

**Caritas Zambia, Civil Society for Poverty Reduction (CSPR) and Jesuit Centre for Theological Reflection (JCTR)**

**Submission to the Estimate Committee on**

**‘The budget process in Zambia and the impact of the current European Union (EU) debt crisis on budget support to Zambia’**

**30<sup>th</sup> December 2011**

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## **1.0 Introduction**

This submission will first start with the budget process in Zambia and its challenges, which will then be followed by impact of the current European Union debt crisis on budget support in Zambia.

Parliament’s involvement in the budget process through authorisation is another imperative avenue that can help in directing public resources to the right sectors. This is the more reason why it (budget process) should be strengthened and must be a process that involves consultation, dialogue and considerations of option and submissions from various stakeholders. Tilting the powers to Parliament to offer constructive criticism on the budget and be able to make amends to the budget will help in directing the resources to the priority areas and reduce the urban and rural divide. Parliament oversight will also help in avoiding resources being misallocated.

## **2.0 challenges of Zambian budget process**

### **2.1 DRAFTING PHASE**

Article 117(1) of the Zambian Constitution stipulates that *‘The minister responsible for finance shall cause to be prepared and shall lay before the National Assembly within three months after the commencement of each financial year estimates of revenue and expenditure of the Republic for the financial year’*

- i. The Ministry of Finance is given the responsibility of drafting the budget i.e. macroeconomics forecast, fiscal framework planning, coordination of budget revenues forecast, tax policies and forecast of new revenues /taxation measures, division of revenue and managing the budget process. However this acts as a major challenge in itself as too much authority is given to the Ministry of Finance to carry out these functions without adequate check and balances leaving out space for non transparent budget decisions and leading to inadequate consultations with other stakeholders within and outside government. For instance the Medium Term Expenditure Framework has not been subjected to debate and public consultation in the last three years except in the Macroeconomic Sector Advisory Group. Stasavaga and Moyo (2000) also argue that line ministries have been ignored, as they are largely marginalized yet line ministries are also more likely than central ministries to have accurate information about the potential benefits of different spending programs within their remit.
- ii. The Ministry of Finance once every year issues out a call circular (May/June), which calls for budget proposals. Unfortunately, this circular only goes to the sectors, parastatals, provincial administration and grant-aided institutions. Districts Councils are not

considered as part of central government hence they do not directly participate in the national budgeting planning and preparation process, thus people in the communities are not involved in the budget preparation and this is compounded by the delayed implementation of the Decentralisation Implementation Plan.

- iii. Linkages of the Medium Term Expenditure Framework (MTEF), National Development Plan and the national budget– there is still a disjoint in these documents making the planning and budgeting process a bit complex with regards to analysis and government policy forecast. This is also compounded by the fact that the MTEF and the NDP is not submitted and discussed (tabled) in parliament.

## **2.2 LEGISLATIVE STAGE**

The legislative arm of the government is responsible for scrutinising and approving the national budget proposals as provided for in the constitution and laws of Zambia. In doing this, it uses the Westminster model, which restricts the powers of the legislators to amend the government's budget. The model only allows, 'reductions only', where parliament may only reduce existing items (i.e. those items included in the budget proposed by the executive), but it may not include new ones or increase existing ones. This has contributed to some challenges that have been experienced in the legislative stage that include but not limited to;

- i. The model makes the Zambian Parliament's influence over the budget limited. In practice, it can only reject or accept the whole proposal. However, if Parliament rejects the proposal, it can be dissolved leading to new elections. These possibilities can act as deterrent to the willingness of Members of Parliament (MPs) to reject the budget proposal. This has often resulted in a scenario where budget drives policy rather than the ideal where policy should drive the national budget.
- ii. The relevant Parliamentary committees do not have enough time to analyze budget proposals before approving them. Parliament is not able to follow up on any budget recommendations mainly because of the tight budget calendar. The Budget committee's deliberate and get submissions while the budget is being discussed on the 'floor'. This makes the submission by stakeholders pointless and they are not considered.

There is also no time given between budget presentation and budget deliberation. There should be at least 4 weeks to enable MPs go through the budget and understand it and consult.

- iii. This is compounded by insufficient time allocated to research and committee discussion, thus the time allocated to parliamentary debate is skewed towards deliberations in the House as opposed to detailed committee investigation. The obstacles to effective legislature participation are also exacerbated by inadequate legislature research capacity.
- iv. Due to the disparity of numbers in parliament between the ruling party and the opposition, the contribution of the estimates committee do not carry any impact on the account of ruling party member's numbers. The fact that there are no secret ballots and the votes of each MP are registered, and pressure for party loyalty, this tends to weaken the oversight and budget-allocation functions of parliament.

- v. This is in addition to the Constitutional constraint issues and regulation. Specifically *Article 81 of the Constitution (National Assembly Standing Orders 80)*- Article 81 of the Constitution provides that Parliament cannot proceed upon any Bill (including an Amendment) which makes provision for the imposition of taxation or the alteration of taxation otherwise other than by reduction. This is also provided for under the Standing Orders 80(2) of the National Assembly. As a result, Parliament has no powers in curbing the excessive use of virements and amendments of the budget (that in principle does not increase the budget deficit).

### **2.3 IMPLEMENTATION STAGE**

The implementation of the budget is the responsibility of the entire government including the quasi government institutions. The Ministry of Finance and National Planning is responsible for disbursements of funds to spending entities. The other ministries are responsible for service delivery in line with their respective portfolios.

There are some challenges that have been identified in the implementation stage and these include but not limited to;

- i. When the budget is approved by parliament, line ministries are given the funds through the Ministry of Finance and national planning. However it has been noticed that there are alot of challenges in monitoring how the government ministries are expending the funds given to them in line with the proposed activities/programmes as there are no departmental minute meetings checking on budget performance, no disbursement reports, etc. Members of Parliament are only availed reports when the Auditor General office reports irregularities. These reports are however, outdated by two financial years. There are no current year financial reports hence making difficulty to make immediate correction on the current year by members of Parliament.
- ii. The Auditor General reports reveals abuse of office, irregularities, misappropriations and misapplication of funds. However, there are no report that are availed on the measures taken to correct the above and also no report is given on what has been done to the people found guilty or investigation done on the irregularities. As a result Members of Parliament cannot actively participate in finding lasting solutions to office abuse and irregularities in the public offices (CSPR, 2011).
- iii. There are also other documents that are not presented on time as such making linkages of the current budget under discussion with past budget performance, for instance;
  - *Annual budget document*-. There are no performance reviews of policies and budget in the previous budget. This has been exacerbated by the fact that the national budget is now read in October before the year ends. There are no analytical content and summaries, clear distinctions between recurrent costs and investments, and projected committed costs.
  - *Audit reports*. There still exist time lags time lag between actual expenditures and audits of expenditures of 2 years. This makes it difficult to make informed discussions of the proposed national budgets based on the audit reports of the previous years, as they are not ready when the current budget is being debated.

