WORLD BANK/GRZ: PUBLIC EXPENDITURE REVIEW 1995.

CHAPTER 1

REVIEW OF FISCAL PERFORMANCE AND THE OUTLOOK

A. Introduction

1.1 In view of the heavy debt burden, the need to rehabilitate the economic and physical infrastructure, and the progressively tightening foreign aid situation, generating adequate domestic revenue is central to Zambia's economic success. Unfortunately, the experience in this respect has not been encouraging particularly since the late 1980s. Moreover, as the revenue declined, expenditure followed suit. In 1993, public expenditure stood at about two-third of the level in the late 1980s, and at less than 60% of the level in the mid-1970s.

1.2 Beginning 1993, with the cash budgeting in place and the erratic movements in donor funding, the evolution and distribution of public expenditure has been largely determined by the trends in revenue. Government's policy for the foreseeable future aims at maintaining and expanding the scope of the cash budgeting practices. Therefore, the discretionary components of domestic expenditure (excluding domestic and foreign debt service obligations and foreign financed capital expenditures) will be dictated by the success in domestic revenue generation. It is therefore important to understand the evolution and composition of Government revenue in the recent past and its likely trend in the near future in order to put the expenditure program in the context of the resource envelope.

1.3 With a view to fill the information gap on revenue in previous PERs, this Chapter will examine the trends and structure of revenue since the early 1970s, and based on simple assumptions, provides a picture of the likely trend for the period 1995-97. In addition, it will explore the factors that influence revenue mobilization. On the expenditure side, taking into account the coverage of the last PER (1992), it will review the patterns of aggregate expenditure and its functional and sectoral allocations during the period between 1990 and 1994. The aggregate discussion in this Chapter will be followed by a closer examination of the inter- and intra-sectoral allocations in subsequent Chapters.

B. Trends and Patterns in Government Revenue

1. *Trends and Composition of Revenue Performance*

1.4 The revenue picture in Zambia has changed greatly over the past quarter-century. Figure 1 shows the patterns in the ratio of non-grant revenue to GDP for the period 1970 to 1994. The average for each five years period since 1970 is summarized in Table I.

TABLE I

REVENUE AS % GDP IN ZAMBIA, 1970-1994

Year		Income Tax	Domestic Indir Tax	Trade Tax	Total Tax Rev.	Of which\ Non-Mineral Tax \a	Mineral Rev.	Non-Tax Rev.	Total Non-Grant Recur Rev.	Real Rev. K Bil
1970-74		10.7	4.1	9.4	24.2	13.3	10.8	5.9	30.1	560.3
1975-79		9.1	9.3	3.3	21.7	N/A	N/A	3.5	25.2	501.6
1980-84		8.3	9.3	4.1	21.7	N/A	N/A	1.8	23.5	491.2
1985-89		6.5	4.5	7.6	18.6	N/A	N/A	1.9	20.5	436.9
1990-94		6.6	5.2	6.3	18.1	16.5	1.6	0.8	19.0	415.0
1970-94	(StDev)	1.9	2.5	3.3	3.4	0.75	2.11	2.1	4.8	
	(Coef Var)	0.25	0.38	0.53	0.16	0.30	0.79	0.74	0.20	

