



5 ~ Fiscal Policy for the MDGs

5.1 Fiscal Cost of the MDGs

The chapter considers fiscal policy in Zambia, and how expenditure and taxation could be used to reduce poverty. As suggested by the discussion of the country's external debt in Chapter 1, since 1990 fiscal policy in Zambia has been closely linked to debt servicing and constrained by external loan conditionalities. It would be accurate to say that throughout the 1990s and 2000s, government expenditure was derivative from the servicing of external debts.

This inversion of social priorities had a debilitating effect on growth, poverty reduction and combating the HIV-AIDS pandemic, which has been as severe as it was avoidable. In mid-2006 it appeared that the debt burden had been reduced to less than US\$ one billion.⁸⁵

If policy conditionalities set by external agencies were made flexible, there is the potential that Zambia could fully achieve all of the MDGs by 2015. However, doing so would represent a major challenge, requiring a substantial increase in government expenditure supported by donors and lenders, and a radical change in the approach to conditionality by those donors and lenders. In its MDG progress report for 2005, the UNDP categorised achieving the MDGs as 'likely'

for five, 'potentially' for three, and 'unlikely' for two. While this represented a substantial improvement from the prospects in 2003 (zero, eight and two, respectively), implied that half the MDGs might not be achieved.

A careful and thorough study of the resource cost of achieving the MDGs provides a reliable estimate of the fiscal effort that the government faces (Mphuka 2005). On the basis of this report and an analysis of the potential for fiscal space over the years 2006-2015, this chapter proposes a financing package that could realise the MDGs. If anything, the proposal underestimates the fiscal effort required, implying that a more modest effort would ensure that the MDGs are not achieved. To lay the basis for the discussion of financing, the chapter first considers debt issues, the constraints created by external conditionalities.

5.2 Debt and the Balance of Payments

It is no mystery why Zambia accumulated a massive external debt during the last thirty years of the twentieth century. While many sub-Saharan countries suffer from debilitating debt burdens, for few would the problem be as severe as for Zambia. Further,

few countries waited as long as Zambia to achieve debt reduction under the HIPC initiative. In December 2000, Zambia reached the so-called decision point, formally qualifying for HIPC relief. The 'completion point' would come over four years later in April 2005, when the outstanding external debt was slightly larger than at the decision point.

Figure 5.1 shows external debt service as a share of export earnings during 1975-2004 for Zambia and the average of other sub-Saharan countries.⁸⁶ Only during the second half of the 1980s did Zambia's share fall below that of the cross-country average. The chart highlights the startling situation of the 1990s, when the adjustment programmes of the IMF and the World Bank were associated with four years of debt service ratios in excess of twenty-five percent. Even more striking is Figure 5.2, showing debt service as a share of GDP, which averaged almost nine percent of GDP for Zambia over thirty years, double the ratio for the other countries. The adjustment programmes did little to change this; the average for Zambia after 1990 was only marginally less than for the years before. To put such a debt service to GDP ratio in perspective, during the Latin American debt crisis of the 1980s, only three of eighteen countries had ratios for a decade above what Zambia averaged for three decades.

Measured per capita the debt burden appeared even more onerous. Figure 5.3 again compares Zambia to the other sub-Saharan countries, over a slightly shorter period, 1980-2004, using three year moving averages to reduce the effect of the extreme values of the 1990s. In current US dollars, the difference between Zambia and the other countries strikes the eye, a twenty-five year average of US\$ 720 for Zambia and US\$ 466 for the other countries. However, these numbers understate the difference between Zambia and other African countries, because of terms of trade changes. Since debts must ultimately be repaid with

exports, a decline in export prices raises the real value of debt. When per capita debt is adjusted for the terms of trade, the average for the other sub-Saharan countries declines slightly, to US\$ 450, while that for Zambia increases to over US\$ 900. Instead of being slightly lower after 1990 than before as is the case in current prices, the terms of trade adjusted per capita debt increases, from US\$ 730 to 1030.

It should be clear from this discussion that debt was not only one of the problems constraining growth and poverty reduction for Zambia, it was the central problem. Full debt cancellation would increase the potential fiscal space for growth-enhancing pro-poor expenditure by as much as five percentage points of GDP. First we consider the relief realised by reaching the HIPC completion point. The amount of debt relief under the HIPC derives from what is called a 'sustainability analysis'.⁸⁷ This analysis involves a projection of future estimation of key debt indicators, the most important being the debt-to-export ratio. Thus, central to the amount of debt relief granted is the projection of export growth.

When Zambia reached its decision point in December 2000 (i.e., it qualified for relief), the IMF made a preliminary sustainability analysis, and in 2005 concluded, 'export growth [during 1999-2003] was considerably slower than projected' (IMF 2005a, 23). Notwithstanding this unrealised optimism, in 2005 the decisive debt sustainability analysis presumed 'strong [export] growth over the medium term, reflecting major investments in mining and agriculture' (IMF 2005a, 25).⁸⁸ Perhaps this prediction was made on the basis of high prices for copper. Before inspecting the details of the sustainability exercise, it can be noted that it seemed to have a basic inconsistency. Macroeconomic equilibrium requires that the sum of all net demand equal zero; that investment minus saving, plus government expenditure minus government revenue, plus exports minus imports, be zero (familiar condition that $[IS]+-[G-$

5

T]+[X-M] = 0). However, the sum appears to be a plus 1.8.⁸⁹ This inconsistency may be a numerical error, because the assumptions about grant inflows and foreign direct investment imply that a trade deficit of eight percent of GDP could be sustained, which would eliminate the discrepancy. Proceeding on the assumption that macro consistency could be resolved, there were several reasons to think that the sustainability analysis was too optimistic. Several of the projections seem dubious compared to the economic record prior to the completion point. The long term growth rate was predicted to be steady at five percent per year. The average for 2001-2004 was slightly less than this at 4.7, which could be viewed as unusually high compared to the previous decade. The projected growth rate appeared all the more optimistic given that the investment share in GDP was predicted 'to hold steady at 22.5 percent of GDP, down over 2-3 percentage points from present levels', and foreign investment 'is projected to fall off from its current high'. When combined with the falling investment share, the policy prescription that the public budget not be expansionary placed the entire burden of demand generation on the optimistic export projection. Further, inflation, below ten percent in only three of the forty years 1965-2004, is 'expected to fall to 5 percent...by 2007' (IMF 2005a, 25). The exercise does not explain how inflation would be so drastically reduced without contractionary policies that would also reduce growth.