## ***2.4 Civil Society Involvement and Engagement***

Civil society is usually unclear as to what its role is how they should participate in the budgetary process. In addition, most organizations can only fulfill their roles to a limited extent, because of the lack of budget information and contextual information. In combination, these two factors constrain the quantity and quality of civil society interaction with the budget process and documents, and civil society to provide meaningful input. Information on the budget process is not regularly provided to the public. Information on actual spending in the previous budget year is not sufficiently timely to allow civil organizations to engage meaningfully with current estimates. There is inadequate information on the estimates themselves.

Civil society has historically been weak in the rural areas of Zambia. The district authorities have not fully accepted the role of civil society as watchdog and voice for the voiceless. Whereas very few civil society organisations in Zambia have a specific focus on public finance, we still find that there is considerable scope for 'budget work' in Zambia especially at district level. This absence of structural dialogue mechanisms is mostly felt at all levels; hence a confrontation approach to problem solving has developed in some districts like Lusaka, Ndola and Solwezi. The options for dialogue and decision-making for civil society are relatively limited. There are no regular fora in which civil society can interact in the budget making process at district levels.

The study (Caritas Zambia, 2006) indicates that in the rural councils, there is poor attendance of DDCC meetings especially budget meetings when estimates were the item of the agenda. This has been attributed to non-inclusive and non-participatory budget meetings; selective invitation to budget meetings; limited accessibility to budget information; lack of clear legal framework on participation; lack of public forum for consultations and technicality of budget language. In general the budget process in Zambia can be said to have adopted top-down approach as opposed to a bottom-up approach.

## **3.0 Specific issue that need to be addressed**

Strengthening the powers to Parliament is needed so that some of the above challenges are addressed and so that they can also offer constructive criticism on the budget and be able to make amendments to the budget which will help the country move with regards to resolving poverty and underdevelopment. The strengthening of parliament in the budget process can be done through constitutional changes and/or having in place, *a budget Act (italic is emphasis)*.

Parliamentarians have key roles to play in national processes and systems of planning, allocation, budgeting, anti-corruption, and audit, among others. These processes influence the effectiveness and impact of *all* development resources weather domestic or foreign resources. Parliamentarians' active contribution to resource allocation can make the strongest role to reducing poverty and achieving the MDGs. This is why we argue that if parliamentarians participate in the budget process through having powers to make meaningful adjustment to the budget, it will help in allocating adequate resources to needy areas and the social sector especially. There is need for the Executive to open up in the budget process through having an *organic budget law that promotes members of parliament to have powers to make amendments to the budget*. Similarly, parliament should be empowered to establish vibrant committees with the requisite technical capacity as oversight mechanisms.

The continuing constitutional and institutional obstacles to amendment of the budget process constrain involvement in the budget process in two ways:

- 1) The perception is created that Parliament role in the budget process in effect is still performing a rubber stamp role.

Parliament matters pertaining to budget processing are governed by Standing Orders especially Standing Order Number 80 of National Assembly and Article 81 of the Constitution which restricts changes being made to the budgeted figures and this provision in the Standing Orders has been a major stumbling block to enhanced budget approval process since Members of Parliament (MPs) are reduced to mere rubber stamps because they cannot change anything. This has become a fiction as the parliamentarian's just sign on the dotted line, essentially by approving huge sums of resources to be spent by the Executive without having time to scrutinise the details. And even if they did – scrutinise- they cannot make any major change to them.

- 2) CSOs do not have easy access to the Executive or Judiciary as alternative means to influence the budget. The Legislature (*Members of Parliament*) is the most available avenue for intervention; but without amendment powers, even this presents only a very weak option for influence. This ends up In the models above, the International Monetary fund (2001) Manual on Fiscal Transparency suggest that parliament's ability to significantly change the Budget is maximized when:

- Existence of a budget Act that guides the budgeting process from drafting to Auditing
- Parliament does have some power of amendment,
- Committees have the right to suggest amendments to the House,
- There is sufficient committee time for Budget scrutiny,
- Ability to coordinate and get input from Civil society and other stakeholders
- Committees involved have access to sufficient independent research capacity and
- Committees involved have access to detailed, timely departmental information.

In the Zambian case, Parliament has strong committees but parliament have powers to only reduce the budget within a particular 'subhead'. This is mainly due to the constitutional provisions and the standing Orders of Parliament.

Article 81 of the Constitution (National Assembly Standing Orders 80)- Article 81 of the Constitution provides that Parliament cannot proceed upon any Bill (including an Amendment) which makes provision for the imposition of taxation or the alteration of taxation otherwise other than by reduction. This is also provided for under the Standing Orders 80(2) of the National Assembly. Although these provisions are not provided for under the Finance Act, going forward, there is need to ensure that the law gives enough leverage to Parliament to make meaningful amendment to the budget.

### **3.1 Specific budget regulatory content that need to be included in the constitution or Budget Act to strengthen parliament**

Government needs to enact a Budget law as stated in the current constitution and conversely, address matters pertaining to budget processing which are governed by standing orders and the provision of the constitution. The Budget Act will provide an important pedestal for the country development

process and ensuring the participation of all stakeholders in the decisions of the budget vis-a-vis the amounts to allocate to a sector, community, institutions, constituency, province, etc.

### **3.2 Proposal strengthening parliament on the National Budget**

#### **3.2.1 Recommendations on the Budget Amendments by Parliament**

Parliament must pass, with or without amendments, or reject the Appropriation bill (proposed budget) before the start of the financial year to which relates;

The standing rules must provide that;

- a) The committee on appropriation to hold public hearing on the Appropriation Bill and proposed amendments
- b) The committee on appropriation to report to the House on the comments on and amendments to the bill;
- c) Other committees to consult with the Committee on Appropriations in respect of the proposed amendments to transfer payments, recurrent and capital expenditure of a vote, or a main division within a vote, taking into consideration any report adopted by the House;
- d) Other committees to consult with the Committee on Appropriation in respect of proposed conditional appropriation;
- e) The committee on appropriation to mediate between the committees proposing conflicting amendments to the Appropriation Bill; and
- f) The committee on Appropriation to recommend to the House the proposed amendments reported by other committees are rejected where those amendments are inconsistent with the fiscal framework, the adopted Division of revenue or not motivated adequately in terms of this section.

The minister and other members of the Cabinet affected by the proposed amendments must be given at least 10 days to respond to any amendments proposed to the Appropriation Bill by the Committee on Appropriation prior to reporting to the House

A report of the committee of Appropriation to the House that proposes amendments to the main appropriation Bill must, in respect of each amendment-

- a) Indicate the reason of the amendments,
- b) Demonstrate how the amendment takes into account the broad strategic priorities and allocations if the relevant budget And allocations to the relevant budget;
- c. Demonstrate the implications of each proposed amendment of an affected vote and the main division within that vote;
- d. Demonstrate the impact of any proposed amendment on the balance between transfer payment, capital and recurrent spending in affected vote;
- e. Set out the impact of any proposed amendments on service delivery; and
- f. Set out the manner in which the amendments relates to the prevailing departmental strategic plan, reports of the Auditor General, committee reports adopted by a House, reports on Finance, annual reports and any other information submitted to a House or Committee in terms of the standing rules or on request.