Source: Annex Table I

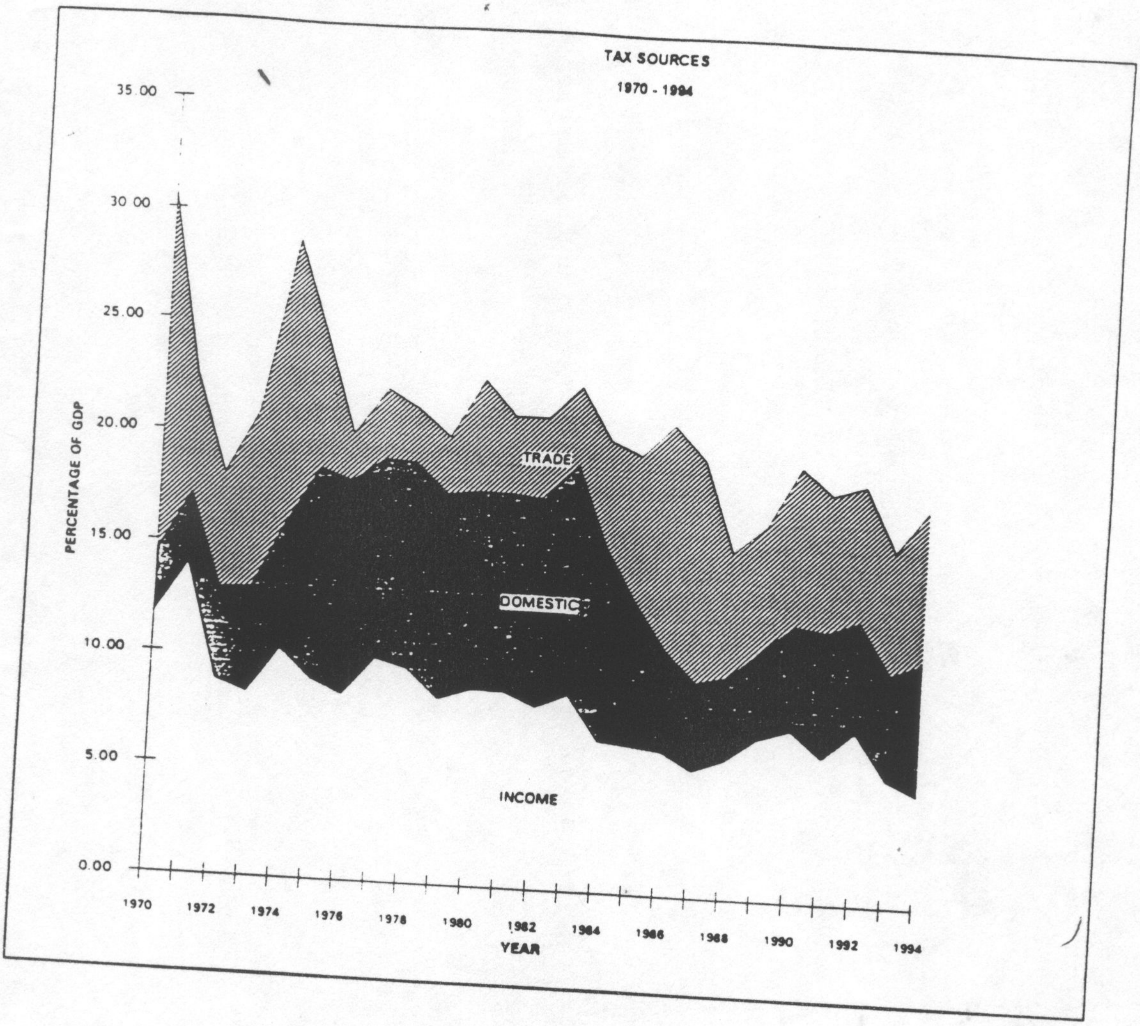
\a Financial Reports do not separately indicate Mining Company Tax for 1974-1987
StDev = Standard Deviation
Coef. Var = Coefficient of Variation

1.5 During the first half of the 1970s, revenue averaged 30.1% of GDP. Zambia benefited from an efficient tax administration, bolstered by mineral revenues averaging nearly 11% of GDP (including mineral company tax). In addition, non-tax revenues averaged 5.9% of GDP. Since that time the overall "revenue ratio" has steadily declined to around 19% of GDP using the CSO's series for GDP. If the series for GDP estimated by the IMF is utilized, this decline is more precipitate in recent years, and revenue has fallen to 13% of GDP on this basis. The difficulties posed for fiscal assessment by this uncertainty are reviewed in Annex I. The discussion in the text, however, uses the CSO figures.

1.6 In real value, revenue declined by about 37% from K 589.9 million in 1970 to K 374.6 million in 1993. Taking the average yearly revenue from 1970-74 and 1990-94, real revenue declined steadily from K 560.3 million to K 415 million, respectively. This represents a 26% decrease.

1.7 Two main factors contributed to the observed decline in revenue performance: mineral revenue (including mineral company tax) fell from 10.8% of GDP in 1970-74 to under 2% of GDP in 1990-94; and non-tax revenue slipped from 5.9% of GDP in 1970-74 to less than 1% of GDP in 1990-94. These steep declines were partially offset by non-mineral taxes, which rose from 13.3% of GDP in 1970-74 to 16.5% of GDP in the first half of the 1990s.

Figure 1



1.8 Compared to other nations of Sub-Saharan Africa, government revenue as a percentage of GDP is relatively low in Zambia. Table II presents revenue statistics for 1991 for twelve Sub-Saharan countries.[1] This is not a proper sample, yet it serves to show that many countries in the region have revenue ratios above 20% of GDP. In particular, the revenue ratio for 1991 was 32.3% in South Africa, 31.5% in Zimbabwe, 26.8% in Lesotho, 23.7% in Malawi, compared to 19.1% for Zambia in that year.

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1 These are all the countries covered in the fiscal tables of the World Bank, World Development Report 1993, Washington D.C.

1.9 As a low-income country which is committed to relying on markets and encouraging private-sector production, Zambia's objective is to achieve and sustain a revenue ratio in the neighborhood of 20%. This target is the basis for budget projections presented below.