The most important variables for the sustainability exercise are presented in Table 5.1, which provides the assumed, or projected, values made in 2000 when Zambia reached the HIPC decision point. These are accompanied by the actual outcomes, as presented by the IMF (IMF 2005a, Tables 11 and 12). It can be noted that the assumed growth rate for 2000-2004 was not far off the actual outcome. However, the growth rate during those five years was well in excess of any previous five-year period

for two decades. Projecting this for the next nineteen years, 2005-2023, implies growth conditions would be considerably more favourable than in the past, notwithstanding the inflation reduction policy which would have a contractionary impact.

The most serious shortcoming of the sustainability analysis assumptions was the underestimation of copper price instability, an instability which implies that caution is required about the continuation the high prices of the mid-2000s. The sustainability exercise includes a 'sensitivity analysis' that includes the 'shock' of a twenty percent fall in the copper price. It is not clear that such a fall would shock anyone familiar with the international copper market, because the coefficient of variation of the copper price during 1995-2004 was .21. This implies that a price fall in excess of twenty percent can be expected in approximately one year out of five. This high degree of instability in the copper price points to the serious danger to debt sustainability and, more fundamentally, to the sustainability of Zambian development: dependence on copper. Past dependence on copper drove Zambia's unsustainable debt accumulation; a return to that dependence is unlikely to be the escape. In the absence of a purposeful plan for export diversification, strongly supported by public investment, copper could again dominate the economy.

Public investment for sustainable development requires fiscal space. Therefore, it must have disappointed the government to discover how little fiscal space debt relief from HIPC would create. The IMF completion point document reports that 'HIPC Initiative interim debt relief' amounted annually to a reduction of debt service of 5.7 percent of GDP for 2001-2005.⁹⁰ However, reduction of the debt service item in the public budget was less than half this, 2.6 percentage points of GDP, and what were named 'Priority poverty reducing programme expenditures' only 1.5 percentage points. The 3.1 percentage point difference between 'HIPC debt relief' and

budget payments represented debt service in another accounting category. To quote from the IMF,

Given that the Bank of Zambia faced large debt service obligation, whose non-payment could have resulted in a curtailment of non-HIPC donor assistance, HIPC interim debt relief accruing to the Bank of Zambia was designated for debt service payments. The remainder has mostly been allocated to priority poverty reducing programmes, which focused on investments in infrastructure, support for small-scale farmers and food security, and increased expenditures in the social sectors, in particular, education. (IMF 2005a, 19).

In other words, over half of HIPC interim debt relief, fifty-five percent, was an accounting entry. Further, to write that the 'remainder was mostly allocated' to poverty reduction programmes involves broad usage of the word 'mostly', since less than sixty percent of the 2.6 percentage points of actual debt service reduction went to this item. Whether the promise by the 'G-8' heads of state in July 2005 to completely cancel all IMF and WB debts to HIPC completion point countries would bring effective debt relief to Zambia is considered below.⁹¹

In the following section it will be shown that far from increasing fiscal space, the overall effect of the HIPC process would slightly reduce it, primarily as a result of macroeconomic conditionalities. Full implementation of the G-8 debt cancellation would increase fiscal space, but within the binding policy conditionalities by less than one percentage point. Thus, the constraining role of these conditionalities on poverty expenditure and achieving the MDGS requires brief consideration of their appropriateness in the context of the poverty reduction strategy process.

5.3 Government Expenditure and Revenue

*Persistence of Donorship*⁹²

The constraining burden of Zambia's debt

for three decades was closely related to a second constraint, conditionalities placed upon lending from external agencies that severely limited the policy space in which successive governments could make decisions. Indeed, so numerous and specific have the conditionalities been, that once the conditionalities were accepted by the governments, very little discretion remained for the important decisions affecting economic management. A review of Tables 5.2 and 5.3 indicate the extent to which the multilateral agencies have affected policy in Zambia, the former listing the major interventions and the latter some of the more important conditionalities. The tables demonstrate clearly that from the late 1980s, policy making in Zambia was characterised by conditionalities that directly constrained the government's actions in almost every important area of economic policy, and in some cases social policy. Table 5.2 also indicates the extremely troubled interaction between the multilateral agencies and Zambian governments, with cancellation or suspension of programmes shaded.

The major role played by policy conditionalities in Zambia implies that a consideration of their appropriateness, both technically and in the lender-borrower relationship, cannot be avoided. Such external constraints played a major role in other countries included by the Global Programme on the Macroeconomics of Poverty Reduction described in the Introduction. A cornerstone of the PRSP process, stressed by the World Bank as a fundamental change in its lending approach, is the principle of recipient ownership of policy making (Klugman 2002).

It is useful to review the discussion in the reports on those countries (see Weeks et al, 2005, Chapter 1). In the conditions they set, donors and lenders must distinguish between actions required by the recipient government in order that the funds be used effectively, and those policies that the donors and lenders have the bargaining power to impose, be they crucial to success

or not. An essential characteristic of the 'donorship regime' was an omniscient external judgementalism. The donor or lender reserved the right to pass unilateral judgement on the appropriateness of and commitment to loan and grant conditionalities. In a national ownership regime, assessment of policies passes to the recipient government, with consultation with the donor. National ownership does not require external development agencies to suspend all judgements; it implies that those judgements arise out of an interactive process with national stakeholders.

A central characteristic of donorship was the presumption that if development assistance failed in its goals, the blame lay with the recipient government, typically explained by a 'lack of political will'.

This approach by donors made several presumptions:

1. That there exist a set of sound policies which the donors know and recipient governments do not (the recipient is ignorant);
2. that recipient governments must not only be informed of the sound policies of which they are ignorant, but they require convincing of the need to implement these (in the absence of donor advocacy, the recipient lacks the judgement to distinguish good policies from bad ones); and,
3. in the past, development failures arose from the mistakes of omission or commission of recipient governments, not in whole or part the result of unsound policies of the donors (development failures are recipient government failures).

While not a characteristic of the years immediately following independence, these presumptions tended to guide donors and lenders in their relations with Zambia from the late 1980s onwards. A variation on the sound policy criticism of recipient governments is that they may be aware of the

policies, and aware of the need for them, but fail to implement them because of special interests within or outside of the government. In such circumstances, the argument goes, donors are justified in their criticism of policy choices, and the criticism may strengthen domestic supporters of sound policies. This argument is also in the tradition of donorship, for it implicitly suggests that institutional, political, and economic interests do not motivate donors. This approach is increasingly unacceptable in the twenty-first century. Following PRSP guidelines, the development strategy of every country should be established through the democratic process, which has functioned relatively well in Zambia since the 1980s.