#### **3.2.2 Recommendation on Supplementary expenditures**

- i. The Minister, when introducing a supplementary appropriation Bill, should present to the National Assembly the reasons for the proposed variations and provide a supplementary document describing the impact that the variations, if approved, will have on the financial plan outlined in the annual budget.
- ii. The Minister shall not, in any fiscal year, introduce more than five supplementary appropriation Bills, except in circumstances of grave national emergency, where the Minister may introduce a Bill, entitled an Emergency Appropriation Bill, to meet the situation.
- iii. The Minister shall present to the National Assembly within sixty days after the end of the first half-year of each fiscal year a report on the year-to-date execution of the annual budget and the prospects for the remainder of that fiscal year.

### **3.1.3 Recommendation to be included in Budget Act: Reports on loan and grant**

The president shall, either at the time of presentation of the budget or at any time before 3 months in each financial year, cause to be presented to parliament information relating to total indebtedness of the state in that financial year showing inter alia-

- a) The total principle and the source of the loans and debt
- b) The accumulated interest on each loan and debt
- c) Provision made for servicing or repayment of each loan and debt
- d) The balance of payment under (c) and;
- e) The utilisation and performance of each loan or debt including the extent of the achievement of the objective targets of each loan

### **3.2.4 Recommendation of documentation and mid-year report**

- i. An update report on the current macroeconomic and fiscal situation
- ii. A comparison report on the out-turned current and capital expenditures and revenues with the estimates originally approved by the National Assembly with explanations of any significant variances; and
- iii. A list of major fiscal risks for the remainder of the fiscal year, together with likely policy responses that the Government proposes to take to meet the expected circumstances.
- iv. Parliament to annually organise the observance of a “Parliamentary Week”, at the mid-point of budget implementation, as part a more transparent public monitoring process;

## **4.0 Conclusion**

The budget process in Zambia is significantly an exclusive activity of the treasury of the Ministry of Finance and National Planning. Members of Parliament as representatives of the people have had no visible role in the formulation, implementation and audit of the budgetary processes before and since independence. Even Parliament’s legislative involvement in the budgetary processes has been and remains only a formality and ritualistic process. This can be changed. Members of Parliament and policy makers need to speak and act on behalf of their constituencies – this can be done through changing the power relations in the most important policy instrument – the National Budget. Parliament needs to have power to change the budget figures/allocations to reflect the community needs in their constituencies. They must ensure openness and inclusiveness of the National Budget by enhancing and strengthen legislation that would allow them to do so as identified above.

## B. The Impact of the current European Union (EU) Debt Crisis on Budget Support to Zambia

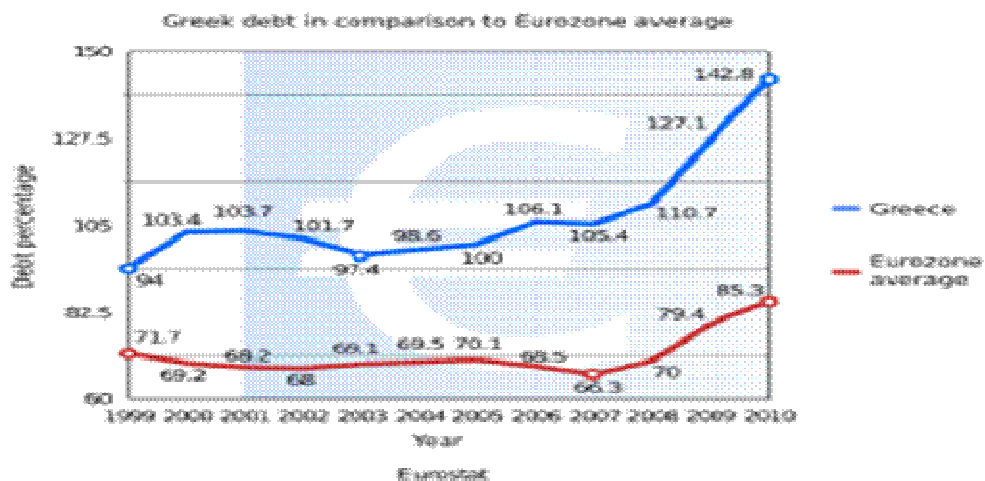
### 1.0 The Background to the Euro Zone Debt Crisis

The European Union (EU) is an economic and political union of 27 member states located in Europe. The EU traces its origin from the European Coal and Steel Community (ECSC) and European Economic Community (EEC) formed in 1958 by 6 European countries – France, West Germany, Italy, Denmark, Luxemburg and Belgium. Over the years, the union has undergone several changes and has grown by the accession of new members to its current 27 membership. In 2002, a common currency called Euro was introduced among 17 EU member countries which formed the Euro Zone under the Maastricht treaty. To join the currency union, member states have to meet the terms of the treaty in terms of *budget deficits, inflation, interest rates* and other monetary requirements.

The cause of the European debt crisis, in its simplest form, has been mainly *overspending by the Southern European Governments* commonly referred to as the PIIGS – Portugal, Ireland, Italy, Greece and Spain during the last decade and especially after the 2008 financial crisis. The European Central bank enabled low risk premiums on interest rates of government debt of the PIIGS countries which encouraged high risk lending and borrowing practices and subsequently encouraged overspending. Low interest rates were also encouraged by increased savings from high growth developing nations which sought high yielding investments in developed nations between 2002 and 2007. Other factors that have been responsible for the European debt crisis include, *international trade imbalances* (trade deficits), *slow growth economic conditions, fiscal policy choices relating to government revenues and expenses and approaches used to bail out private banks of socializing private losses or assuming private debt burdens.*

The crisis initially started with Greece in December 2009. The EU discovered that Greece was burdened with debt amounting to 113% of its GDP, nearly double the euro zone limit of 60%. The debt level has since increased to over 140% of its GDP (Figure 1). The budget deficit in the same year also was found to be 12.7%, more than four times the maximum allowed by the EU rules of 3%. The high government debt situation has been worsened by the country's lack of competitiveness which has made it difficult for government to generate sufficient funds to finance its debt without external aid.

Figure 1: Greek Debt in Comparison with Euro zone Average Debt



Source: Eurostat

Other PIIGS countries have equally been found to be highly indebted beyond the Euro zone thresholds (figure 2). Ireland has already received IMF bailout package and Italy and Spain are in line for a bail out from the EU. The inflexibility of the monetary policy on individual EU member countries as they are unable to conduct their own monetary policy has not made matters easier. The EU countries cannot devalue their currency relative to their trading partners to make their exports cheaper thereby increasing GDP and tax revenue while reducing trade deficit.