1.10 In the 1994 Budget estimates, the projected sources of revenue are as follows: (i) 27.3% from income tax (excluding mining company tax), (ii) 31.7% from domestic indirect taxes, (iii) 37.3% from taxes on imports (including sales tax), (iv) 3.0% from mineral tax (including mining company tax), and (v) 3.6% from non-tax revenue (including parastatal dividends) (A detailed assessment of each revenue source is provided in Annex II.). The Bar Chart in Figure 2 provides the magnitude of real revenue (1977 prices) from different sources for 1970 and 1994, and the yearly average for 1970-74 and 1990-94. The data indicate the continued heavy reliance of Zambia on foreign trade taxes, although domestic trade also make a significant contribution.

1.11 Table II puts Zambia's revenue mix in regional perspective (using figures for 1991). The share of revenue from income tax in Zambia (26.5%) is below the average for Sub-Saharan Africa (30.9%). In contrast, the revenue share from taxes on goods and services (44.5%) is far above the regional average (25.2%). Trade taxes in Zambia -- excluding sales tax on imports, which is not classified as a tax on trade, per se, in the World Bank tables -- account for 25.4% of total revenue in Zambia, which is slightly above the regional average of 23.8%. Zambia is at the bottom of the scale, however, in collecting "other tax" -- which category includes property tax and employers' payroll tax -- and in raising non-tax revenue.

1.12 It may be noted that some heavy taxes on the productive sector, especially in past years, have been implicit rather than explicit. For example, maintaining an overvalued exchange rate meant that the earnings of the export sector (primarily ZCCM) were effectively taxed and importers (including GRZ itself) were effectively subsidized. This tax sometimes amounted to 30% or more of gross export turnover. Other forms of price control likewise taxed producers in many sectors and subsidized consumers -- with neither the revenue nor the expenditure appearing in the Budget.

1.13 To summarize, the overall revenue yield deteriorated badly after the early 1970s. A primary cause was the economic distress following the decline in the volume of production and copper prices in the middle 1970s (An assessment of the operations of the copper sector and its fiscal implications during the recent past and the outlook through 1997 is provided in Annex III.) The loss of mining tax revenue (including mining company income tax) explains the full decline in tax revenue. Other sources of revenue, combined, yield a larger percentage of GDP today than in the early 1970s. The increase in non-mineral tax revenue was largely due to introducing new taxes (such as sales tax and the import license levy) while boosting tax rates. Such rate increases may have been

TABLE II
Taxes In Sub-Saharan Africa, 1991 \a

		Composition of Revenue (% from each source)						
	PerCapita Income $	CurrRev As % GDP	Income Tax	TxDmstc Goods\c	Intrntnal TradeTx/d	Other Tax	Non-Tax Revenue	Sum
1. Chad	210	8.9	22.6	33.7	15.3	6.6	21.8	100.0
2. Madagascar	210	9.1	15.3	19.5	44.5	1.1	19.6	100.0
3. Sierra Leone	210	6.6	31.5	23.4	40.4	0.2	4.6	100.1
4. Malawi	230	23.7	35.0	33.2	17.7	1.2	12.9	100.0
5. Kenya	340	21.2	29.8	43.2	15.0	1.5	10.5	100.0
6. Lesotho	580	26.8	16.9	16.7	51.8	0.1	14.5	100.0
7. Zimbabwe	650	31.5	44.4	26.3	19.0	1.0	9.3	100.0
8. Cote d'Ivoire	690	26.5	16.7	27.8	27.8	18.1	9.6	100.0
9. Cameroon	850	19.0	45.2	20.2	14.0	15.5	5.1	100.0
10. Botswana	2530	63.4	38.8	1.9	13.4	0.1	45.9	100.1
11. South Africa	2560	32.3	46.8	32.7	8.8	4.6	7.1	100.0
12. Gabon	3780	35.8	27.6	23.7	17.4	1.2	30.1	100.0
AVG 12 COUNTRIES	1070	25.4	30.9	25.2	23.8	4.3	15.9	100.0
- excluding Botswana	937	21.9	30.2	27.3	24.7	4.6	13.2	100.0
ZAMBIA \b		19.1	26.5	44.5	25.4	0.0	3.6	100.0

\a Source: World Bank, World Development Report 1993; Table includes all sub-Saharan countries for which recent data are reported

\b Zambia data from Ministry of Finance.

\c Excise duty and sales tax (including sales tax on imports).

\d Customs duty, export taxes, company tax on export monopoly, import levy.

counterproductive in the long run, as compliance deteriorated and tax administration became increasingly ineffectual in the 1980s. The Government is now working to reverse this adverse trend by strengthening tax administration and reducing tax rates.

