import cover. Despite the widespread talk of austerity, the national budget provided additional resources for education, health, social protection and agriculture.

*Agriculture received a substantial increase in resources via an expansion of the Farmers Input Support Program (FSIP).*

The education budget was increased from ZMW 9.1 billion budgeted for in 2016 to ZMW 10.6 billion in 2017. For health, the budget is being increased from ZMW 4.4 billion budgeted for in 2016 to ZMW 5.8 billion in 2017. Social protection has also received a substantial increase in expenditure. Resources are being planned to ensure pension contributions are properly financed and to scale up the cash transfer program. The number of households expected to receive the cash is being increased by 258,000 households and the monthly transfer raised from US\$7 to US\$9.

Agriculture received a substantial increase in resources via an expansion of the Farmers Input Support Program (FSIP) to provide ZMW 1,700 to 1.6 million farmers at the start of the 2017-18 farming season. To finance this, the FSIP budget is being increased by 160% to ZMW 2.86 billion. Crucially, the increased FSIP resource allocation coincides with a full shift to the electronic voucher system that is intended to allow farmers to select the inputs they would like, and to support farming beyond maize. A recent pilot suggests there are still challenges to overcome, including targeting, but there is potential for large financial savings when compared to the traditional system where Government procured and transported inputs directly to farmers<sup>27</sup>. The allocation for the Food Reserve Agency is also up by 14% to ZMW 942 million in 2017.

*Many structural reforms were announced as part of the budget, and if implemented will provide a boost to the economy and diversification efforts.*

To make fiscal space for these increases, the defense spend declines by 7%, fuel subsidies have been eliminated and Government has re-announced its intention to remove the electricity subsidy. The remaining financing gap is filled by borrowing and an increase in domestic revenue collection. New revenue measures have been introduced to bring greater fiscal sustainability over the medium term. Tax policy changes include both efforts to improve compliance as well as changes in rates with a target of ensuring at least 18% of GDP is collected in 2017. **Section II: Raising Revenue for Economic Recovery** provides an overview.

Many structural reforms were announced as part of the budget, and if implemented will provide a boost to the economy and diversification efforts. Highlights include an intention not to impose export bans on maize in future (and instead tax maize exports at 10%); economic zones accelerated; girls' education promoted; youth empowerment, crucially through skills; trade and public finance management reforms; and a full review of government parastatals. However, there are concerns as to whether the legal underpinnings to these reforms can be legislated on a timely basis. At least ten pieces of legislation require adjustment to permit these reforms to move forward.

### **Public debt levels remain elevated**

During the budget address, the Minister stated: *"We cannot spend what we do not have. We cannot borrow beyond our ability to repay"*<sup>28</sup>. This is because debt levels remain elevated in 2016, as repeat fiscal deficits between 2012 and 2015 were financed by external non-concessional borrowing. In July 2015, Zambia issued its third Eurobond for US\$1.25 billion (with an average tenor of 11 years) at a considerably higher cost than previous issues (the yield at issue was 9.375%). The Eurobond issues now total US\$3 billion and have sharply increased overall debt levels. The Eurobonds are associated with repayment risks, given the bullet structure of the first two bonds (they each need to be repaid in one single year) and foreign currency risks<sup>29</sup>.

*Foreign currency risks became a reality in Zambia in 2015, as a weaker kwacha has increased the cost of servicing external borrowing.*

Large exchange rate depreciations carry the risk of balance sheet effects, especially where there is substantial offshore foreign currency borrowing by Government and corporations. Foreign currency risks became a reality in Zambia in 2015, as a weaker kwacha has increased the cost of servicing external borrowing. Despite the appreciation of the kwacha in 2016, the total public sector debt is estimated at 56% of GDP up from 53% in 2015, driven by an increase in external debt.

The increased indebtedness not only impacts when the debts require repayment, but also in the form of increased debt servicing costs each and every year. In 2017, interest payments are expected to utilize 20% of all domestic revenue, up from just 12% in 2014 and leaving less room for developmental expenditure.

Participation by foreigners in the domestic debt market declined between January and September 2016, on account of risk aversion towards emerging and developing countries, and increased foreign exchange risk. Tighter liquidity has also constrained the



participation of domestic commercial banks in the domestic debt market, and the size of the auction was halved from ZMW 900 million to ZMW 450 million in January 2016. However, non-bank financial institutions increased their participation in Q1 2016 and as liquidity conditions have improved, the auction size was lifted to ZMW 700 million on May 12, 2016. Overall, Treasury Bills were undersubscribed by 52.2% between January and September 2016. However, more foreign participants have returned to the domestic debt market recently, following relative stability and a slight strengthening of the kwacha, easing liquidity constraints and an anticipation that Government will secure an IMF Program. Issues have successively been oversubscribed since October 15, 2016. Accordingly, the outstanding stock of government securities increased by 3.4% in Q3, to ZMW 25.3 million, and interest rates on government securities declined.<sup>30</sup>

*Imports have become more expensive due to a weak Kwacha, and have declined much faster than exports in 2016, helping reduce the trade imbalance.*

### **International trade and reserves have declined**

Zambia relies on copper for approximately 77% of its exports, and as global copper prices have been low, the US\$ value of exports has fallen in 2016. During the first three quarters of 2016, the value of exports was US\$4,588 million, 10.4% less than in the same period in 2015 (figure 10)<sup>31</sup>. The value of copper exports fell by a much larger magnitude (10.5%) than the value of non-copper exports (2.2%).

Imports have become more expensive due to a weak kwacha, and have declined much faster than exports in 2016, helping reduce the trade imbalance and current account deficit. In the first three quarters of 2016, imports were US\$5,163 million, 16.9% less than their level at the same time in 2015. As a result, total trade (exports plus imports) over the first three quarters of 2016 was US\$9,751 million compared to US\$11,334 million in the same period in 2015.

Zambia has recorded quarterly trade deficits since Q1 2015, but the trade deficit has narrowed by 14% in the first three quarters of 2016 compared to the same period in 2015. This has come about through a painful adjustment where imports have decreased in 2016 and an overall reduction in trade volumes.

Falling exports have also reduced the inflow of foreign currency. Data from the BoZ suggest that the inflow of foreign currency in the first half of 2016 was US\$397 million compared to US\$499 million during the same period in 2015<sup>32</sup>. On the other hand, the outflow of foreign currency was US\$1,065 million in the first six months of 2016 compared to US\$829 million in 2015. Of the outflows, 34.0% relates to external public debt servicing, 4.5% to other uses by Government (including the importation of electricity and fuel), 33% to transactions by non-government entities, and 28.1% was used by BoZ for foreign currency market interventions.