**Figure 2: Debt Levels in the PIIG Countries**

<b>Debt Levels in the PIIGS (2010)</b>				
	Public sector {% of GDP}	External sector {% of GDP}	Non-financial corporations {% of GDP}	Household debt {% of GDI}
Greece	142.8	183.8	71.5	84.8*
Ireland	96.2	1,093.5	283.7	211.3**
Spain	60.6	162.7	197.9	125.3
Portugal	93.0	229.3	147.3	133.7
Italy	119.0	116.9	116.1	71.6

Notes: GDI = Gross Disposable Income; \* data for 2008; \*\* data for 2009.  
Sources: Eurostat; D&B

**Source:** D & B Special Report, July 2011

The high sovereign debt levels in the PIIGS countries have led to loss of confidence by investors thereby heightening international financial investors' fears of a sovereign default as some of the debts are externally owed. The interconnection in the global financial system means that if one nation defaults on its sovereign debt or enters into recession that places some of the external private debt at risk, the banking systems of creditor nations face losses. Because of the risk of default, Credit ratings agencies subsequently downgraded Greek bank and government debt to below investment grade status which intensified the debt crisis. The downgrade further increased borrowing costs for the government. Unable to access funds at sustainable interest rates in financial markets, Greece requested for support from the EU and IMF which generated a three year rescue package worth EUR110 billion in May 2010. The rescue package was accompanied by austerity measures such as increased tax rates, reduced public expenditure and increased retirement age which have led to social unrest. Other PIIGS countries too received bailout packages like Portugal and Ireland. Portugal secured a EUR 78 billion bailout package from the EU as emergency external funding was needed to meet the costs of redeeming and refinancing Portugal's external obligation.

The systemic debt crisis in Europe has destabilized financial markets in Europe on the back of financial investor's fears that several euro-zone countries would face severe difficulties in financing their large budget deficits and growing public debt burdens. This has led to fears of contagion of the debt crisis not only to European countries but to countries outside Europe including Africa.

## **2.0 The Impact of the Euro Zone Debt Crisis on EU Budget Support to Zambia**

The Euro Zone debt crisis sparked by the Greek debt crisis has adverse implications to the Zambian economy in general and the government's fiscal position in particular due to strong economic links

between the EU and Zambia. The extent of the adverse implications of the debt crisis however, depends on the degree of trade and financial linkages.

- **Reduction in Aid Flows**

The European debt crisis has seen a number of European countries implement austerity measures that have included budget cuts. Budget cuts have resulted in a number of European countries cut or plan to cut back aid flows to developing countries including Zambia. For instance, UK has announced cuts in state spending of Pounds 83 billion between 2014 and 2015. Germany and France also plan to trim Euro 81.6 billion and Euro 45 billion in public spending between 2011 and 2014 respectively<sup>1</sup>. These measures will adversely affect Africa, given the continent's relatively high dependence on the EU for ODA. In 2010 alone, the EU in combination with its 27 member states spent Euros 53.8 billion on ODA, making it the largest aid donor in the world. EU is also the largest donor in Zambia, disbursing 14% of the total aid received between 2006 and 2009.<sup>2</sup> The impact on budget support might however be neutralized by UK's promise (the third largest donor to Zambia) to increase aid to Zambia by 15% between 2011 and 2014.<sup>3</sup> Decline in aid might therefore not be a serious problem in the short run. The country has however already experienced a reduction in aid flow leading to increased external financing to fill the fiscal gap. The 2011 budget for example projects a decline in foreign aid at 7% of the total budget compared with 14% in 2010 (2011 and 2012 budgets).

A contraction in ODA from European countries could therefore pose tough challenges to Zambia in managing public finance, especially in mobilizing resources for expanding infrastructure investments and strengthening social protection. The situation could be worsened if tax revenues substantially decrease alongside declines in export volumes of both traditional and non traditional exports.

- **Reduction of Tax Revenue**

The debt crisis in Euro Zone countries may also indirectly reduce tax revenues of countries that export to the Euro Zone. The slowdown in economic growth has implied lower demand for imports. Reduced exports of countries such as Zambia that exports to Europe means reduced government revenue through trade and other taxes. This could make it difficult for Zambia to maintain the planned levels of public expenditures including long term infrastructure investment. However, the low level of fiscal deficit of Zambia and the sustainable debt levels are likely to make the country less vulnerable. The limited trade exposure that Zambia has with Europe whose export to the EU accounts for less than 20% (figure 3) of total export earnings may also make the adverse effects less severe.

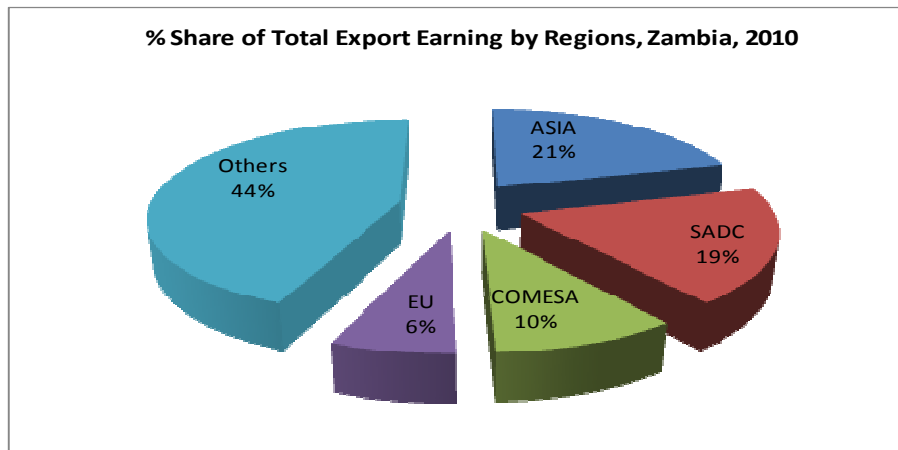
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<sup>1</sup> Overseas Development Institute: The euro zone crisis; risks for developing countries

<sup>2</sup> Development Cooperation Report 2009

<sup>3</sup> <http://www.lusakatimes.com/2011/03/02/uk-increase-aid-funding-zambia/>

**Figure 3:**



Source: Own working based on Central Statistical Office Statistics

#### **Other likely effects of the Euro Debt Crisis**

- **Increased cost of borrowing**

In order to insure investment against high risks of default that have arisen with the occurrence of debt crisis in Europe, investors will demand higher interest rates. Therefore, emerging economies such as Zambia that are about to issue their sovereign bonds are likely to borrow at higher interest rate due to heightened risk averseness and unwillingness to invest.