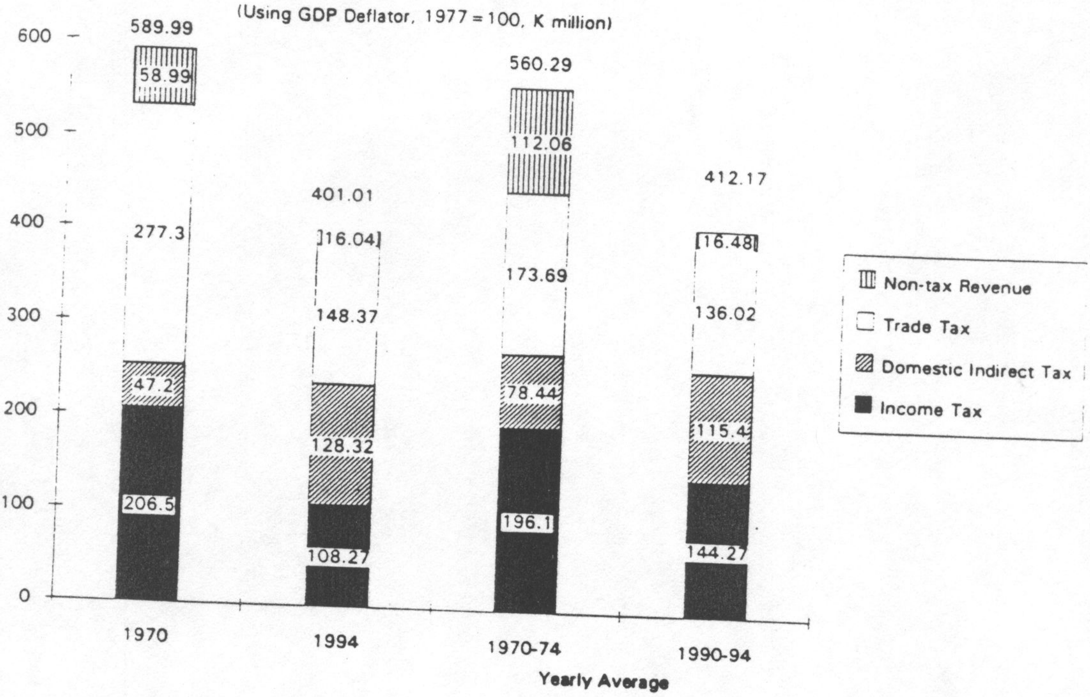
2. *Macroeconomic Changes and the Size and Pattern of Revenue*

1.14 Changing macroeconomic conditions undoubtedly played a role in determining revenue trends over the past 25 years. As indicated in the previous section, falling copper prices and the receding volume of production since the 1970s has been a major cause of the decline in revenue yield. The general economic downturn which ensued also impaired revenue collection by shrinking the tax base, relative to GDP. This occurs because the relative size of the (readily taxable) modern sector declined, more households fell below

Figure 2

Sources of Real Revenue

(Using GDP Deflator, 1977 = 100, K million)



the income tax threshold, company profits were depressed and import capacity was impaired by foreign exchange constraints. Similarly, the revenue problems faced in 1993 and 1994 are due in part to depressed economic conditions.

1.15 Of course, the decline in revenue yield cannot be blamed entirely on macroeconomic conditions. Other contributing factors include a diminished capacity for tax administration (partly due to underfunding and poor salaries), the widespread provision of exemptions and tax favors (creating inequities in the tax system), excessive tax rates (making tax evasion very profitable) and a general deterioration in tax ethics throughout society. In addition, the adverse macroeconomic conditions were largely a product of the policies which were being pursued. In all of these respects, favorable policies have been or are being implemented to turn the situation around to open the way for sustainable economic growth and restore the viability of economic institutions. But, some time could elapse before these measures mature and produce substantial results.

1.16 Macroeconomic conditions affect not only the trend in tax revenue, but also the variability of revenues from year to year. The bottom rows in Table I above show the standard deviation of the revenue-to-GDP ratio for each source, over the period 1970-

C. Trends and Patterns in Government Expenditure

1. *Trends in Public Expenditure*

1.20 Since the last PER covered expenditure performance between 1983 and 1990, the current Review will focus on the changes since then.[2] Since 1990 there has been a very substantial contraction in total (non-interest) primary expenditure from around 25% of GDP in 1990 to less than 18% in 1993 even after accommodating exceptional drought-related expenditure of almost 5% of GDP in 1992 and 2.5% in 1993. Expenditure projections for 1994, however, suggest that the reduction in expenditure achieved so far is unlikely to be sustained in 1994 and the total volume of primary expenditure is likely to remain at approximately 17% of GDP. Table III illustrates the evolution of expenditure from 1990-1994 according to functional classification, as a share of GDP.