*Zambia has recorded quarterly trade deficits since Q1 2015, but the trade deficit has narrowed by 14% in the first three quarters of 2016.*

**Figure 10 Trade levels reduced and reserves have fallen**



Source: Central Statistical Office

*Lower foreign currency inflows combined with high outflows have put pressure on reserves and the current account in 2015 and 2016.*

Lower foreign currency inflows combined with high outflows have put pressure on reserves and the current account in 2015 and 2016. After increasing from US\$2,773 million in June 2015 to US\$3,937 million in July 2015, following the issue of a US\$1,250 million Eurobond, reserves have fallen for each successive month to reach US\$2,052 million in August 2016. Measured as a ratio of months of import, reserves fell from 4.6 months of import cover in August 2015 to 2.9 in August 2016.

### ***Prosperity has not been shared equally***

The benefits of GDP growth have accrued mainly to the richer segments of the population in urban areas, and poverty remains largely concentrated in rural areas. In April 2016, the CSO launched the preliminary results from the 2015 Living Conditions Monitoring Survey (LCMS)<sup>33</sup>. Their survey provides estimates of living conditions for Zambia's 3 million households. Consumption is chosen as the preferred welfare indicator and is assessed via four main components: food, non-food, durable goods and housing.

The LCMS finds that despite GDP growth averaging 7.4% between 2004 and 2014, there was only a marginal reduction in poverty. The CSO reports that in 2015, 54.4% of the population were defined as poor and 40.8% of the population were experiencing extreme poverty as per the government's poverty line. Using the US\$1.9 per day (2011 PPP terms) measure for international comparison, poverty is estimated at 61.3% in 2015<sup>34</sup>. The poverty measured is largely a rural phenomenon, with 77% of the poorest households located in rural areas.

*Results from the same survey also suggest that Zambia has one of the highest Gini coefficients, measuring inequality, in the world.*

Results from the same survey also suggest that Zambia has one of the highest Gini coefficients, measuring inequality, in the world. The richest 10% of Zambia's population are shown to receive 56% of income, the second richest 17% and the third richest 9%. This leaves just 18% of income for the remaining 60% of Zambia's. The income profile of 2015 and persistent poverty suggest the rapid growth of 2004-13 was largely exclusive, suggesting that Zambia not only needs to return to faster growth, but also to ensure that growth is more inclusive going forward.

## C. ECONOMIC OUTLOOK, RISKS AND POLICY CHALLENGES

Given the tough global conditions for growth and domestic challenges, GDP growth is forecast to remain close to 3.0% in 2016, before improving in 2017 (4.0%) and 2018 (4.2%). The 2017 forecast assumes progress with the economic recovery plan, a better electricity situation than in 2015/2016 and improved copper exports. For the medium term, it assumes even higher copper production, that copper prices will recover marginally, and that progress is made with structural reforms identified in the 2017 budget. To shift to faster and inclusive growth, efforts are needed to overcome a set of interlinked economic policy challenges – if progress is made on only some of them, and not on others, the desired outcomes will not be achieved. The sequencing and coordination of measures are key in 2017 and over the course of a medium-term economic recovery plan.

*GDP growth will remain close to 3.0% in 2016, before improving in 2017.*

### **Medium-term outlook**

Reflecting the external headwinds and domestic pressures, the expectation is that GDP growth will remain close to 3.0% in 2016, before improving in 2017 (4.0%) and again in 2018 (4.2%). The outlook for the Zambian economy is underpinned by three main assumptions:

- i. Copper prices increase slightly over the medium term. World Bank forecasts suggest commodity prices are likely to increase by 4.5% in 2017 and 2018 as the global supply of metals balances better<sup>35</sup>.
- ii. Progress is made with implementing the ‘Zambia Plus’ economic recovery plan, including support from an IMF program and concessional financing from the World Bank and African Development Bank.
- iii. The impact of the power crisis is less severe than in 2015 and 2016 as new generation capacity comes on stream. This will help increase both mining production and output from other industry and services.

*Copper prices recovery could also be slow if the level of oversupply persists beyond expectations.*

### **Risks to the outlook**

The outlook is subject to both domestic and external downside and upside risks. Externally, lower than predicted output growth in China would weigh on the demand for Zambia’s exports, further reducing copper prices, and would severely affect Zambia’s prospects. Copper prices recovery could also be slow if the level of oversupply persists beyond expectations. Furthermore, tighter global financing conditions would also increase the cost of tapping international debt markets over the medium term. On the upside, China’s manufacturing data has been stronger than expected and the outcome of the USA elections has led markets to speculate that infrastructure spending, crucial for copper demand, will increase.

The main domestic risks relate to the supply of electricity and confidence in the economy. Government has embarked on some bold reforms, but if it fails to stick to the fiscal consolidation path the economic recovery plan sets out, then confidence in the economy will stay muted. Slow fiscal adjustment could lead to exchange rate uncertainty, which will trigger inflation, and monetary responses will then dampen credit and economic growth into 2018.

### **Policy challenges**

Commodity-exporting countries’ policy makers face increasing challenges across the globe. Zambia is no exception and is grappling with multiple challenges as the economy has slowed down. Many challenges lay ahead, but the overriding challenge is that they are interlinked – if progress is made on only some of them, and not on others, the desired outcomes will not be achieved. So the sequencing and coordination of measures are key in 2017 and over the course of a medium-term economic recovery plan.

Large fiscal deficits and inefficiencies in government spending persist as sources of vulnerability for Zambia. There remains a need for fiscal and monetary policy to work in tandem. In 2015, fiscal policy was too loose and monetary policy had to shoulder the burden of adjustment. Inflation was tamed and exchange rate volatility reduced, but

*The sequencing and co-ordination of measures are key in 2017 and over the course of a medium-term economic recovery plan.*

at the cost of very tight liquidity putting a strain on the financial sector and business across the country<sup>36</sup>. A better balance is needed for faster growth. What remains critical is that any reduction in the fiscal deficit is planned and managed carefully. A disorderly and incomplete adjustment will not restore market confidence. A too severe or too quick adjustment will undermine growth.

The immediate policy challenges measures can be grouped as either fiscal measures or structural measures as follows:

### **Fiscal measures**

- **Set and publish medium-term targets:** In order to deliver successfully on the fiscal measures, Government needs to develop and publish robust medium-term targets that provide the policy framework – economic policy cannot continue moving from year to year on an ad hoc basis.
- **Arrears clearance:** The accumulation of arrears has returned as a concern since 2015. Arrears attract interest costs, leading to increased government interest payment bills. Arrears can also affect the broader economy by reducing the credit worthiness of government suppliers, which in turn imposes difficulties in accessing credit, and that in turn reduces economic growth and employment. The 2017 budget allows for a reduction in the stock, but a strategy for which stock to prioritize is required.
- **Improve debt management:** Publication of a medium-term debt strategy is essential to ensure a move from borrowing on an ad hoc basis to one based on proper debt sustainability analysis, which considers all the risks related to the types of borrowing and the costs of repayment. Further, borrowing decisions need to be clearly harmonized with the spending priorities. Setting an appropriate debt ceiling and improving market communication via quarterly debt reports and improved websites are also essential quick wins.
- **Revenue mobilization:** Zambia needs to strengthen efforts to improve domestic revenue mobilization and to meet the targets in the budget. **Section II: Raising Revenue for Economic Recovery** of this report is focused on revenue issues.