- **Reduced inflow of private investment both Foreign Direct Investment and Portfolio Investment**

The effects of European debt crisis could also be transmitted through foreign direct investment and short term portfolio investment. If European banks which are the major players in the project finance such as the mines face liquidity shortage and start reducing their exposure to emerging countries, Zambia will be affected. Zambia's economic growth in the recent past has been propelled by foreign investment and any disruption to the flow of investment will have telling effects on the economy.

- **Reduced Remittances**

While statistics about remittances to Zambia are not readily available, it is a fact that a lot of Zambians are living in the Diaspora who remit substantial amounts of financial resources to their relatives. The Debt crisis has resulted in economic recession in most countries and massive layoffs especially of unskilled labour. This will significantly reduce the flow of remittances,

#### **Macroeconomic effects**

- **Depreciation of the currency**

Reduced trade as a result of the crisis will reduce foreign currency flows to Zambia thereby put more pressure on the local currency. The debt crisis has also forced a lot of investors who are risk averse to demand more US dollar based assets in the international market thereby putting pressure on the local currency.

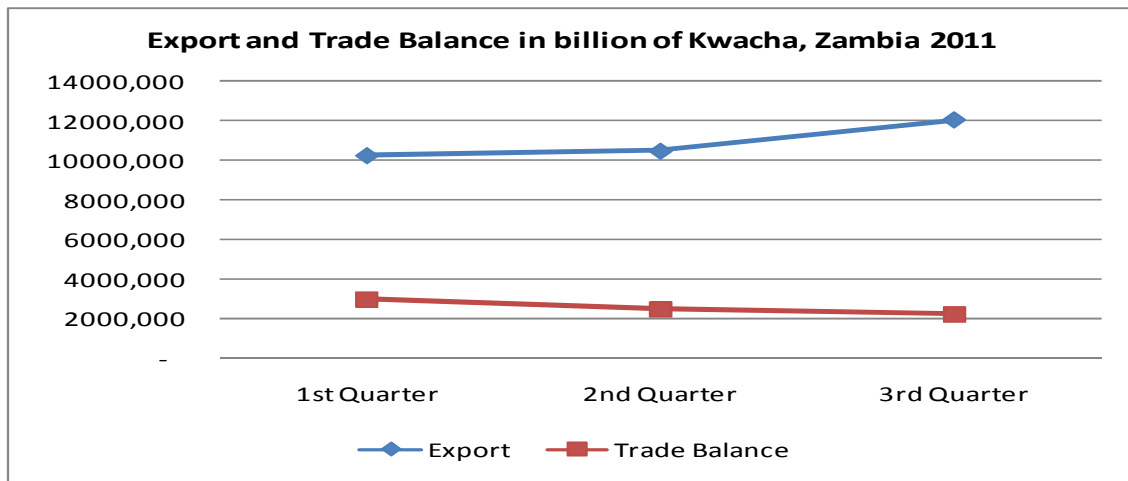
- **Inflation**

The depreciation in the local currency will may translate into increased cost of doing business and ultimately increased inflation

- **Trade deficit**

Depreciation in the local currency implies that the cost of imports will increase thereby result in a trade deficit and thus may cause balance of payment problems. The trade balance however is still positive. Statistics from the first three quarters of 2011 shows that export volumes actually increased during the period. The trade balance has however shown some marginal decline.

**Figure 4**



Source: Own working based on Central Statistical Office Statistics

### 3.0 Effectiveness of EU Assistance and any External Assistance to Zambia

Zambia has had a good relationship with its cooperating partners and its relationship has evolved over the last twenty years during which Zambia has received significant amount of development assistance, receiving almost US \$3 million between 2006 and 2009<sup>4</sup>. Aid disbursement does not automatically translate into tangible development. It must be efficiently managed by the recipient country and directed at projects with significant development outcome such as poverty reduction projects if aid can be said to be effective.

Zambia receives aid from both bilateral and multilateral donors. European Union is the largest donor to Zambia followed by the United States, United Kingdom and then the United Nations comprised of United Nations Agencies. Of the almost US \$3 million that the Zambian government received between 2006 and 2009 in foreign financing, 14.3% came from the EU. The United States, United Kingdom and the United Nations each contributed 10.7%, 9.0% and 8.9% respectively (Ibid)<sup>5</sup>. The

<sup>4</sup> Development Cooperation Report 2009

<sup>5</sup> Ibid

balance is contributed by other cooperating partners. It is important to note that over the four years period; more than 50% of total disbursements were for projects, including both grants and loans. Budget support accounted for 26% of total assistance over the period. Budget support declined slightly in 2009, largely because Sweden decided to halt general budget support and the suspension of EU sector budget support to roads following governance concerns in the health and the roads sector. Realising the need for aid effectiveness, the Zambian government and donors have come together to coordinate aid activities to enhance its effectiveness.

### **Donor Coordination Efforts**

Following the Paris Declaration on Aid Effectiveness in 2005 which called for principles of aid effectiveness: harmonization, ownership, alignment, mutual accountability and managing for results; commitments were put in place to make aid more effective and realize Millennium Development Goals.

- **Sector Advisory Groups** – donor coordination included the setting up of Sector Advisory Groups (SAGs) by government in 2003. Membership comprises various stakeholders including cooperating partners and Civil Society Organizations. SAGs are meant to serve as the main forum for policy discussion and implementation and monitoring of development cooperation and programmes between government, CSO, the private sector and cooperating partners. The Ministry of Finance reports that Cooperating Partners' involvement in SAGs has proved to be a useful mechanism for coordinating external assistance.
- **Zambia Aid Policy and Strategy** – following the signing of the Paris Declaration in 2005, the Zambian government developed and launched the aid policy and strategy in 2007. The main objective of the strategy is to ensure that a clear, systematic and coordinated approach for soliciting and managing aid is maintained. It sets out the principles on which interaction between Government and its Cooperating Partners is based which include the following:
  - Country ownership – aid shall be delivered, managed, monitored and reported through the existing public sector management system
  - Simplification of processes and procedures
  - Grants as the preferred mode of assistance
  - Encouragement of partners to progressively move towards budget support
  - Promotion of strong partnerships with non state actors
- **Joint Assistance Strategy for Zambia** – the Joint Assistance Strategy for Zambia (JASZ) is a cooperating partners' response to the Zambian Government's Aid Policy and Strategy. It is also the strategy for implementing the commitments of the Paris Declaration by the Cooperating Partners. Its objectives include:
  - Establish a shared vision and guiding principles for cooperating partners' support of the development strategy of the Zambian government (Fifth National Development Plan)
  - Deepen the results focus of assistance programmes
  - Simplify aid management and improve predictability
  - Reduce transaction costs for Government

- **Millennium Development Goals Contract (MDG)** – The MDG Contract is an enhanced form of budget support designed to be measured against indicators linked to education, health and other MDGs aimed at tackling poverty. Cooperating partners disburse aid towards the achievement of Millennium development goals. This has made it easy for both partner country and cooperating partners to measure results. It has been observed that the proportion of HIV pregnant women receiving antiretroviral treatment increased from 40% in 2007 to 66% in 2009 under the MDG contract (Development Cooperation Report, 2010). Therefore the use of MDG contracts to firmly link funding with anti-poverty goals is clearly a major step forward in enhancing aid effectiveness.
- **Poverty Reduction Budget Support (PRBS)** - In 2005, the Government of the Zambia and a group of bilateral and multilateral Cooperating Partners signed a Memorandum of Understanding for the provision of direct budgetary support. The MoU sets out basic arrangements underlying budget support and clarifies the responsibilities of all parties. According to the minutes of the review meeting held by Ministry of Finance and National Planning, Cooperating Partners and Civil Society Organization held on 24<sup>th</sup> May 2011, government had made some improvement in the use of budget support recording 62% in 2010 from 58% in 2009<sup>6</sup>. However, concerns were raised regarding high levels of poverty, especially in rural areas and high prevalence of corruption. Sweden and Denmark<sup>7</sup> eventually pulled out of the Poverty Reduction Budget Support Group.