1.21 The sharp expenditure contraction reflects the government's commitment to achieving fiscal balance in order to eliminate the extremely high level of inflation that had been experienced since 1989. This commitment has coincided with the liberalization of the domestic asset market which has seen a rise in domestic interest costs which in turn reduced the level of primary expenditure consistent with the balanced budget objective. Moreover, since this balanced budget objective has been pursued at a time when revenue productivity was declining, the expenditure squeeze has been particularly severe: the 5% reduction in the primary budget deficit since 1990 involved a fall in primary expenditure equivalent to 7.6% of GDP.

1.22 To put this squeeze in perspective total real expenditure declined by 27% from K 608.9 billion in 1990 to K 446.3 billion in 1993; while real primary expenditure experienced a sharper decline of about 40%, falling from K 562.4 billion to K 337.9 billion.[3] A longer-term assessment indicates that in 1992 total and primary expenditure had dropped to 44% and 35%, respectively, of the level in 1975.

Domestic Interest Costs and Primary Expenditure

1.23 Since the government is committed to achieving an overall domestic budget balance, the primary balance - total revenue less primary expenditure - is required to record a surplus equivalent to domestic interest charges. The increase in the cost of servicing domestic debt has been dramatic, rising from 2.1% of GDP in 1990 to over 5% of GDP in 1993 while the revised outlook for 1994 indicates that interest costs will rise to

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[2] Data on aggregate expenditure at current prices and real 1977 prices covering the period 1975-94 is provided in Annex Tables 1.7 and 1.8.

[3] Expenditure expressed in current US dollars reveals that total primary expenditure fell from $994 million in 1990 to $536 million in 1993 and is targeted to fall to approximately $475 million in 1994.

just under 5.5% of GDP, equivalent to almost 30% of total revenue. This is in part a result of the liberalization of domestic asset markets and the elimination of the implicit tax accruing to the government when it could borrow from the domestic debt market at below market rates. In view of the higher than anticipated interest costs (reflecting both higher interest rates and a growing stock of outstanding debt) the target of a balanced overall budget for 1994 is unlikely to be met, despite a projected primary surplus of approximately 2% of GDP. Revised projections for 1994 anticipate an overall deficit of approximately 3.5% of GDP.

1.24 Since the liberalization of the domestic debt market, however, real interest rates have been extremely high and well above real rates in neighboring countries. While nominal rates have declined somewhat in the course of 1994, they remain high and have the direct consequence of imposing a tighter than anticipated squeeze on non-interest expenditure.[4] As will be discussed below, most of the burden of the high interest bill has been borne by the capital expenditure to the detriment of Zambia's prospects for growth and the up-keep of the physical infrastructure.

3. *The structure of primary expenditure*

1.25 While the overall decline in expenditure is impressive - such that Zambia is now a relatively low public expenditure economy - the manner in which the contraction in expenditure has been achieved raises serious concern. While the decline in recurrent expenditure has been led in large measure by reductions in defense expenditure and the elimination of consumer subsidies, there has also been a less welcome decline in the RDC component and, especially, in the capital budget. Figure 3 illustrates the long-term changes in the main components of expenditureprovided in Table III.

1.26 The sharp decline in expenditure from 1991 to 1992 was due to the abolition of consumer subsidies on maize which consequently reduced explicit subsidies to an insignificant amount (other consumer subsidies having been removed in 1989 and 1990). To some degree, however, the table overstates the reduction in effective subsidies to agriculture since the item labeled "exceptional expenditure" and the drought expenditure items also include items more appropriately classed as on going subsidy measures such as net injections to crop financing for working capital and seasonal inputs. In addition, some parastatals enjoy subsidies implied in the non-payment of income and trade taxes.

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4 The implications of financing the fiscal deficit through Treasury bills and its implications to the interest, exchange rate and the stabilization program is provided in a background paper to the PER. C.S. Adam and D.L. Bavan, Zambia Public Expenditure Review - 1994: Comments on Part II of the Draft Review, Center for the Study of African Economics, University of Oxford, 12 September 1994. This issue is, however, beyond the scope of the current Review.

TABLE III

GOVERNMENT FINANCIAL POSITION 1990-1994
(as percent of CSO GDP)