It is the view of this mission that relations between the Zambian government and donors and lenders continues to be one of donorship, and considerably more so than in almost any other African country. As a result, for at least two decades Zambia suffered from a profound 'aid dependency', which included but went well beyond dependency on external funding. In practice, the capacity for national policy making was seriously undermined by the frequent interventions of external Agencies, in decisions both large and small. This tendency was quite clear in the budgetary process, where the scope for independent national policy decisions was extremely limited.

The HIPC debt reduction process was very much a part of the donorship approach. Qualification for relief reaching the 'decision point' explicitly required faithful adherence, over several years, to IMF and World Bank programmes characterised by detailed conditionalities (see Table 5.2). The considerable delay in obtaining debt relief, 'completion point', resulted from the government making insufficient progress on a specific conditionality, privatisation of the Zambian National Commercial Bank (see discussion in Situmbeko & Zulu 2004, 42ff). In no areas of policy were the constraints of conditionalities more restrictive

than for fiscal policy. After 1990, direct fiscal conditionalities included 1) deficit limits, 2) a cap on the share of public sector wages in GDP, and 3) 'cash budgeting'. The last, which limited expenditure to each ministry's own current cash balance, was particularly distorting for policy implementation. The cash limit was particularly dysfunctional and irrational for capital projects, whose expenditure requirements were often 'front-loaded', leading to interruptions in the construction process. These interruptions resulted in abandoning projects in process.⁹³

Debt Reduction and Fiscal Space

The fundamental purpose of the HIPC process and the G-8 debt cancellation is to create fiscal space for poverty reducing expenditures. Poverty Reduction Strategy Papers were created as part of this process, and later became more general in purpose, to serve as the basis for donor and lender support and to link growth to the MDGs. Thus, if debt relief fails to create space for increased expenditure for poverty reduction, the process was both futile and pointless. A close inspection of the official IMF projection of revenue and expenditure in the five years immediately following Zambia reaching the decision point yields the conclusion that as a portion of GDP, HIPC debt relief slightly reduced the amount of expenditure available for poverty programmes, and the G-8 cancellation increased only marginally.

During 2000-2004 the Zambian government paid seven percent of GDP as debt service, and the debt sustainability exercise described earlier in this chapter projected that this would fall to 1.7 percent during 2006-2010 (see Table 5.4, data columns 2 and 3).⁹⁴ Someone unfamiliar with the HIPC process might conclude that the fall from seven to 1.7 percent would release the difference between the two, 5.3 percent of GDP, for expenditure at the discretion of the government. Were this the case, the prospects for sustainable growth with poverty reduction would be dramatically

improved in Zambia. The IMF projection that tax and other revenue sources would generate a slightly larger share of GDP, from 18.8 to nineteen, would be further cause for optimism.

Such optimism would be misplaced. First, the IMF exercise anticipated that grants and the grant component of loans, over six percent of GDP during 2000-2004, would fall to three percent (see notes to Table 5.4),⁹⁵ though such a decline would seem to contradict a fundamental commitment associated with HIPC relief.⁹⁶ The decline in grants of 3.5 percentage points reduces relief on budgeted debt service from 5.3 to 1.8 percentage points. For practical purposes, total expenditure less external grants for 2006-2010 is mandated by the conditions that it not exceed, by more than one percent, total revenue. With the added condition that domestic borrowing be limited to .6 percent of GDP (implying that .4 percentage points would be covered by external grants), the net reduction in the fiscal deficit must be 3.3 percent of GDP.

This rather tedious tracking of percentages and fractions thereof yields the conclusion that in the first five years after the HIPC decision point, assuming other public expenditure obligations are not reduced, the change in fiscal space for poverty expenditure would be minus .8 percent of GDP. We can summarise the calculations as follows: 1) other things unchanged, HIPC debt relief would increase fiscal space by 5.3 percentage points of GDP; 2) the expected increase in government revenue would increase this by a further .2 percentage points; 3) a reduction in grants by 3.5 percentage points reduces this to two percentage points of GDP; and 4) a lower deficit limit reduces it to minus .8 percentage points.

If the G-8 cancellation of IMF and World Bank debts were realised, the result improves, but only marginally. The further reduction of debt service, from 1.7 to 0.1 percent of GDP creates a small

positive change in fiscal space of 0.8 percentage points. Even without a detailed analysis of the cost of achieving the MDGs, it should be obvious that this change would be inadequate.

5.4 Creating Fiscal Space for the MDGs⁹⁷

If Zambia would achieve sustained growth with poverty reduction, and approach the MDGs, the fiscal space HIPC and the G-8 fail to provide must be created through other means. Though it brought an extremely small poverty expenditure 'dividend', HIPC and the G-8 processes were not pointless, for they dramatically reduced Zambia's external debt and the servicing associated with that debt. In the long run this could only assist the achievement of sustained growth; though the cost, in terms of distorted policy priorities and government human resource inputs, well exceeds what was achieved. Higher levels of non-debt ODA assistance might be realised, but at the time of this report there was no commitment on the part of donors and lenders. The long, protracted HIPC process carries an important lesson: the present and future governments of Zambia must seek domestically the resources for generating growth and poverty reduction. To consider the scale of the task to fund the achievement of the MDGs, one can begin with the fiscal allocations for 2005, shown in the first data column of Table 5.5, with the second column giving each item as a percentage of the domestic budget, and column three percentage of GDP. The fourth column reports the estimated expenditure share in GDP necessary to achieve the MDGs (Mphuka 2005, and see notes to Table 5.5). This fourth column sums to almost a quarter of GDP, considerably larger than domestic budget. If an assumption is made that the expenditures in budget categories that correspond to the MDG categories are fully used to achieve the MDGs, then the net increase in expenditure sums to

17.1 percent of GDP (sum of the 'MDG gaps', last cell of the last column).

Having quantified the fiscal effort required, one can move to Table 5.6, which provides proposal for funding the 'MDG gap'. The first two sources of funding come from government interest payments. External interest payments were 0.4 percent of GDP in 2005, and would fall to 0.1 after realisation of the G-8 debt cancellation. Item 2 presumes a restructuring of the domestic debt, by issuing new bonds to credits at a fifty percent discount. This policy is discussed in Annexes 6A.3 and 6A.4.

Third, the proposal calls for an increase in tax revenue of three percentage points in GDP. Figure 5.4 shows that taxes accounted for the overwhelming proportion of revenue, with fees and other sources making a minor contribution. Increasing non-tax revenue would in most cases be regressive, as the discussion of 'user fees' in Chapter 7 demonstrates. Four major types of taxes account for almost all of tax revenue, as shown in Figure 5.5. Unlike almost every other sub-Saharan country, personal income taxes brought the largest share of revenue in Zambia. Increasing the rates for the highest income earners would bring a small increase in revenue; though this might be better used to reduce rates on the poorest income tax payers, some of whom were below the poverty line (see Chapter 3). Given the tariff reductions during the 1990s, trade taxes held remarkably steady in their contribution, suggesting there to be limited scope for increased revenue from this source. The VAT levy, despite claims about its effectiveness, generated relatively little revenue, and its expansion, were that cost effective in terms of collection, would be aggressive and anti-poor.