From the foregoing, it can be noted that a lot of efforts have been put in place by both Zambia and cooperating partners to enhance the effectiveness of aid. Cooperating partners have for example increased aid disbursement through budget support to give government space in prioritizing projects to fund and thereby enhance its effectiveness. As share of total aid disbursement to Zambia between 2006 and 2009, budget support consisted 26%, only second to project support at 52% (Development Cooperation, 2010). Government however should do more to ensure that aid resources are used prudently and efficiently. In 2009, Sweden withheld budget support and the EU also suspended sector budget support to the roads sector following governance concerns in the health and roads sectors. There is need to arrest corrupt practices by public officers in the use of aid and general public resources in order to enhance its effectiveness through donor confidence in country systems.

#### **4.0 Challenges of Domestic Resource Mobilization**

Domestic resource mobilization refers to the generation of savings from domestic resources and their allocation to economically and socially productive investments. Domestic resource mobilization can either be public or private. The private side concerns private domestic savings, which the financial sector channels towards investment. Public resource mobilization on the other hand is about public savings which is the excess of public revenues on the current government expenditure (tax and non tax revenue less government recurrent expenditure). This is what is available for government to fund public investment such as roads, schools, health facilities etc.

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<sup>6</sup> Agreed minutes of the first joint poverty reduction budget support review 2011

<sup>7</sup> The Poverty Reduction Budget Support Group now comprise Germany, United Kingdom, Norway, Finland, The European Union, the World Bank and the African Development Bank

It is important to note that foreign financing has serious limitations such as unpredictability and unsustainability and therefore should not be relied upon as the main source of development financing. The reduced flow of external financing due to the recent global financial crisis and the ongoing Euro Zone debt crisis is enough evidence of its limitations and thus the need to consolidate domestic resource mobilization.

### **Limitations:**

#### **Private savings:**

Theoretical literature asserts a positive relationship between the level of private savings and the level of economic growth of a country. The strong economic growth in East Asia is always used as a classical example of the evidence of a positive relationship between the level of savings and economic growth. Between 1960 and 2000, the average savings rate in the East Asian countries was 25% while that of Latin America was 14%. Over the same period, the East Asian countries experienced high growth rates while Latin America lagged behind (Aghion et. al., 2009). UNCTAD (2007) also reports that Sub-Saharan Africa has the lowest savings rate in the developing world. Gross domestic savings in the region is said to have averaged about 18 per cent of gross domestic product (GDP) in 2005, compared with 26 per cent in South Asia and nearly 43 per cent in East Asia and Pacific countries. The low savings rate for Southern African partly explains its low levels of development.

This implies that if Zambia has to develop, there must be sustained economic growth which may be sustained by an increased savings rate. However the key problem in Zambia is that only a small portion of the population has access to the saving facilities. Melzer (2007) found that only 14% of Zambians save with banks. Lack of banking facilities is largely responsible for the low level of saving particularly in rural areas but high cost of opening and maintaining bank accounts is also another hindrance. It has been banks practices in Zambia to annually revise bank charges upwards even when inflation has stabilized. This practice should be discouraged as it hinders a lot of people from saving.

### ***Public Domestic Resource Mobilization***

#### **i. Taxation**

Primarily, a country's tax system must provide sufficient funds for government expenditure programmes. Taxes are the most important source of government revenue in modern economies. It is at the heart of the social contract between a state and its citizens who in return of paying tax are provided with security, infrastructure and social services.

While tax contribution to the budget has shown some improvement from about 50 per cent in 2001 to about 70 per cent in 2010, tax revenues are still insufficient to finance the national budget. The following have been some of the challenges to effective domestic resource mobilization through taxation:

- **Large informal sector** – following the liberalization of the economy in 1991, a lot of companies closed down and most people found themselves in the informal sector. Of the 5,000, 000 labor force in Zambia, 90% is said to be in the informal sector whose tax contribution is negligible. While a lot of economic activities go on in the informal sector, effective taxation of the sector is difficult. Only 2% of the total tax revenue comes from the informal sector even though the majority of the labor force is in the informal sector. Zambia Revenue Authority does not have the capacity to capture all the economic activities going on

in the informal sector. The low contribution of tax revenue by the informal sector has contributed to the poor performance of tax revenue as a resource mobilization mechanism.

- **Numerous tax incentives** – the Zambian government gives out a lot of tax incentives especially in the mining sector. Tax revenue is foregone through these tax incentives and therefore should be well managed.
- **Lack of autonomy of Zambia Revenue Authority** – it has been realized world over that an autonomous revenue agency is a recipe for effective revenue mobilization. Zambia started well with the establishment of Zambia Revenue Authority and tax revenues increased soon after the establishment of Zambia Revenue Authority in 1994. The establishment of Zambian Revenue Authority was accompanied by increased financing of the authority. However, government funding to the agency of late has been erratic and government interference in the operations of the institution has hindered its performance.
- **Tax Avoidance and Evasion** – government loses a lot of tax revenue through such practices which is a very common practice particularly in cross boarder trading. Media reports states that tax revenues from Chirundu Boarder post has increased by more than 100% after the establishment of one boarder post and the introduction of ZRA scanners as it has curbed smuggling.<sup>8</sup> There has been reports of tax avoidance even in the mining sector