	1990 Actual	1991 Actual	1992 Actual	1993 Actual	1994 GRZ Budget	1994 Jun-94 Revision
EXPENDITURE						
Personal Emoluments	4.17	4.62	4.62	3.52	3.63	4.00
Civil Service Reform			0.30	0.29	0.28	0.28
RDCs	4.32	3.55	3.32	3.63	3.22	3.22
Subsidies (excl. drought)	3.77	6.34	0.51	0.00	0.12	0.21
Transfers	2.70	2.69	2.45	2.71	3.23	3.50
Defense & Security	3.92	2.47	2.96	1.63	1.23	1.62
TOTAL RECURRENT (Excl. Int.)	18.88	19.66	14.16	11.77	11.71	12.84
Domestic Capital Expenditure	6.56	5.16	3.77	3.47	2.47	2.35
Exceptional Expenditure		0.43	0.77	0.09	1.65	1.82
TOTAL NON-DROUGHT EXPENDITURE	25.44	25.25	18.70	15.34	15.83	17.01
Add: Drought Expenditure			4.61	2.50		
TOTAL PRIMARY EXPENDITURE	25.44	25.25	23.31	17.84	15.83	17.01
TOTAL EXPENDITURE (Inc. Int.)	27.54	27.94	26.36	22.86	18.65	22.48
TOTAL NON-DROUGHT REVENUE	20.48	18.05	19.99	16.58	18.57	19.39
TOTAL NET REVENUE (inc. drought rev.)	20.48	18.05	22.03	17.71	18.57	19.39
DEFICIT						
Primary Surplus (deficit)	-4.96	-7.0	-1.28	-0.13	2.75	2.38
Less: Arrears	0.00	1.07	0.33	0.01	0.45	0.47
Primary Surplus/Deficit (cash basis)	-4.96	-8.27	-1.62	-0.14	2.30	1.91
Domestic Interest	2.10	2.69	3.05	5.02	2.82	5.47
Overall Domestic Surplus/Deficit	-7.06	-10.96	-4.67	-5.16	-0.52	-3.56
Domestic Public Savings	-0.5	-4.29	2.78	-0.22	4.02	1.08

Source: Ministry of Finance and IMF

1.27 The contraction in other recurrent expenditure has been more gradual over time and less dramatic. The wage bill has declined by approximately 1% of GDP from 1991 to 1993, although again the outlook for 1994 suggests a modest increase. The wage bill still represents the biggest single primary expenditure item in the budget and although it has declined slightly since its high level in 1991 the squeeze has been almost exclusively in terms of a reduction in the real wages of all civil servants rather than through a significant reduction in the established (or actual) posts. Indeed, as has been witnessed in the 1993 and 1994 wage negotiations it is increasingly difficult to maintain downward pressure on the wage bill solely by reducing real wages and it is by no means clear that this is a desirable strategy. The government's success in implementing its public sector reform program is thus central to maintaining the squeeze on the wage bill without destroying the incentives to attract and maintain quality people in the civil service. Chapter Eight provides a more detailed assessment of Public Sector Employment and Pay and provides policy measures to manage the size of the civil service and the wages bill.

1994. The most erratic revenue sources, as is shown in Annex Table 1.2, have been excise duty, mineral export tax, mineral company tax and non-tax revenue. Also, non-mining company tax is more volatile than P.A.Y.E. In general, broadly based taxes, in addition to being less distortionary, tend to exhibit less volatility than narrowly based taxes.