### **Structural measures**

- **Fast-track electricity sector reforms:** The 2017 budget repeats Government's previous statement of intent for cost-reflective tariffs. Financial sustainability will help the sector, but there are other necessary reforms; including improved planning; better, fairer and more efficient tendering systems; and the removal of many inefficiencies in the management and supply of electricity that get passed through to the consumer. ZESCO should be prioritized as one of the first organizations to go through the announced State Owned Enterprises (SOE) review.
- **Boosting the non-copper economy:** The commodity price shock highlights the need for Zambia to reduce its dependency on copper, a challenge it has been grappling with for over 50 years. There were plenty of good ideas presented in the 2017 budget, and the forthcoming National Development Plan should cement the reform direction, especially in agriculture – a leading non-copper sector. However, efforts are needed to remove constraints to the necessary structural reforms. For example, many legislative changes are required, but there is a bottle-neck in getting new laws passed. How can this bottle-neck be alleviated or which legislative changes should be at the front of this queue?

*In order to deliver successfully on the fiscal measures, Government needs to develop and publish robust medium-term targets.*

*Efforts are needed to remove constraints to the necessary structural reforms.*



# SECTION 2 RAISING REVENUE FOR ECONOMIC RECOVERY

## D. REVENUE PERFORMANCE

Both public spending and revenues have grown considerably since 2010, but in recent years the pace of expenditure has exceeded that of revenue. If current levels of government expenditure are to be maintained in a sustainable manner, then higher domestic revenue collections are essential. After ten years of rapid growth Zambia has emerged from being a country with a high aid dependency to one where in 2015 grants provided just 1.4% of revenue compared to 98.6% domestic revenues.

*The 2017 budget and 'Zambia Plus' economic recovery program have put an emphasis on the need to improve domestic revenue collection.*

The 2017 budget and 'Zambia Plus' economic recovery program have put an emphasis on the need to improve domestic revenue collection. Repeat and large fiscal deficits have led to rising debt levels and put pressure on this fiscal stance. Both spending and revenues have grown considerably since 2010, but in the recent years the pace of expenditure has exceeded that of revenue. As growth has slowed down in 2015 and 2016, public expenditure has continued on its upward trend in real terms (figure 11).

The gap between expenditure and revenue has been met by:

- i. Large Eurobond issues in 2012, 2014 and 2015;
- ii. Bridging loans from the central bank in 2013 and 2016; and
- iii. Considerable arrears being allowed to accumulate, in 2015 and especially 2016.

If current expenditure levels are to be maintained in a sustainable manner, higher domestic revenue collection appears essential.

*Too much taxation can stem the growth of the private sector; too little and it's not possible to provide the levels of public services demanded.*

There are mixed perceptions about taxation and public spending in Zambia. One view is that taxes are too high, while another is that expenditure should not be reduced and should even be expanded from current levels. These views are hard to balance. Too much taxation can stem the growth of the private sector; too little and it's not possible to provide the levels of public services demanded, the infrastructure required to develop, and the means of redistributing resources to the poorer households.

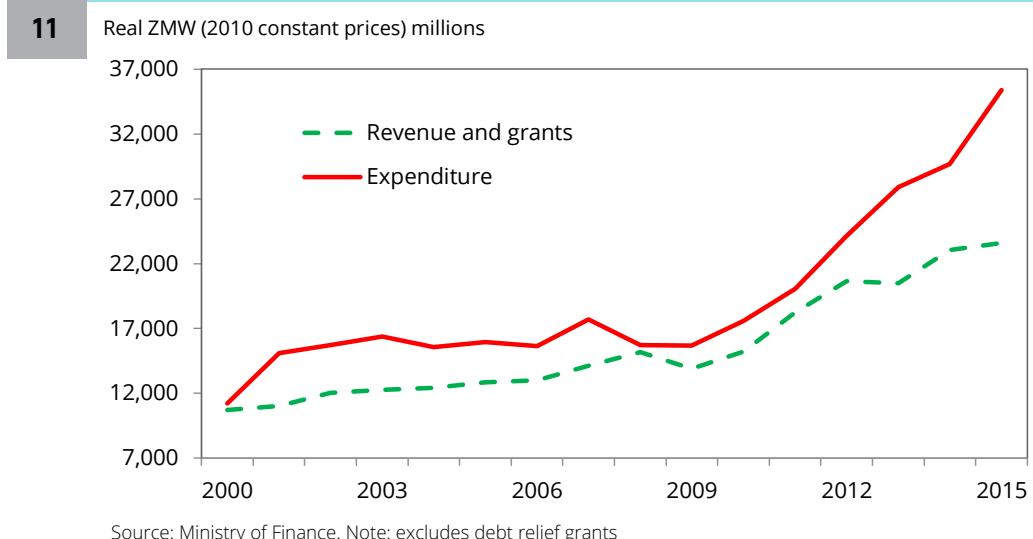
Zambia is experiencing rapid population growth of nearly 3% per annum, meaning that the population doubles in approximately 24 years. While a larger population can create more growth and more potential tax payers, a larger population also requires higher levels of spending on services such as education and health to maintain the current levels of access and quality for all Zambians.

*Zambia needs to calibrate carefully how much revenue is required for its development goals.*

*The current revenue target is 'at least 18%' of GDP.*

*There are many countries collecting and spending a bigger proportion of GDP than Zambia, especially in the Southern African Customs Union (SACU) region.*