## **5.0 Recommendations to improve Domestic Resource Mobilization**

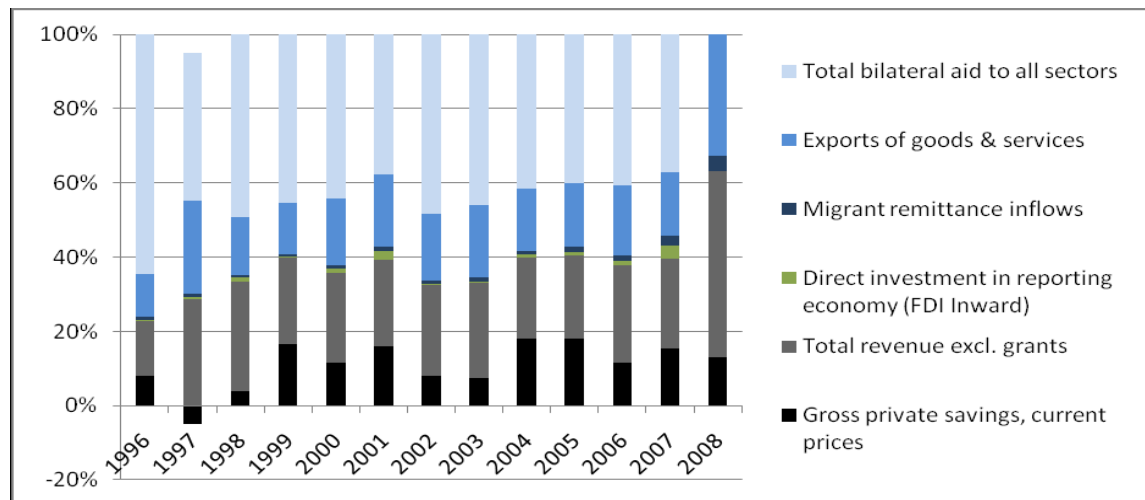
### **i. Institutional Reforms**

To respond to the demand of increased revenue collection, most countries have created independent revenue collection agencies to collect tax revenues on behalf of government. These agencies have been delinked from the larger civil service and made autonomous in their revenue collection responsibilities. A number of countries in Southern Africa such as Rwanda, Kenya, South Africa, Zimbabwe and Mozambique have established independent revenue agencies and tax revenue collection has responded well. As at 2008, tax revenue contribution to the Rwandan budget increased to almost 60% from about 30% ten years earlier as shown below (AfDBG, 2010). The increase is largely due to the establishment of an independent revenue agency.

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<sup>8</sup> The post newspaper of Tuesday 3<sup>rd</sup> January 2011

Figure 2: Trends in Rwanda's overall development financing mix (1996 to 2008)



Source: African Development Bank Group, 2010

A number of Country case studies done on a number of African countries by African Development Bank on Domestic Resource Mobilization reveals the important role that independent revenue agencies play in domestic resource mobilization. An autonomous revenue agency determines to a great extent how effective the tax policy in place will be implemented. A good tax policy or system with weak administration may not yield desired levels of revenues.

Secondly, creation of autonomous revenue agencies has been accompanied with major developments in tax policies such as Value Added Tax (VAT) that replaced sales tax, and informal sector taxes meant to broaden the tax base and building administrative capacity. For these tax policies to reflect broader national development objectives and priorities, they are formulated through a wide consultative process that involves non state actors and the wide community at large.

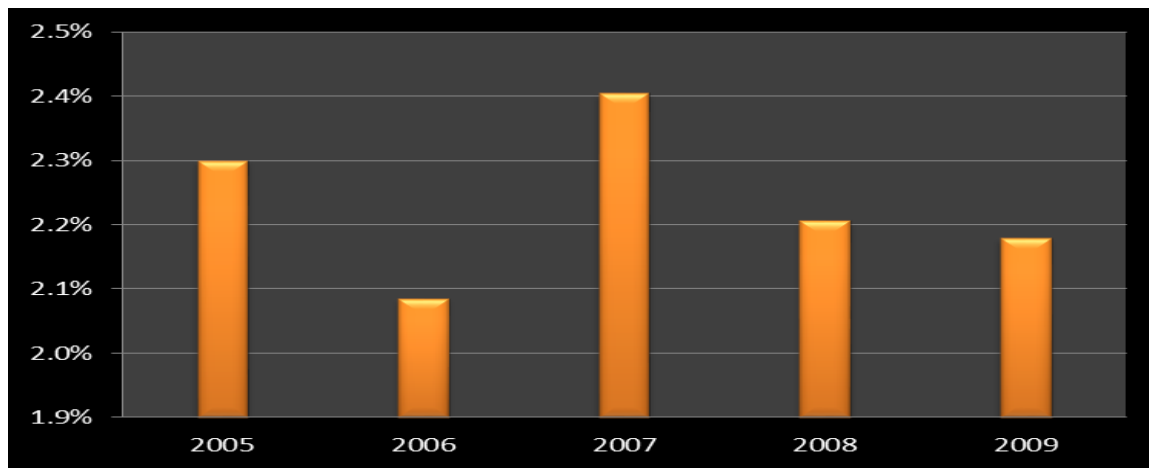
Governments have also improved financing of these revenue agencies to make them financially independent. For the Rwandan government, it has allowed its revenue agency to retain a 3 to 3.5% of its total revenue collection to meet its administrative costs.

Appreciating the concept of having an autonomous revenue agency, Zambia established Zambia Revenue Authority during its sweeping tax reforms in the early 1990s. The government further introduced new taxes such as VAT and other taxes targeted at the informal sector. These institutional reforms resulted in increased tax revenues raising the tax to GDP ratio to about 19% in 2000. The ratio however declined to about 15% in 2009, raising concerns about lack of administrative capacity of ZRA to collect tax.

There is urgent need for the Zambian government to consolidate tax reforms to make ZRA more autonomous, geared at broadening tax base, rationalizing taxes to improve the investment climate, enhancing compliance and improving other aspects of tax revenue administration such as technical capacity particularly in the area of tax investigation, internal audit and compliance which is currently lacking. Key changes to tax policy in most countries have revolved around pursuit of equity, further widening the tax base and promoting increased investment.

Government should further increase funding to ZRA, guarantee the institution's independence and address the need to maintain incentives for staff within the Agency to raise their commitment and discourage them from indulging in corrupt practices which could undermine revenue generation. Government's funding of ZRA in the last few years has been erratic compared to when ZRA was just formed. The initial arrangement was similar to that of Rwanda where the ZRA was allowed to keep 3% of the tax revenue collected. But since this arrangement was abandoned; government's funding of the institution has not been consistent and has adversely affected the performance of the agency. It is important for government to revisit the funding arrangement of ZRA.

**Figure 3: Government funding as a ratio of revenue collection, 2005 to 2009**



Source: JCTR Tax Study Report (2010)

## ii) Fiscal Decentralization and Local Tax Mobilization

Local government revenues are a major source of revenue even though they are underutilized by most governments in developing countries. The importance of local government revenues to some extent depends on the local government functions. Local government revenue plays a more important role in Local governments that have exclusively been assigned traditional municipal functions such as South Africa and Kenya. On the other hand, local governments that only provide basic municipal functions such as those in Zambia are much more dependent on government transfers/ grants than on locally mobilized resources and thus do not fully utilize local government revenues.

It should however be noted that local governments are better placed to collect certain taxes than central government such as informal sector taxes. The Zambian government should therefore speed up the process of fiscal decentralization that will empower local authorities to collect certain taxes beyond the levies they are currently collecting to make them financially sustainable.