3. *The Agenda for Tax Reform*

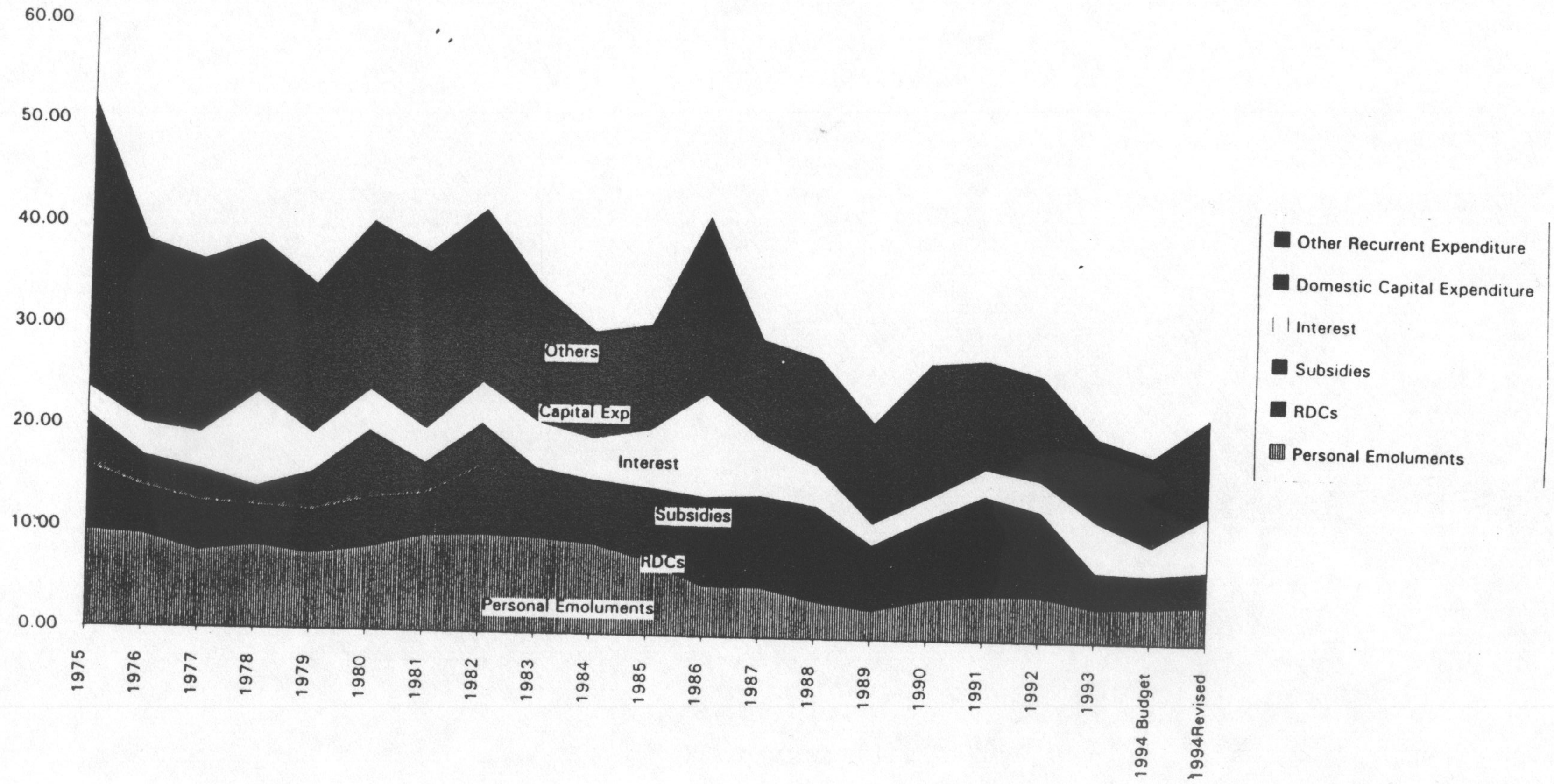
1.17 Upon taking office in 1991, the new Government embarked on a comprehensive tax reform program to address serious problems of tax policy and tax administration which had emerged over the past two decades. The principles of the tax reform program as stated in the Terms of Reference of the Tax Policy Task Force in 1992 were to set up a tax system which is fair, more bouyant, simpler and more economically efficient. This program has been under implementation since early 1993. The policy measures that have been put in place to date include (i) establishing the Zambia Revenue Authority, to professionalize tax administration; (ii) unifying the sales tax and converting the tax schedule to the Harmonized System; (iii) simplifying customs duty schedule while cutting the maximum duty to 40%, reducing the dispersion of duty rates and streamlining procedures for duty drawback; (iv) eliminating the import license levy; (v) introducing targeted investment incentives in the form of exemptions from import duty and sales tax; (vi) simplifying the income tax structure and reducing the maximum marginal tax rate to 35%; (vii) reducing the basic company tax rate to 35%, while expanding the sectoral coverage of accelerated depreciation; (viii) overhauling the tax regime applying to the mining sector; (ix) eliminating numerous "nuisance" taxes which raised little revenue, including the education levy, stamp duties and selective employment tax. (x) reducing the property transfer tax rate to 2.5%, from 7.5%; and (xi) simplifying the structure of estate duty.

1.18 Although much has been achieved, the tax reform program is far from complete. The unfinished agenda includes (i) converting the sales tax to VAT; (ii) reducing customs duty rates, as well as the sales tax rate and several excise duty rates; (iii) adjusting individual income tax bands and the tax credit to correct for the effects of inflation; (iv) rationalizing energy and fuel taxation; (v) reforming the system of land taxation; and (vi) introducing capital gains tax in lieu of property transfer tax.

1.19 In the present context, it is important to emphasize that the tax reform program is not meant to achieve any large increase in the overall tax yield (i.e. tax burden). The objective is to strike a balance between resources for the private sector and public services, and to raise the necessary revenue fairly and efficiently. If programmed improvements in tax administration and reforms in the tax structure prove highly effective in generating additional revenue, a significant portion of such gain could be returned to the public via lower tax rates or it could be transferred to the banking sector to be on-lent for productive purposes.

Figure 3

COMPOSITION OF EXPENDITURE AS A % OF GDP, 1975-94



1.28 Despite attempts throughout this period to improve service delivery by increasing the share of RDCs in total expenditure the converse has occurred with their share in GDP falling from around 4.3% of GDP in 1990 to 3.6% in 1993. This decline has been in approximately equal measure with the decline in personnel emoluments which suggest that the ratio of RDC to PE costs has remained relatively constant over the period. However, to the extent that prices of RDC goods and services have increased more rapidly than wage costs, which is implicit in the national accounts, the nominal ratio of RDCs to PEs actually understates the true decline in the *volume* of RDCs. Furthermore, since a fairly substantial portion of RDCs is personnel-related expenditures, such as various types of allowances, the actual amount of resources devoted to materials and supplies could be much lower than what the figures portray. The extent to which this is reflected in a deterioration in the coverage and the quality of public services is addressed in the respective sectoral chapters.