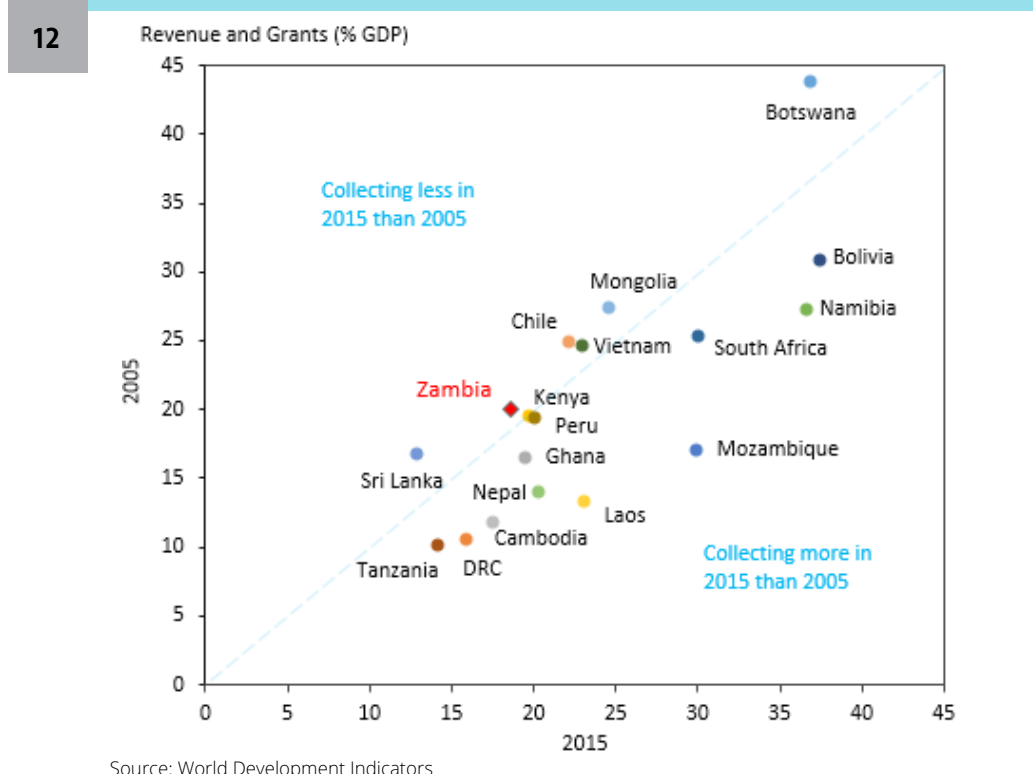
**Figure Growing gap between expenditure and revenue**



Zambia needs to calibrate carefully how much revenue is required for its development goals and to ensure this analysis feeds into the revenue policy and the administration of taxation. To achieve this, coordination is required between the different entities responsible for revenue collection and policy (box 4). This sort of assessment needs to feed into Zambia’s development planning, and the expenditure needs matched to realistic revenue scenarios. The current target is ‘at least 18%’ of GDP, but there is no optimal rate. This target rate is below the 22.6% target in the revised sixth National Development Plan (NDP), but when compared to other middle-income countries, Zambia is close to the median.

There are many countries collecting and spending a bigger proportion of GDP than Zambia, especially in the Southern African Customs Union (SACU) region, but also many successful countries collecting and spending less revenue (figure 12). There are also other countries struggling to improve revenues, such as Uganda or Tanzania, where revenue collection remains low, relative to other countries, in spite of consistent economic growth.

**Figure How does Zambia’s revenue collection compare?**



**Box 4 Who manages domestic revenue?**

The Zambia Revenue Authority is tasked with tax collection, administration, compliance and enforcement via its operations and inspections. Operations are split into Domestic Taxes and Customs Services. The ZRA is governed by an Act of Parliament, Chapter 321 of the Laws of Zambia enacted in 1993. Under this law, it produces an annual report for Parliament. A few large taxpayers, especially from the mining sector, dominate collection in Zambia and consequently the ZRA has a large taxpayers unit.

The Ministry of Finance is responsible for formulating revenue policy (both tax and to some extent non-tax revenues). Each year, tax policies are reviewed by a Tax Policy Review Committee, brought together by the Ministry of Finance, with the aim of optimizing revenue collection in the most cost-efficient and professional manner possible. The revenue targets are set by the Minister of Finance and approved by Parliament.

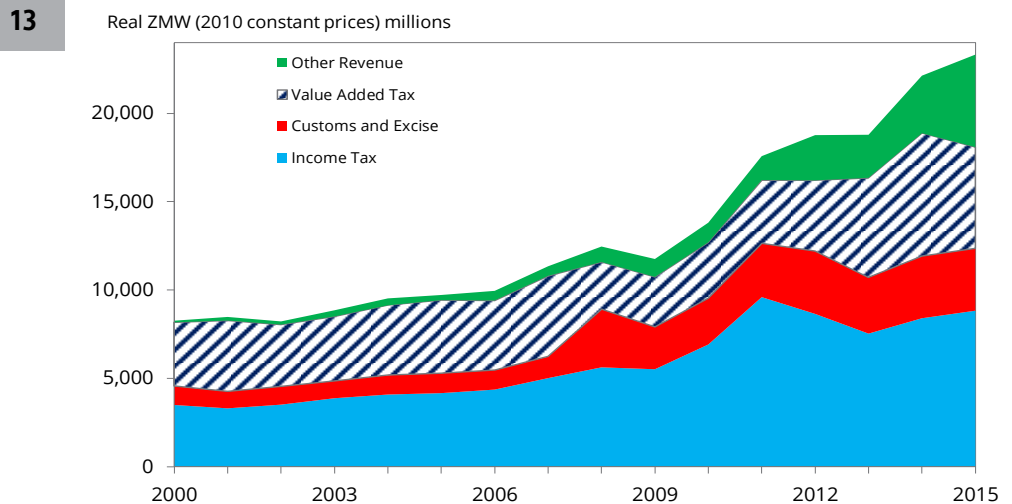
The following laws govern the collection of revenue:

- Income Tax Act, Chapter 323 of the Laws of Zambia;
- Customs and Excise Act, Chapter 322 of the Laws of Zambia
- Value Added Tax Act, Chapter 331 of the Laws of Zambia;
- Property Transfer Tax Act, Chapter 340 of the Laws of Zambia; and
- Mines and Minerals Development Act, No. 7 of 2008.

*Revenues increased in real terms as the economy grew from the early 2000s and by 2015, domestic revenue had reached 18.5% of GDP.*

**Revenue performance**

After ten years of rapid growth and a doubling in size of the economy between 2004 to 2014, Zambia has emerged from being a country with a high aid dependency to one where in 2015 grants provided just 1.4% of revenue compared to 98.6% domestic revenue, earned largely through taxation. Revenues increased in real terms as the economy grew from the early 2000s (figure 13) and by 2013, domestic revenue had reached 16.9% of GDP. It then rose to 18.2% of GDP in 2014 and 18.5% in 2015 (table 2). In 2016, revenues were targeted to reach 20.1% of GDP, but as growth and trade slowed, so did VAT and customs receipts. The forecast for 2016 is 17.9% of GDP (including the one-off BoZ dividend equal to 2.1% of GDP).

**Figure 13 Changes in revenue composition since 2000**

Source: Ministry of Finance

*Income tax has provided the largest share of domestic revenue since 2000, reaching approximately 38% in 2015.*

Income tax has provided the largest share of domestic revenue since 2000, reaching approximately 38% in 2015. The amount collected has grown by 231%, in real terms, since 2000. Despite the high growth, a Zambia Institute for Policy and Research (ZIPAR) study in 2014 estimated that only 52% of "true" income was being taxed and an additional 6.7% of 2014 GDP might have been collected, compared to 6.9% actually collected, if PAYE had been received from all self-employed and paid employees at the time<sup>37</sup>. While reaching this level of collection would be enormously challenging, it highlights the scope for improved compliance.