There would be considerable scope for increasing the company tax, which in 1990 brought over six percent of total tax income. Trade liberalisation and the decline of copper reduced its contribution dramatically. However, the rejuvenation of the

copper sector and the growth of agribusiness provide scope for expanding the tax base, especially if various forms of tax exemptions were removed. Priority could be given to a study of the potential for expanding the base and increasing the rates of the company tax.

Fourth, the proposal assumes that one-third of 'other expenditures' (9.9 percent of GDP, see Table 5.5) be shifted to MDG expenditure. Some of this shift may involve no more than re-labelling, because the cost of implementing MDG expenditure would fall under general government operations. However, the majority of the shift would require re-assigning civil servants to new activities, which would have a training cost.

Item five calls for an increase in domestic borrowing, which would be viable if the domestic debt were restructured as suggested above. The domestic borrowing level for 2006-2010 to which the government agreed as part of the HIPC process, less than one percent of GDP, has little practical justification in economics. Once the domestic debt is made sustainable, such a small deficit would be far below the optimum level. Accumulating domestic debt at the rate implied by .6 percent of GDP would imply a rapidly declining debt to GDP ratio if the economy grows at the anticipated five percent per annum. With regard to inflation, the Quantity Theory of Money suggests for a typical value for the velocity of money that the inflationary impact would be small even if the deficit were monetised. If covered by domestic borrowing, a deficit has no direct inflationary effect because the net impact on the money supply is zero.

The other possible impact of a higher deficit would be upward pressure on commercial interest rates, which is shown to be unlikely in the next chapter. If this 'crowding out' effect were operative, it would be demand reducing for the private sector through its impact on investment, but not inflationary. However, since the increase in the deficit could be used for

public investment, the net effect on aggregate investment, private and public, would be positive, and growth-enhancing. Finally, the capital expenditure required for the achievement of the MDGs would bring public investment well above three percent of GDP. It is contrary to economic theory and common sense to fund investment out of current income, since the investments generate a future flow of income to fund themselves (that is why there are capital markets). The reason for the government not to fully fund investment by borrowing is the possible inflationary effect, which was discussed above. Thus, there would be no compelling economic argument against expanding fiscal space through domestic borrowing in excess of the extremely low 'cap' of .6 percent of GDP, to three percent.

Item 6, 'foreign financed capital expenditure', is not part of the domestic budget, and was 3.4 percent of GDP in 2005. The calculations assume that all of this would contribute to achieving the MDGs during 2006-2015. Finally, an increase in ODA grants serves as the residual item to fill the MDG gap.

The percentages for MDG expenditures in Tables 5.5 and 5.6 were calculated on the assumption of a growth in per capita income of 2.2 percent per annum (Mphuka 2005). According to World Bank data, population growth was 1.4 percent in 2004. On the assumption that population will expand at the slightly higher rate of 1.5 percent during 2006-2015, a per capita growth rate of 2.2 percent implies GDP growth of 3.7 percent. At this rate of growth, the seven financing items would need to cover an increase in government expenditure of 8.8 percentage points, with the share of expenditure in GDP rising from 27.1 to 35.9 percent. However, if the economy were to grow at the IMF projected rate of five percent per annum, the increase in government expenditure would decline to 8.3 percentage points, for a share of 35.4 percent of GDP. However, a five percent rate of growth would not achieve the first

MDG, reduction of extreme income poverty by half. Assuming distribution neutral growth and a continuous distribution function for household income, reducing the number of the extreme poor by fifty percent implies a doubling of per capita income.⁹⁸ This would require a ten year growth rate of seven percent per annum. In this case, the increase in government expenditure falls to 7.5 percent of GDP, and the share of government expenditure to 34.5 percent.

It is the view of the mission that a ten year growth rate of seven percent is possible for Zambia under the full-funding of MDGs scenario. The increased government expenditure, partly financed through domestic borrowing, would provide the necessary demand stimulus even if export growth slowed. Supply constraints would be progressively relieved by the MDG public investment. However, there would be little prospect for five percent growth, much less seven percent, if the deficit target of 0.6 of GDP were maintained, and monetary policy pursued an inflation rate of five percent.

5.5 A Macro Framework for the MDGs

For the MDG commitment to be more than a slogan in Zambia, it is necessary 1) to estimate the spending levels required to achieve them, 2) programme those spending levels into the fiscal budget, and 3) foster a macro framework that fosters the growth rates that sustain those spending levels. The Mphuka study accomplished the first task. The second step would require bold, innovative and possibly controversial measures, such as domestic debt restructuring, larger fiscal deficits, and increases in rates, coverage and types of taxation.

The third step requires one to address the potential that the funding measures would have negative effects on the economy. The most important of these would be 1) inflationary pressures created by the increased spending; 2) the 'Dutch Disease' effects of a higher level of ODA (McKinley

2005); 3) crowding out effects of an increased fiscal deficit, 4) the probability of private sector disincentives of higher taxation; and 5) public sector capacity to expand anti-poverty programmes.

Taking the MDGs seriously requires that none of these potential difficulties be treated in a reductionist manner in which they serve as 'trump cards' for limiting public expenditure. For example, the possibility of inflationary effects arising from a larger fiscal deficit is not an argument against increasing deficits, but an issue for empirical investigation. Further, empirical evidence that deficits above a certain level reduce growth should not be viewed as precluding deficits above the 'trigger' level.⁹⁹ Rather, the size of the negative growth effect should be assessed, and compared to policies to compensate for the effect. The same point holds for inflation effects. Even if moderate inflation can be shown to have a negative growth effect, the policy issue is the size of the effect in Zambia, and the possibility of policies to counter it without reducing MDG expenditure.¹⁰⁰

In this approach, poverty reduction is the goal, and a social cost-benefit analysis should be made of the potentially negative effects of inflation, Dutch disease, crowding out, disincentives and administrative capacity. This analysis would include consideration of policies consistent with poverty reduction targets to counter these effects. This approach would place the MDGs in the 'driver's seat' of fiscal policy in Zambia.