Local government revenue mobilization however, has its own challenges which need to be addressed before fiscal decentralization can bear fruits. These include inadequate local government tax enforcement mechanisms and political interference. Markets and bus stations which are the major sources of local government levies for example are partly controlled by cadres of the ruling party there by limiting the amount of levies that local government can collect. Media reports suggest that

Lusaka City Council will be collecting about K900 million per month after the removal of cadres from Intercity Bus Terminus.

### **iii) Reducing the size of the informal sector economy**

The size of the informal economy<sup>9</sup> varies widely. The informal economy poses a challenge to effective tax revenue mobilization. Transactions are usually concealed from tax authorities or sometimes only partly concealed and may be reported at lower than true values so as to reduce rather than entirely eliminate taxes. Shadow economy therefore acts as a conduit of tax evasion and avoidance.

While the correct size of the informal sector in Zambia is not known, it is widely acknowledged that a large size of Zambian labor force is involved in economic activities in the informal sector. With only around five hundred people of the around five million labor force involved in formal employment, it is estimated that over four million people (over 80 percent of the labor force) is involved in the informal sector.

There is urgent need to formulate appropriate policies and effective administration measures that will maximize the revenue risks posed by the informal sector economy, including formalizing the sector. Factors that hinder formalization of the economy include the overall tax levels and the effectiveness of the tax administration. The World Bank Doing Business 2010 report shows that the cost of doing business processes such as registration and paying tax is significantly higher in developing countries than in OECD countries (IMF 2010). While Zambia has improved on this score, currently standing at number 76 out 183 countries, it can do better (World Bank 2011).

At the administration level, the large number of participants in the informal sector poses logistical challenges to the revenue agencies. Massive education campaign must be embarked on to reduce community tolerance for the shadow economy, provide targeted assistance to promote voluntary compliance, encourage self regulation among business associations etc. A number of countries have encouraged self regulation through the formation of partnerships with key industry and business associations which has proven very effective in countries such as New Zealand, Australia, Ghana and many other countries.

### **iv) Rationalization of Tax incentives**

Tax policy measures which may include tax exemptions, deductions and tax credits, deferrals of tax payments or subsidies are provided to stimulate both domestic and foreign investments in the hope of mobilizing needed financial resources in support of government policy goals. While such incentives may promote investment in the short and medium term, their long term economic effectiveness can be limited as they tend to dampen tax efforts. Sometimes even the anticipated job creation, backward and forward linkages and knowledge transfer for which tax incentives are given are never realized for a number reason.

For Zambia, the sectors in which foreign capital is mainly invested such as mines are highly mechanized and thus create fewer jobs. Little of forward and backward linkages and knowledge spill

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<sup>9</sup> An environment where businesses operating outside the tax system and registered businesses conceal transactions to avoid paying taxes

over may be created as foreign investors keep outsourcing both labor and capital from abroad thereby creating little impact on the local economy. Therefore, excessive use of tax incentives can complicate tax administration, create distortions and serve as a conduit of tax evasion and encourage corruption (Bird, 2008).

Tax exemptions and incentives may also just undermine equity and fairness in the way tax burden is distributed. The Zambian government should therefore review its tax incentives including those earmarked for Multi Facility Economic Zones (MFEZ) investment. IMF asserts in its 2008 assessment (IMF, 2008) of Kenya and Tanzania that investment incentives offered to firms in special economic zones “are not an important factor in attracting foreign investment”. Rather they create distortions and result in the loss of tax revenues. The revenue loss might also be enormous. According to the JCTR tax study report (JCTR, 2010), the revenue loss from tax concessions offered and announced in annual budgets was estimated at K 803 billion (approximately US\$161 million) between 2002 and 2009. In the 2009 budget alone, the tax foregone arising from tax concessions was estimated at K217 billion (approximately US\$43 million).

Tax incentives must therefore be cautiously implemented considering the forgone tax revenue through these incentives bring about. A report from the conference on *Revenue Mobilization in Sub-Saharan Africa* hosted by the IMF and Kenyan government in March 2011 cites South Africa and Canada as countries that require, according to International Best Practices that full cost-benefit analysis for any major piece of tax legislation aimed at attracting foreign investors be done to assess the associated financial and economic costs, benefits and impact on various stakeholders and in particular on a country’s long term tax revenues (IMF, 2008, P.3). Malawi and Mozambique are other countries that have taken the issue of tax incentives seriously by establishing a ceiling for the value of tax incentives that must be approved by government each year. Zambia should therefore review its tax exemptions and incentives policy in relation to the lost tax revenues otherwise it can negate domestic resource mobilization results.

#### **v) Improved Fiscal Management**

Taxation is governed by an implicit fiscal social contract between government and tax payers. Government collects taxes on the basis that it will provide specific socio-economic benefits to the people to justify taxation. This is true especially in a democratic dispensation like Zambia. Any mismanagement of public resources which might be revealed in corruption, lack of willingness to fight corruption, social economic decline and overall deterioration in public service undermines public confidence in a government and thus endangers tax compliance.

Zambia should therefore show great commitment to reducing waste in public expenditure management as a matter of priority not only to free up resources that can be devoted to productive public expenditures but enhance tax compliance. Public Resources should thus be applied to the best possible public benefit.

A case in point of fiscal mismanagement that undermines tax compliance is the recent case of MMD refusal to pay taxes on imported motor vehicles which they had imported for their campaigns<sup>10</sup>. The PF while in opposition took ZRA and MMD to court but the case was thrown out of court on technical

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<sup>10</sup><http://www.zambianwatchdog.com/archives/21403> Accessed on 16/12/2011

grounds that the PF did not follow the right procedure in taking the case to court. ZRA should be seen to be firm and be able to collect tax revenue from whoever it is due from regardless of their status in society if people have to maintain confidence in the system and pay tax voluntarily.

#### **vi) Arresting capital flight**

Africa is estimated to lose hundreds of billions of dollars in domestic revenues annually through capital flight, tax evasion, repatriation of profits by transnational corporations and high debt repayments. Indeed, empirical evidence suggests quite ironically that Sub-Saharan Africa is a “net creditor” to the rest of the world—in the sense that the private assets held abroad by Africans exceed the continent’s liabilities to the rest of the world (UN LDC IV/ UN OHRL, 2010). Zambia is not an exception as it has been experiencing capital flight in similar manner. Zambia has liberalized its current account and thus there is no limit to how much capital that investors can externalize. Secondly, there have been reports of illicit capital transfer in the mining sector through tax evasion. The problem therefore seems to be endemic and therefore needs urgent attention. This capital flight, which is very difficult to measure as it is partly illicit, deprives countries such as Zambia of a sizable portion of the resources they need for development financing. Some estimates indicate that capital flight exceeds the stock of external debt in a number of LDCs. It also undermines domestic investment and thus reduces long-term growth.

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