VAT collections have grown by 59%, in real terms, since 2000. In recent decades, VAT has evolved as the main workhorse of taxation in developing countries. In Zambia, it provided 25% of domestic revenue in 2015. A recent study found Zambia's VAT effi-



*Non-tax revenue, which includes mining royalties, grew slowly in the 2000s, but since 2010 has grown by 40% per year on average.*

ciency to be comparable to the average of other countries in the sub-Saharan Africa region, although it did show some volatility<sup>38</sup>. However, between 2004 and 2014, the real economy doubled in size while VAT only grew by 81%, suggesting that there is scope to improve collections.

Non-tax revenue, which includes mining royalties, grew slowly in the 2000s. However, since 2010, it has grown by 40% per year on average (albeit from a low base), as mining firms have produced more and improved their tax compliance. In 2016, a large increase in non-tax revenue was projected through the enhanced collection of fees and fines. However, those lines had not performed as expected in the first nine months of 2016 and non-tax sources, excluding the BoZ dividend (and despite an increase in royalty), provided just 62% of targeted non-tax revenue.

As revenue collection has improved, it has also become more cost-effective. Since 2013, the ratio of the ZRAs budget to total revenue collected has decreased from ZMW 2 spent for every kwacha collected, to ZMW 1.4 in 2015, in spite of the slower economic growth that year.

### 2017 budget revenue targets

The Minister of Finance set a revenue target of at least 18% of GDP in 2017, with the aim of limiting the fiscal deficit to 7% of GDP while dismantling some of the arrears that built up in 2015 and 2016. This target removes the ambition of the previous budget to increase revenues as a percentage of GDP, and instead settles for a similar level of collection recorded in 2014 and 2015. Non-revenue targets for 2017 are much more realistic than for 2016 (down by nearly ZMW 4 billion) and an increase of ZMW 4.8 billion or 16% is expected from tax revenue, via new tax measures and efforts to improve compliance (table 4)<sup>39</sup>.

To achieve this target, the allocation of resources to ZRA is being increased from ZMW 427 million in 2016 (which appears as if it will be received in full) to ZMW 769 million in 2017; an increase of 80%. However, only ZMW 100 million is expected to be available to fund new operational capacity. Much of the increase relates to the establishment of a pension fund and a gratuity fund (ZMW 150 million) and to cover exchange rate losses in respect of a number of contracts that are in US\$.

*Non-revenue targets for 2017 are much more realistic than for 2016 (down by nearly ZMW 4 billion).*

Area	Measures
Direct Taxes	<ul style="list-style-type: none"> <li>•10% rental income tax on Statutory Bodies</li> <li>•15% Advanced income tax</li> <li>•100% capital allowance on agriculture equipment</li> <li>•Exempt PAYE threshold ZMW 3,300</li> <li>•Income above ZMW 6,200 at 37.5%</li> </ul>
Customs and Excise	<ul style="list-style-type: none"> <li>•17.5% excise duty on airtime</li> <li>•15% on spare parts</li> <li>•ZMW 240 per mille on cigarettes</li> <li>•Carbon tax rates ZMW 70-ZMW 275</li> <li>•5% surtax on locally manufactured goods</li> <li>•15% on semi-processed edible oils</li> <li>•40% on plastic bags</li> </ul>
VAT	<ul style="list-style-type: none"> <li>•Input VAT not claimable by non-registered supplier</li> <li>•90% diesel input VAT claimable, input VAT on petrol non-claimable</li> <li>•Abolish VAT group registration</li> </ul>
Export Taxes	<ul style="list-style-type: none"> <li>•ZMW 10/kg on raw timber</li> <li>•ZMW 5/kg on semi-processed timber</li> <li>•10% on maize</li> </ul>
Non-Tax Revenues	<ul style="list-style-type: none"> <li>•Skills development 0.5%</li> <li>•Fees on cross-border vehicles US\$20-US\$75</li> <li>•Increase in various user fees and charges</li> </ul>

Source: ZIPAR (2016) <sup>40</sup>

## E. MINING REVENUE

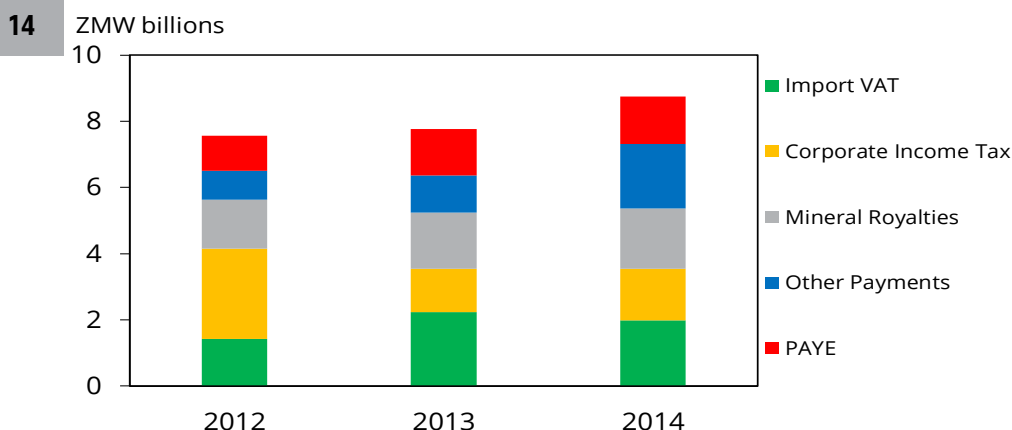
The absence of good data on mining companies has helped support a common perception that not much revenue is being collected from them in Zambia. The reality is that the mining sector (which includes quarrying and cement production) contributed ZMW 8.8 billion in 2014, equivalent to 28% of total domestic revenue, up from ZMW 7.7 billion in 2013 and ZMW 7.6 billion in 2012. There remains a pressing need for an improved flow of information and transparency to ensure the contribution of the sector is better understood. Efforts are also needed to improve the monitoring of the country's mineral value chain from exploration to export, and to ensure that at the given rates, Zambia collects the revenues it is due.

*The lack of quality data has been a huge barrier to an improved understanding of the contribution made by the mining sector.*

The lack of quality data has been a huge barrier to an improved understanding of the contribution made by the mining sector in Zambia. However, the Zambia Extractives Industries Transparency Initiative (ZEITI) has produced good data for the period 2008 to 2014, although the data was released with a delay of almost a year (for example the 2014 data was made public on December 2015).

The ZEITI report finds that the mining sector (which includes quarrying and cement production) contributed ZMW 8.8 billion in 2014, equivalent to 28% of total domestic revenue<sup>41</sup>. This was up from ZMW 7.7 billion in 2013 and ZMW 7.6 billion in 2012. The contribution to Government is split across tax revenue (VAT, Corporate Income Tax (CIT), and PAYE) and non-tax revenue (mostly royalties) (figure 14). A considerable amount of import VAT is paid because the mining conducted in Zambia is capital-intensive and heavily reliant on imported goods, as opposed to local content or labor, for production.