85 In early 2006, the Ministry of Finance and National Planning estimated that on the assumption of full implementation of G-8 debt cancellation, the total debt stock would fall to US\$ 747 million, of which Paris Club bilateral debt would be US\$ 110 million, bilateral non-Paris Club 280 million, and multilateral 356 million. The only two creditors that Zambia would owe over fifty million would be the European Investment Bank (twenty-five percent of the US\$ 747 million), China (twenty percent), Russia (fifteen percent), and International Fund for Agricultural Development (eleven percent). IMF and World Bank debts would be completely cancelled. The source for these numbers is information provided by the ministry. 86 The chart does not include 2005 and 2006 when debts were reduced dramatically, first by reaching the HIPC completion point in 2005, and further bilateral relief, and the promise of G-8 relief in 2006.

87 A WB web page describes the debt sustainability analysis as follows:

Reducing the threshold for a poor country's external debt to be considered unsustainable was an important area of consensus of the HIPC review, and a major element of the enhancement endorsed in September 1999. As with the original framework, external debt sustainability will continue to be determined by a Debt Sustainability Analysis (DSA) prepared by the debtor country, World Bank and the IMF, to determine whether a country is facing an unsustainable debt situation after the full application of traditional debt relief mechanisms. The new framework also allows for two related set of criteria to be considered. The first, which will continue to apply to most HIPCs, is the ratio of a country's debt to its exports. Under the enhanced framework, sustainable debt-to-export levels are defined at a fixed ratio of 150 percent (on a net present value basis, or NPV). The second, for those HIPCs with very open economies where exclusive reliance on external indicators may not adequately reflect the fiscal burden of external debt, an NPV debt-to-export target below 150 can be recommended if the country concerned meets two criteria at the decision point: an export-to-GDP ratio of at least 30 percent and a minimum threshold of fiscal revenue in relation to GDP of 15 percent. For these countries, the NPV debt-to-export target will be set at a level which achieves a 250 percent of the NPV debt-to-revenue ratio at the decision point. Côte d'Ivoire and Guyana qualified under this criteria [sic] under the initial framework. (<http://www.worldbank.org/hipc/faq/faq.html>)

88 Though the numbers for other variables are given, the precise rate at which exports would grow does not appear in the text of the IMF document, or in the box entitled 'Macroeconomic Assumptions Underlying the Debt Sustainability Analysis over the Period 2004-2023'. In the box, the full statement that refers to exports reads as follows:

Export volume is projected to show strong growth over the medium term, reflecting major investments in mining and agriculture, before slowing down to 4 percent annual growth over the long term, when mining exports are assumed to expand at about 7 percent a year, while other (non-traditional) exports grow at about 7 percent a year. (IMF 2005a, 25).

In the text of the document virtually the same statement is found:

Following a strong export performance over the medium term mainly reflecting recent and ongoing investments in mining, agriculture, and tourism, export volumes are expected to grow at a more moderate pace of 4 percent over the long term. (IMF 2005a, 26)

However, the export growth rates can be calculated from a table in the IMF document, and this is done in Table 6.1.

89 In text Box 3 the investment ratio is specified as 'about 22.5 percent of GDP, down 2-3 percentage points from present levels'. For saving, the box states '[gross national savings (after official transfers and debt relief) is projected to remain in the range of 18-19 percent of GDP]' (IMF 2005a, 25, Box 3). The export and import shares can be calculated from Table 12, lines 4, 10 and 11.

Government revenue excluding grants is given in line 6 of the same table. Box 3 specifies the deficit as .6 percent of GDP above revenue plus grants. A grant level of three percent of GDP is also given in the table. These numbers imply: $[22.5 - 18.5] + [22.6 - 18.5] + [29.2 - 35.4] = 1.8$.

90 The percentages by year are given as 7.3, 7.1, 5.5, 2.9 and 5.9, respectively, with the penultimate 'estimated' and the last 'projected' (IMF 2005a, Table 2).

91 A WB web page on developing country debt states the following: The bulk of the debt relief envisaged by the [G-8] proposal would be provided by IDA. A number of issues need to be resolved before the proposal can be implemented, including key issues related to donor financing and additionality of donor resources. Bank staff have presented options for resolving key issues, which are

actively being considered by the Bank's Executive Directors as well as IDA donors. This proposal was discussed by the Development Committee during the 2005 Annual Meetings. It was also endorsed by our shareholders. Bank staff are working to resolve remaining implementation issues so that the proposal can be presented to its Board. <http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/EXTDEBTDEPT/0,,contentMDK:20634753~menuPK:64166739~pagePK:64166689~piPK:64166646~theSitePK:469043,00.html>

92 For a comprehensive discussion, see Weeks (2006).

93 Officials at the Ministry of Finance and National Planning cited examples of cost increases and abandonment of projects directly resulting from cash budgeting requirements (interviews conducted in November 2004).

94 The IMF extends its projections to 2023 (see Table 6.1). Such a long time period involves too high a degree of uncertainty of estimation for the purposes of this report. The five-year period 2006-2010 is compared to 2000-2004, rather than 2001-2005, because relevant data for 2005 were not available when this report was written.

95 On page 35 (Table 12) of the IMF's Selected Issues document (IMF 2004a), the following numbers are given for 2000-2003, for the category 'revenue and grants' as a proportion of GDP, 25.1, 24.8, 26.2 and 25.0. The percentages category 'revenue' alone are 19.4, 19.1, 17.9 and 18.1. 6.7 is the average difference over the four years. The Ministry of Finance and Economic Planning reported 24.2 and 18.5, respectively, for 2004. The 'decision point' document provides figures only for the category 'revenue excluding grants'. The only mention of grant levels is in Box 2 (see quotation in Table 6.4).

96 On its HIPC web site (in 2005), the WB presents several 'frequently asked questions' (FAQ). In reply to the question, does debt relief replace development assistance, the following answer is given:

No. HIPC debt relief can be fully beneficial to a country only if it is provided in addition to previous rates of development assistance. A comparison of current debt service payments and concessional assistance illustrates how important continued aid programmes are to these countries. The ratio of gross inflows (from long-term debt and grants) to debt service paid averaged about two-to-one for the HIPCs as a group during the 1990s, and ranged upwards four-to-one in half of these countries. Annual net transfers to the HIPCs on medium- and long-term resource flows (including grants) averaged about 10 percent of GNP over the 1990-96 period.

Debt reduction must be additional to development assistance. (Emphasis added, www.worldbank.org/hipc)

97 This section draws on the draft Chapter 52 of the forthcoming National Development Plan.

98 The relationship between poverty and per capita income depends on the distribution of income. For example, if all households in extreme poverty were clustered just below the extreme poverty income line, a relatively small increase in per capita income would be needed to cut poverty by half. The assumption that doubling per capita income cuts poverty by half is a useful first approximation. While it is an over-estimate if households are clustered just under the poverty line, this may be offset by increased inequality in the distribution of the growth increment.

99 In a 2005 paper Adam and Bevan report a negative 'threshold effect [on growth] at a level of the deficit around 1.5% of GDP' based on cross-country regressions. Their conclusion is highly qualified:

While there appears to be a growth payoff to reducing deficits to this level, this effect disappears or reverses itself for further fiscal contraction. The magnitude of this payoff, but not its general character, necessarily depends on how changes in the deficit

are financed... and on how the change in the deficit is accommodated elsewhere in the Budget. (Adam and Bevan 2005), p. 571)

100 In a 2001 IMF Staff Paper, Khan and Senhadji report that '[t]he threshold level of inflation above which inflation significantly slows growth is estimated at... 11-12 percent for developing countries' (Khan and Senhadji 2001, 1). However, the effect is quite small. For example, consider the IMF projected growth rate for Zambia of five percent, and assume that increasing the deficit increases inflation. According to the Khan and Senhadji statistics, an increase in the rate of inflation from 11 percent (the threshold and about Zambia's inflation rate in 2006) to twenty per cent would reduce the growth rate by .47 percentage points. This implies an arc elasticity of -.11. Ceteris paribus, from the threshold level, a doubling of the inflation rate reduces the growth rate from an initial five percent to 4.4 percent (see Khan and Senhadji 2001, Table 3). With a velocity of money of four, a nine percent increase inflation requires an increase in the fiscal deficit of 2.25 percentage points of GDP. For any realistic capital-output ratio, this decline in the growth rate would easily be overcome by using the increased funds from the increased deficit for public investment.

Table 5.1: HIPC Debt Sustainability Analysis: assumptions and outcomes for GDP and exports, 2000 onwards

| Item | 2000 | 2001 | 2002 | 2003 | 2004 | 2000-04 | 2005-13 | 2014-23 |
|-----------------------------|------|------|------|------|------|---------|---------|---------|
| GDP Growth | | | | | | | | |
| assumed | 4.0 | 5.0 | 5.0 | 5.0 | 5.0 | 4.8 | 5.0 | 5.0 |
| actual | 3.0 | 4.6 | 5.3 | 5.0 | 3.9 | 4.5 | | |
| Exports G7S US\$ mn | | | | | | | | |
| assumed | 1036 | 1241 | 1413 | 1506 | 1604 | 1360 | 2297 | 3977 |
| actual | 861 | 1028 | 1052 | 1217 | 1820 | 1196 | 7.8 | 5.7 |
| Export volume (growth rate) | | | | | | | | |
| assumed | 22.9 | 18.1 | 13.0 | 6.4 | 6.3 | 13.3 | | |
| actual | -5.7 | 26.2 | 11.2 | 1.8 | 5.6 | 7.8 | -5.5 | |
| Indices (1995-99 = 100) | | | | | | | | |
| Terms of trade | | | | | | | | |
| assumed | 113 | 114 | 117 | 117 | 117 | 115 | | |
| actual | 96 | 94 | 88 | 92 | 110 | 96 | -19.5 | |
| Export Earnings | | | | | | | | |
| assumed | 96 | 105 | 116 | 130 | 145 | 118 | | |
| actual | 80 | 101 | 112 | 120 | 131 | 109 | -9.7 | |
| Copper volume | | | | | | | | |
| assumed | 84 | 97 | 102 | 106 | 109 | 99 | | |
| actual | 92 | 87 | 79 | 88 | 130 | 95 | -4.4 | |
| Price | | | | | | | | |
| assumed | 80 | 102 | 118 | 135 | 158 | 119 | | |
| actual | 73 | 87 | 88 | 105 | 170 | 105 | -14.2 | |
| Earnings | | | | | | | | |
| assumed | 113 | 114 | 117 | 117 | 117 | 115 | | |
| actual | 96 | 94 | 88 | 92 | 110 | 96 | -19.5 | |

Note: Shaded Cells for Exports G&S are annual growth rates. The other shaded cells give the percentage point difference between assumed values and outcomes.

Source: IMF (2005a, Tables 11 and 12).

Table 5.2: IMF and World Bank operations in Zambia, 1973-2005

| Date | IMF | World Bank |
|---------|---|---|
| 1973 | one year standby agreement | Programme loan for 1973 oil price shock |
| 1976 | one year standby agreement | Programme loan in response to fall in copper prices |
| 1978 | two year standby agreement | First IDA credit (previously Zambia was a middle-income country by WB measure) |
| 1981 | three year Extended Fund Facility | |
| 1982 | Extended Fund Facility cancelled | |
| 1983 | one year standby at end of year | WB suspends disbursements due to government non-payment of external debts, negotiations resume at end of year |
| 1984 | 21 month standby agreement | Project loan for copper sector |
| 1985 | Standby suspended | Policy package agreed with the WB, resulting in first Structural Adjustment loan |
| 1987 | Government cancels IMF programme | Government cancels WB programme |
| 1989-90 | Preliminary agreement for new lending | |
| 1991 | Lending agreement suspended by IMF | Lending agreement suspended by WB |
| 1992 | agreement reached allowing access to IMF loans despite arrears | arrears to WB cleared |
| 1995 | three year Enhanced Structural Adjustment Facility (ESAF), one year Adjustment Facility (SAF), total of US\$1,300 million | Recovery & Investment Project (ERIP) Structural agreed, with sectoral programmes resulting |
| 1999 | 3 year ESAF (US\$ 350 million) | Sectoral & Project loans |
| 2000 | IPRSP positively reviewed by joint IMF/WB board; in December HIPC decision point reached | Sectoral & Project loans |
| 2002 | PRSP positively reviewed by joint IMF/WB board, but HIPC process delayed over bank privatisation | Sectoral & Project loans |
| 2004 | Poverty Reduction & Growth Facility loan (PRGF) of US\$ 320 million | Sectoral & Project loans |
| 2005 | HIPC completion point reached in April, after over four years | Sectoral & Project loans |

Source: World Development Movement (2004), up-dated from WB and IMF websites.