**Figure 14 Mining contribution to the Government Budget**



Source: ZEITI (2015)

*The Mining Investment and Governance Review presents an objective assessment of the mining sector of several countries.*

The Mining Investment and Governance Review (MInGov) presents an objective assessment of the mining sector of several countries. Zambia was surveyed in 2016 and it was concluded that the country remains an appealing place for investment due to its favorable geology; long history of mining; political stability; low risk of expropriation; high levels of security; and a relatively favorable economic environment<sup>42</sup>. Some of the positive findings were overshadowed by concerns of a lack of transparency and accountability regarding revenue management, a lack of consistency surrounding fiscal policy, and a lack of support for diversifying the economy and leveraging of infrastructure for the general population.

Tax policies and instruments, accountability and inclusiveness, and institutional capacity and effectiveness all performed in the "high" scoring range in the survey. Tax policies and instruments, and rules for auditing, base erosion and profit shifting, are deemed generally strong. The tax code is clear and readily available. Tax, cost, and physical audits of the major mining companies are undertaken. Transfer pricing, advanced pricing, and thin capitalization are each increasingly subject to policies developed by the ZRA, although key pieces of legislation are needed to strengthen this framework.

*Transfer pricing, advanced pricing, and thin capitalization are each increasingly subject to policies developed by the ZRA.*

*The mining tax regime has changed eight times in the past eight years.*

*The successful implementation of the reforms is expected to increase transparency in the mineral value chain.*

Despite the strengths identified in the MInGov survey, the mining tax regime continues to evolve, and efforts by the Government to ensure it has an adequate minimal revenue stream in all production periods has so far borne limited results and created a relatively turbulent mining taxation and market environment.

The mining tax regime has changed eight times in the past eight years, and has in 2015 and 2016 been a source of tension between the mining companies and Government, as prices have softened and reduced power supply has complicated production. This withstanding, the July 2016 tax regime was welcomed by the industry as a step towards balancing the competing interests, as the mines endeavor to maximize their returns from the extraction while the Government works to ensure Zambia gets a fair return for those assets and the associated environmental damage<sup>43</sup>.

It is also important to note that at current prices, there is limited investment in the mining sector, so a balance is also needed between maximizing revenue flows during this period and creating the conditions needed to attract a new wave of investment that can maintain or grow the sector in future<sup>44</sup>.

### **Better monitoring of the sector's outputs**

A Mineral Value Chain Monitoring Project (MVCMP) is being used to support the design of a system to improve the monitoring of the country's mineral value chain from exploration to export. This will help to ensure that at the given rates, Zambia collects the revenues it is due.

Central to the reforms is the use of the online Mineral Output Statistical Evaluation System (MOSES), which is used by the customs department at the export stage of mineral declaration. Through the system, the mines will submit mineral production reports and apply for Mineral Export Permits. In addition, handheld equipment, linked to the system, can be used for spot checks when clearing export-bound minerals. An analysis laboratory can also be used for more accurate verification of mineral content. Objective testing using machinery has been shown to be effective in reducing opportunities for corruption.

The successful implementation of the reforms is expected to increase transparency in the mineral value chain and result in higher revenue mobilization. When complemented with reforms in the mining tax regime and strengthened accountability institutions in the country, it is also likely to improve the attractiveness of Zambia as a minerals investment destination.

## F. PLANNED REVENUE REFORMS AND CHALLENGES

There have been many revenue related reforms over the past few years, and some are still ongoing or planned for the future. The reforms are aimed not only at increasing revenue collection, but also ensuring that collection is efficient and free from corruption. A recent assessment cites compliance as one of the weakest areas in Zambia's tax administration system. Key efforts to tackle this problem include the TaxOnline system, more enforcement measures and audits, and the introduction of Electronic Fiscal Devices (EFD) that link retailers directly to the ZRA.

*Zambia has a sound tax administration structure, with a number of systems which encourage taxpayer compliance.*

### *The tax administration system has been improving*

At the request of the ZRA, an assessment of Zambia's tax administration system was undertaken in May 2016. The Tax Administration Diagnostic Assessment Tool (TADAT) was used<sup>45</sup>. The aim of the assessment was to help determine reform priorities and highlight reform achievements.

The assessment found that Zambia has a sound tax administration structure, with a number of systems which encourage taxpayer compliance (table 5). The TaxOnline system, introduced in October 2013, is viewed positively and is clearly a benefit to both the ZRA and taxpayers. The ZRA is deemed to be sufficiently transparent and focused on encouraging voluntary compliance by providing a wide range of support, and seeks taxpayer feedback regularly.

The study also listed a number of areas where reform should be targeted. The assessment cites very low online filing, very high rates of tax arrears, and a backlog of VAT refund claims. They also found that the database of registered taxpayers contained inaccuracies, including a large number of inactive taxpayers. These issues point towards generally low taxpayer compliance. Furthermore, the systems used to manage and analyze the compliance risks are fragmented. Further, there remains an opportunity to strengthen the analysis of internal and external data, and the outcome of audits, to improve decision making and inform steps to improve compliance.

Table 5 Zambia's tax administration systems		
5	Areas of success	Areas for improvement
	<ul style="list-style-type: none"> <li>• Structured processes are used to identify, prioritize and mitigate institutional risks.</li> <li>• A wide range of information is made available to taxpayers and there are mechanisms for taxpayer feedback to ZRA.</li> <li>• The TaxOnline system provides a strong foundation for taxpayer accounts, and allows for electronic filing and payment.</li> <li>• Efficient collection systems: withholding at source is available for all employment income, interest and dividends; and advance payment instruments are in place for all business income.</li> <li>• Audit cases are selected centrally on the basis of identified risks.</li> <li>• The dispute resolution process includes a tax appeals tribunal which is being used.</li> </ul>	<ul style="list-style-type: none"> <li>• Uncertainty regarding the accuracy of the taxpayer registration database (for example the total number of registered taxpayers is not known with certainty).</li> <li>• Very low rates of on-time filing across all core tax types.</li> <li>• The value of tax arrears is very high, casting doubt on tax debt management procedures.</li> <li>• Management of compliance risks is weak and fragmented, and the outcome of compliance activities (including audits) are not well evaluated.</li> <li>• Taxpayer disputes are not well handled. They are not independent of the audit process and there is no set period within which an administrative review must be completed.</li> <li>• An ombudsman exists but is not used for addressing complaints about ZRA.</li> </ul>

*While the ZRA is making an effort to improve taxpayer education, taxation remains complicated and insufficiently understood.*

Areas of success	Areas for improvement
<ul style="list-style-type: none"> <li>•The revenue accounting system is robust and funds for repayment claims are ring-fenced.</li> <li>•Regular internal and external audits provide good oversight and accountability.</li> <li>•Annual reports, strategic plans, and responses to audit findings are produced in a timely manner and published.</li> </ul>	<ul style="list-style-type: none"> <li>•The revenue accounting system does not interface with the Ministry of Finance's systems.</li> <li>•There are significant delays in processing claims and making VAT refunds.</li> <li>•ZRA does not have a system of public or private bidding rulings or cooperative compliance arrangements.</li> </ul>

Source: TADAT: Performance Assessment Report 2016 – Zambia

While the ZRA is making an effort to improve taxpayer education, taxation remains complicated and insufficiently understood in Zambia. From a survey conducted in 2014 (including 22 large tax payers), ZIPAR concluded that tax literacy is low. They found that the respondents interviewed had limited knowledge of tax and the tax system in Zambia, suggesting further efforts are needed to ensure that messaging for taxpayer education is effective<sup>46</sup>. ZIPAR suggested that more workshops and seminars are needed and that the ZRA website needs to be improved as a source of information and guidance. The more complicated and difficult it is to assess tax obligations, the more likely they will be evaded. Communication is very important when it comes to tax systems and can be a key driver of improving compliance.