Table 5.3: Some IMF & World Bank conditionalities for Zambia, 1991-2005

| Date | IFI | Details |
|------|------------------|---|
| 1991 | World Bank | Economic Reform Credit deregulate maize markets, limit bank credits, Remove tariff bans, reduce civil service employment, initiate privatisation |
| 1992 | World Bank | Privatisation and Industrial Reform Credit (PIRC I) harmonise sales taxes, broaden tax base, reduce tariffs, reduce public employment by ten thousand, pass privatisation law, restructure state mining company |
| 1992 | IMF | Rights Accumulation Programme pay arrears to international creditors |
| 1993 | World Bank | PIRC II reduce tariffs, develop land market, change investment act, privatise 60 companies including state copper corporation |
| 1994 | World Bank | Economic & Structural Adjustment Credit (ESAC I) redirect budget funds to social sectors, eliminate export ban on maize, create legal framework for land leasehold, sell public owned farms, financial plan for Zambia Airways |
| 1995 | World Bank | Economic Recovery & Investment Project (ERIP) introduce value added tax, minimum budget and spending targets for social services, change social security system, privatise state copper corporation |
| 1995 | IMF | Enhanced Structural Adjustment Facility (ESAF) quantitative benchmarks including increase domestic assets of BOZ, increase foreign reserves, reduce government domestic debt arrears; restructure civil service, publish banking regulations, privatise state copper corporation |
| 1996 | World Bank | ESAC II social sector funding at least 35% of total public budget, implement 1995 land act, amend employment & industrial labour relations act, formulate policy for NGOs to delivery social services |
| 1999 | World Bank | Structural Adjustment Fund reform civil service, publish banking regulations, privatise state copper corporation |
| 1999 | IMF | ESAF privatise state enterprises including ZCCM, telecommunications, electricity, post office; no intervention in exchange rate market; deregulate strategic grain reserve; end public distribution of fertiliser; restrictive monetary & fiscal policy |
| 2000 | IMF & World Bank | HIPC decision point complete privatisation of public enterprises |
| 2001 | IMF | PRGF privatisation of ZNCB & ZESCO, deregulate & privatise energy sector and ZNOC; no intervention in exchange rate market; limit government expenditure |

Source: World Development Movement (2004), up-dated from WB and IMF websites.

Table 5.4: The public budget, actual (2000-04) and IMF projections (2006-10)

| Fiscal categories | Actual 2000-04 | HIPC 2006-10 | HIPC & G8 2006-10 | Change: HIPC | HIPC & G8 |
|-------------------|-------------------|-----------------|----------------------|-----------------|-----------|
| Total income | 25.3 | 22.5 | 22.5 | -3.3 | -2.8 |
| Revenue | 18.8 | 19.0 | 19.0 | 0.2 | 0.2 |
| Grants | 6.5 | 3.5 | 3.5 | -3.5 | -3.0 |
| Total expenditure | 29.2 | 23.1 | 23.1 | -6.6 | -6.1 |
| Non-external debt | 22.2 | 21.4 | 23.0 | 0.8 | 0.8 |
| External debt | 7.0 | 1.7 | 0.1 | -5.3 | -6.9 |
| Overall deficit | -3.9 | -0.6 | -0.6 | -3.3 | -3.3 |
| Fiscal space | | | | -0.8 | 0.8 |

Notes and Sources:

The averages for 2000-04 are from the Ministry of Finance and are the same as given in IMF reports. For 2006-10 revenue and grants are from IMF (2005a) Table 12, and debt service from Table 15. Eight percent for wages and salaries was the upper limit conditionality set by the IMF. The 2006-10 overall deficit is set out in Box 3 under the heading 'fiscal policy'. 'Net change in fiscal space' is defined as the change in the level of government expenditure net of debt service, funded by revenue, grants and domestic borrowing. The increase in revenue and decline in debt service increased fiscal space, while the fall in grants and the deficit decreased fiscal space.

The IMF source explains the parameters of the 2006-10 budget as follows:

The 3-year PRGF-supported programme is anchored on reducing government's domestic borrowing to 0.6 percent of GDP in 2007, before falling to near zero over the long term. Government revenues are projected to rise gradually to 19 percent of GDP by 2011 and continue growing to 20 percent of GDP by 2016, before holding steady at that level.

Government spending, excluding externally financed projects, is expected to gradually fall to about 1 percentage point of GDP above government revenues, with the balance financed by budget support grants and loans. Externally financed projects are projected to decline gradually to 34 percent of GDP over the long term, with grants making up an increasing share of the total. (IMF 2005a, Box 3)

The G-8 differs from the HIPC one by debt service falling to one tenth of one percent of GDP (estimate by the Ministry of Finance and National Planning, based on the assumption that total debt will fall to below US\$ 500 million).

Table 5.5: Government expenditures in 2005 and the MDG 'Gap'

| Expenditure items | 2005 Actual | Percent domestic budget | GDP | Percent of GDP | |
|---------------------------|---------------|-------------------------|------------|----------------|-------------|
| | | | | MDG cost | MDG gap |
| Econ sectors | 1023.6 | 17.0 | 3.1 | | |
| Agriculture | 346 | 5.8 | 1.1 | | |
| Mining | 16.4 | 0.3 | 0.1 | | |
| Tourism | 40.8 | 0.7 | 0.1 | | |
| Communication & Transport | 437.4 | 7.3 | 1.3 | 3.0 | -1.7 |
| Energy | 22.3 | 0.4 | 0.1 | 2.0 | -1.9 |
| Construction | 82.4 | 1.4 | 0.3 | 3.0 | -2.7 |
| Commerce | 42.0 | 0.7 | 0.1 | | |
| Environment | 20.2 | 0.3 | 0.1 | | |
| Other | 15.7 | 0.3 | 0.0 | | |
| Social sectors | 1763.9 | 29.3 | 5.4 | | |
| Education | 1062.8 | 17.6 | 3.3 | 3.0 | 0.3 |
| Health | 480.0 | 8.0 | 1.5 | 7.0 | -5.5 |
| Water & Sanitation | 32.4 | 0.5 | 0.1 | 2.0 | -1.9 |
| Social safety nets | 89.7 | 1.5 | 0.3 | 3.0 | -2.7 |
| Disaster relief | 52.3 | 0.9 | 0.2 | | |
| Other | 46.7 | 0.8 | 0.1 | 1.0 | -0.9 |
| | | | | <u>Totals:</u> | |
| Other expenditure | 3235.1 | 53.7 | 9.9 | 24.0 | 17.1 |
| Total domestic budget | 6022.6 | | 18.4 | | |
| Total discretionary | 4697.7 | | 14.4 | | |
| Total expenditure | 6621.3 | | 20.3 | | |
| Capital expenditure | 2224.5 | | 6.8 | | |
| Foreign financed | | | | | |

Notes:

*Billions of Kwacha.

The MDG 'gap' is the difference between the 2005 budget allocation and the cost estimate of the achieving the MDG (both as percent of GDP). This makes the strong assumption that all 2005 expenditures in the relevant categories contributed to achieving the MDGs. The MDG costing categories are hunger, education, gender equality, health, water & sanitation, improving lives of slum dwellers, energy, roads and 'other' (Mphuka 2005, 35). The total estimate is 24 percent of GDP (25 percent in the source, presumably due to rounding). The percentage estimates in the source are allocated as follows: hunger to social safety nets; improving lives of slum dwellers to social safety nets; roads equally divided between construction and transport; and education, health, water & sanitation and energy to the same budget categories. The allocation is for presentation and does not affect the calculation.

Table 5.6: Proposal for the financing to achieve the MDGs in 2015*

| Per capita growth= | 3.7% %GDP Change | | 5.0% %GDP Change | | 7.0% %GDP Change | |
|-------------------------------|---------------------|------|---------------------|------|---------------------|------|
| MDG deficit | -17.1 | | -16.1 | | -14.6 | |
| 1. Reduction ext debt service | 0.4 | 0.0 | 0.4 | 0.0 | 0.3 | 0.0 |
| 2. Restructure domestic debt | 1.2 | 0.0 | 1.1 | 0.0 | 1.0 | 0.0 |
| 3. Increase tax revenue | 3.0 | 3.0 | 2.8 | 2.8 | 2.6 | 2.6 |
| 4. Shift 'other' expenditures | 3.3 | 0.0 | 3.1 | 0.0 | 2.8 | 0.0 |
| 5. Increase fiscal deficit | 2.4 | 2.4 | 2.3 | 2.3 | 2.1 | 2.1 |
| 6. Foreign financial cap exp | 3.4 | 0.0 | 3.2 | 0.0 | 2.9 | 0.0 |
| 7. Increase in ODA grants | 3.4 | 3.4 | 3.2 | 3.2 | 2.9 | 2.9 |
| Sum | 17.1 | 8.8 | 16.1 | 8.3 | 14.6 | 7.5 |
| Total expenditure 2005 | | 27.1 | | 27.1 | | 27.1 |
| Total expenditure, MDGs met* | | 35.9 | | 35.4 | | 34.6 |

Notes:

*All estimates are averages for 2006-2015.

**The income poverty target is only met in the 7 percent growth scenario (assuming distribution neutral growth).

1. Reduction of external debt service: assuming full G8 cancellation and bilateral cancellation.

2. Restructure domestic debt: new government bonds replace domestic debt at a 50 percent discount.

3. Increased corporate tax, with most revenue coming from mining.

4. Reallocation of one-third of total from 'General public Services, Defence and Public Safety'.

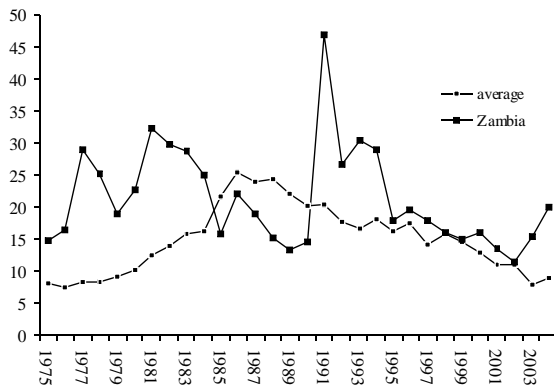
5. Fiscal deficit (public borrowing) rises to three percent of GDP.

6. Increase in external grants (residual item to fully cover the MDG gap).

7. Budget item 'Foreign financed' capital expenditures, which is not included in Table 5.4.

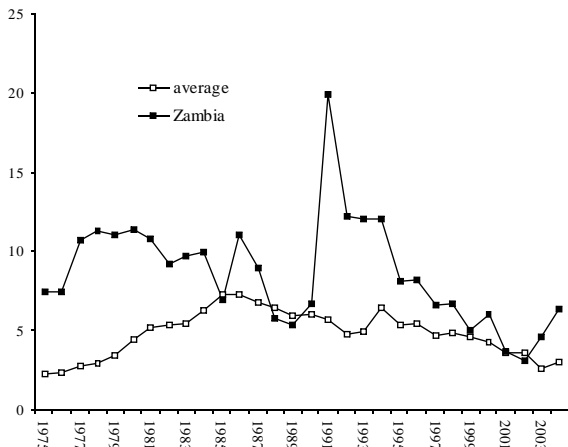
All three per capita growth rates assume population increase of 1.5 percent per annum (see www.worldbank.org, Zambia page).

Figure 5.1: External debt service as percentage of exports, Zambia and other sub-saharan countries, 1975-2004



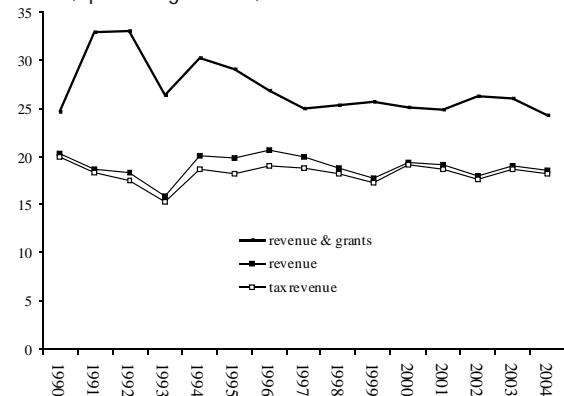
Sources: Ministry of Finance and National Planning, Macroeconomic Indicators (1997-2005), IMF (2004b, 2004f, 2005a & 2005b), World Bank World Development Indicators (web site).

Figure 5.2 External debt service as percentage of GDP, Zambia and other sub-saharan countries, 1975-2004



Sources: See Figure 5.1.

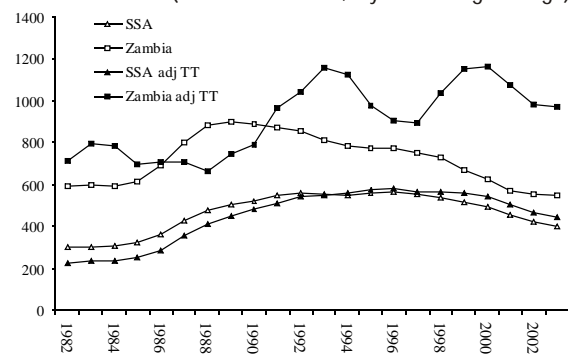
Figure 5.4: External grants, revenue and taxes as percentage of GDP, 1990-2004



Sources: Ministry of Finance and National Planning, Macroeconomic Indicators (1997-2005).

Note: Difference between taxes and revenue in 2000 was almost all proceeds from the privatisation of ZESCO.

Figure 5.3 External debt per capita, Zambia and other sub-saharan countries, observed and adjusted for the terms of trade 1975-2004 (current US dollars, 3 year moving average)



Sources: See Figure 5.1.

Figure 5.5: Types of taxes as a percentage of GDP, 1990-2004