*The payment of taxes is more likely to motivate citizens to hold Government accountable for the resources it manages.*

There already exists a lively debate on how Zambia can overcome its revenue challenges, central to the conversation is the Zambia Tax Platform (ZTP), whose members, from a wide range of civil society organizations, have provided a wealth of research and suggestions on how revenue can be raised efficiently to finance development in the country. The ZTP argues that there are four important objectives for reform<sup>47</sup>. First is that while raising revenue provides development financing, it should come from a broad base so that citizens engage and advocate for efficient expenditure service on the services they are entitled to. Second is redistribution, as tax revenues can supplement low-income families' income buy financing transfers and the provision of public services. Third is re-pricing. The consumption of desirable goods can be encouraged via exemptions from indirect taxes, while goods that harm people's health, such as cigarettes and alcohol, can be made more expensive as a disincentive for consumption. Fourth is representation. The payment of taxes is more likely to motivate citizens to hold Government accountable for the resources it manages on behalf of its people, as well as the spending it carries out on their behalf.

### **Tackling compliance**

The TADAT assessment cites compliance issues as one of the weakest areas in Zambia's tax administration system. Efforts have been made to try and improve compliance, but a large gap remains. In 2015, the ZRA undertook various enforcement activities and managed to increase the number of compliance issues it detected, as well as the value of these cases (up by 234% to ZMW 899 million in 2015). The majority of cases handled related to under-declaration; under-valuation; wrong tariff classification; forgery; and smuggling of various commodities including liquor, timber and motor vehicles. Compliance-enforcing initiatives and efforts geared at collecting tax arrears can be successful, but they require resources; principally human resources, as well as vehicles and fuel to carry out site visits.

*Investing resources to increase enforcement activities makes particular sense if more revenue can be realized as a result.*

Investing resources to increase enforcement activities makes particular sense if more revenue can be realized as a result. However, care is needed to ensure that additional resources are targeted as efficiently as possible from a revenue return perspective. In medium-sized African countries such as Zambia, large taxpayers (under 1,000) typically dominate revenue collections, providing 80% of revenues. Medium taxpayers (around 10,000) typically provide a further 15% of revenues. Small taxpayers (over 100,000) typically only provide 5%.

*A key reform to support the collection of revenues from medium-size taxpayers registered for VAT purposes is the use of Electronic Fiscal Devices.*

Efforts to improve tax collection are more likely to yield substantial resources if they are targeted at medium and large taxpayers. To realize similar levels of resources from small taxpayers would require coverage of many more thousands of taxpayers, and enforcement activities of this magnitude could overwhelm the available resources and manpower. For small taxpayers public sensitization campaigns might be more effective from a cost-return perspective.

The large payers unit in ZRA is already making good progress, so one of the core areas for attention for improving compliance relates to medium-size tax payers. Here the planned introduction of EFD and wider use of electronic filing via the TaxOnline system is expected to yield results in 2017 and over the medium term.

In the Doing Business Report for 2017, Zambia is ranked 58th for the ease of paying taxes; this is two places down from its rank of 56th in 2016, but the scoring remains very similar (i.e. other countries have improved)<sup>48</sup>. A gain has been made since 2014 because Zambia has simplified its tax system to improve tax compliance, although it still remains relatively complex. An important development has been TaxOnline. However, the compliance rate for using TaxOnline needs to be tackled if the full benefits are to be realized.

A key reform to support the collection of revenues from medium-size taxpayers registered for VAT purposes is the use of EFD that are linked via a SIM card to the ZRA. This will help with the flow of information from taxpayers to ZRA, although manpower will still be required to make physical checks and ensure transactions are made through the system. Regardless of whether the EFDs are in place, consumers must demand that their transactions go through the vendor's books and a receipt is issued.

*Very little property tax is being collected in Zambia.*

Both of these reforms and other compliance drives are expected to yield results, but this expectation should be cautioned by the reality that activities often take time to ramp up, and revenue flows results may only improve considerably over the medium term.

#### **New revenue areas**

Road tolls were recently introduced in Zambia, and in November 2016, Government announced that the toll rate would be doubled and additional roads would be tolled. The premise for this is that the funds collected can be channelled towards road maintenance activities to increase the life of the road, as well as to provide a potential revenue stream for road expansion via public private partnerships.

Another key area that remains in its infancy is property tax. Very little property tax is being collected in Zambia, as is the case in many other African countries (box 5). While the 2016 budget did target increased revenue from property tax, no systems were put in place to reach the targets. There remains a need to value properties and to do so every five years, especially in a rapidly growing city like Lusaka. Property tax in Zambia is administered by local councils and levied on the value of capital-improved land. This is an important revenue source for local councils, but the collection and enforcement of property tax has been poor. The reasons cited for this are a lack of capacity, unclear property rights, and an old value base<sup>49</sup>.

*Not all tax challenges can be overcome at the country level; some require international collaboration.*

#### **Tackling Illicit Financial Flows**

Not all tax challenges can be overcome at the country level; some require international collaboration. For example, the practice of illegally hiding income from tax authorities and sending it abroad hampers Government's efforts to mobilize domestic resources. The concept of Illicit Financial Flows (IFF) refers broadly to the cross-border movement of capital associated with illegal activity or more explicitly, money that is illegally earned, transferred or used that crosses borders<sup>50</sup>. Specific IFF acts include illegal acts (for example corruption, tax evasion), or when funds flowing out of the country are the results of illegal acts (for example smuggling and trafficking in minerals and wildlife). There have long been concerns that Zambia is being affected by these types of practices. Many numbers estimating the magnitude are quoted, but because of a lack of transparency, accuracy in estimating the potential losses is difficult. Despite the challenges in calculating the extent of the losses, it seems reasonable to conclude they are substantial.

**Box Challenges with Property Tax**

**5** Property tax as a percentage of GDP averages 0.6% in developing countries, and 0.5% in Sub-Saharan Africa<sup>51</sup>; while in Zambia just 0.1% of GDP is collected. This suggests that there are gains to be made, but expectations need to be managed given the challenges developing countries face in this area.

There are three common challenges. First is resistance by vested political and economic elites, and investors in property markets. Fair enforcement is key to improving property tax collection. Residents are unlikely to comply if they are not confident that their neighbor pay their fair share, irrespective of their political affiliation and economic influence. Persuasion can also enhance compliance. For example, Rwanda, Tanzania, and Uganda hold annual taxpayers' appreciation week, when the benefits of paying tax are communicated to the public.

Second is inefficiency, which results from the level at which the taxes are collected or the methods of collection. In Botswana, Malawi, and Tanzania, property tax assessment and collection has been sub-contracted to the private sector. This often improves collection, but at the expense of building amicable community relations and state-building. Implementing the use of technology, such as mobile payments, can also increase collection, as has been the case in Kenya and Tanzania.

Third is the low level of land titling. In Africa, land is largely owned by the state or is under customary land rights, making it difficult to tax. In Zambia, only 200,000 land titles exist. In 2017, Government will begin a pilot program to title land in Lusaka. A good example to emulate is Rwanda, where between 2008 and November 2016, 8.4 million titles had been created and digitalized.

*Source: McCluskey, W.J. and Franzsen, R.C.D. (2016). Property Tax Reform in Africa: Challenges and Potential. African Tax Institute, University of Pretoria, South Africa.*

*Zambia must address weaknesses in its legal and regulatory regimes that make it susceptible to the activities that lead to Illicit Financial Flows.*

It is important to understand how and why money flows out, and to then devise strategies to stem these flows. Solutions to addressing IFFs differ depending on the country context and the underlying activities that result in these outflows. In some cases, actions will involve preventing criminal activity. In other cases, it may involve identifying and sanctioning serious and substantial illegal tax evasions.

Zambia must address weaknesses in its legal and regulatory regimes that make it susceptible to the activities that lead to IFFs, but what is also crucial is that other countries must take the lead on preventing inflows of illicit money. What is key is that Government includes a wide range of stakeholders in the process, as coordination and cooperation around key issues and players requires active participation from the private sector, international organizations, and civil society.

***Are tax incentives being used effectively?***

Tax incentives have been used in Zambia with the intention of attracting foreign direct investment (FDI) to generate employment and enhance economic growth. The Zambia Development Agency (ZDA) is responsible for promoting investment in the country, and administers the investment with other Government entities. For a firm to receive a tax incentive in Zambia, the Ministry of Finance (with the mandate for tax policy) makes a decision that is processed via a Statutory Instrument, or approved via the national budget. Both the Minister of Finance and the Minister of Commerce, Trade and Industry are empowered with respect to tax incentives via their respective legislation. There is no single overriding framework for the use of tax incentives and in consequence, their issuance is at times inconsistent. There is a risk that the tax incentives are not crucial to a firm's decision to locate or invest in Zambia and thus a portion of potential revenue is forgone. Further, they can be potential sources of corruption.

*There is a risk that the tax incentives are not crucial to a firm's decision to locate or invest and thus a portion of potential revenue is forgone.*

Full transparency about what incentives have been offered to which firms will help policy makers evaluate exemption decisions better. Tax incentives need to be reviewed frequently to ensure those which no longer serve or have served their purpose are phased out. The entire tax incentives scheme should be part of a broader strategy of promoting investment from both Zambian and international firms that create employment, transfer key skills and technologies, improve foreign exchange earnings, and promote economic diversification.<sup>52</sup> The strategy can be laid out transparently in the National Development Plans, and clarity should be provided on how incentives will be monitored and reviewed.

## G. IDEAS TO IMPROVE TAX POLICY AND REVENUE ADMINISTRATION

Efforts are needed to ensure there is sufficient revenue to fund Government spending. There are two key areas in which Government is working. The first is on improving tax policy, which falls under the responsibility of the Ministry of Finance, and the second is improving tax administration, which falls under the responsibility of the ZRA.

*Communication is very important when it comes to tax systems and can be a key driver of improving compliance.*

Extensive advice can already be found in the numerous documents and briefings provided on the Zambian revenues situation (many of which are quoted in this Brief). This section does not aim to include them all, but does suggest that the priority issues could be guided by the following.

Many of the planned reforms and other compliance drives are expected to yield results, but this expectation should be cautioned by the reality that activities often take time to ramp up, and revenue flows results may only improve considerably over the medium term.

### **Improved tax policy ideas**

By using the revenue data available, tax policy can become much better informed. There is much more data available since TaxOnline has been established, and it can be interfaced with other sources of data, such as the Labour Force Survey or Living Conditions Monitoring Survey, to better understand what types of households are being taxed and at what levels.

Three important studies for 2017 to inform tax policy are:

- i. **Tax gap study:** Carry out a full review of tax base erosion to understand the extent of the tax gap and whether it is driven by non-filing or underreporting. This will then inform the most appropriate policy response to address the tax gap.
- ii. **Tax exemptions analysis:** List and evaluate the costs and benefits of current incentives. This analysis can be used to develop an incentive policy framework (as part of a broader investment strategy) that is made public and that lists the different incentives offered. The results of the analysis should feed into a clear and transparent tax exemptions strategy that is integrated into the goals of the 5-year development plans.
- iii. **Marginal Effective Tax Rates (METR) study:** Carry out a study aimed at understanding whether the revenue gains from a marginal tax increase would outweigh the potential loss of revenue.

*Efforts to improve monitoring of the country's mineral value chain from exploration to export need to be expanded.*

### **Improved tax administration ideas**

Four ideas for improving tax administration are as follows:

- i. **Provide a strategy to increase tax compliance:** The large payers unit in ZRA is already making good progress, so one of the core areas for attention for improving compliance relates to medium-size tax payers. Here the planned introduction of Electronic Fiscal Devices and wider use of electronic filing via the Tax-Online system is expected to yield results in 2017 and over the medium term. However, a clear strategy would help guide the use of resources, make comparisons between competing ideas to ensure the most cost-effective option is pursued, and might also motivate increased resources and staffing for revenue collection.
- ii. **Scaling up taxpayer-focused public education campaigns:** While the ZRA is making an effort to improve taxpayer education, taxation remains complicated and insufficiently understood in Zambia. Communication is very important when it comes to tax systems and can be a key driver of improving compliance. To encourage citizens to pay taxes there needs to be better understanding, and a sense of trust that public resources are being used effectively. Government can partner with civil society organizations in these campaigns.



- iii. **Design and build an effective system for property tax:** It is not enough to simply target increased revenue in this area; efforts are needed to build a system. For example, much work is needed related to land titling and valuation. A good starting point is to review how other countries have progressed.
- v. **Improving transparency in reporting mineral revenue:** Efforts to improve monitoring of the country's mineral value chain from exploration to export need to be expanded. This will ensure that at the given rates, Zambia collects the revenues it is due.

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