4. *Sectoral Allocation of Recurrent Expenditure*

1.29 Table IV illustrates the sectoral breakdown of discretionary recurrent and capital expenditure for the period from 1990-994. The actual outturn for 1993 is still provisional. This breakdown illustrates the composition of discretionary expenditure which is defined as total expenditure less constitutional and statutory expenditure, pensions and central transfers and subsidies. It therefore consists of the resources spent in the delivery of public services rather than in the macroeconomic management of relative prices through administering consumer and producer subsidies. The social sectors include health, education, labor and social services, housing, local government, and other welfare services. Productive services consist of agricultural support, mining and geological services, commerce industry and trade services, tourism, energy and transport. Finally, administrative services consist of the provision of central and provincial administration, the maintenance of the judiciary and legislature, foreign affairs and law and order (excluding defense).

1.30 A long view of the sectoral composition of total discretionary expenditure shows that over the period from 1970 to 1990 the year-on-year shares of total expenditure were relatively volatile (reflecting, in the main, fluctuations in capital expenditure allocations), but over the two decades there was a relatively steady decline in the share of productive sector expenditure in the total from around 35% of the total to around 30%, and a rise in the share of central administration costs from around 20% in the 1970s to an average of 35% in the 1980s. The share of social sector spending also declined from around 45% in the 1970s to approximately 35% in the 1980s.

1.31 Since 1990 the picture is less clear, mainly as a result of high levels of volatility in expenditure items. Starting with recurrent expenditure, there was a reduction in the share of administrative expenditure from 56% of the total to 43% between 1990 and 1992, although this was slightly reversed in 1993 with administrative expenditure claiming over 45% of total discretionary expenditure. In the main this was offset by an increase in the social sector share from 36% to 43% from 1990 to 1992. A useful way to characterize this shift is to look at the switch between health and education on the one hand and central administration on the other hand provided in Annex Table 1.3. These are typically the three largest components of expenditure. In 1990 the shares were 18.3% for health, 15% for education and 35% for central administration. By 1992 this had changed quite substantially, to 16% for health, 23% for education and 20% for central administration. Partly reflecting the concern about the deteriorating social conditions and the higher priorities attached to the social sectors, the 1994 budget shifts this move towards the social sectors even further with budgeted share of 23% for health, 22% for education and 12% for central administration. But, it is noteworthy that the higher expenditures in health and education is a reflection of the labor intensity and the proportionately higher share of wages and salaries in these sectors.

TABLE IV

Sectoral Allocation Of Discretionary Recurrent And Capital Expenditure (Percentage)

	1990 Actual	1991 Actual	1992 Actual	1993 Budget	1993 Actual	1994 Budget
Recurrent Expenditure (PEs, RDCs, Grants and Other Pmts)						
ECONOMIC SECTORS	8.12	16.26	14.33	13.06	9.62	16.26
SOCIAL SECTORS	36.00	42.94	42.72	41.69	45.13	50.27
ADMINISTRATION SECTORS	55.88	40.80	42.95	45.26	45.24	33.47
	100.00	100.00	100.00	100.00	100.00	100.00
Domestic Capital Expenditure (Incl.Loans &Investments)						
ECONOMIC SECTORS	61.00	58.00	67.00	58.00	45.00	59.81
SOCIAL SECTORS	14.00	18.00	18.00	17.00	17.00	18.01
ADMINISTRATION SECTORS	26.00	24.00	15.00	25.00	37.00	22.18
	100.00	100.00	100.00	100.00	100.00	100.00
Share of Recurrent Expenditure	77.71	76.73	61.44	74.42	84.13	78.2
Share of Capital Expenditure	22.29	23.27	38.56	25.58	15.87	21.8
	100.00	100.00	100.00	100.00	100.00	100.00

Source: Annex Table 1.3 and 1.4

1.32 Notwithstanding the preliminary nature of the actual outturn figures, changes in the sectoral distribution of expenditure between the 1993 budget and the outturn for 1994 indicate that in the face of the aggregate expenditure squeeze, engendered by the implementation of the cash budget, the social sectors were quite successful in maintaining their share of the smaller-than-expected total discretionary expenditure. It is notable, however, that the administration sector also maintained its share so that it was the economic sectors which faced a relative decline in their share of total discretionary recurrent expenditure. The agriculture and transport budgets experienced the most significant reduction in their shares.

1.33 Finally, we note that despite the persistent squeeze on aggregate expenditure, the share of discretionary resources secured by foreign affairs has been steadily rising. In the 1970s the foreign affairs budget accounted for approximately 1.4% of total domestic revenue; from 1981-85 the share rose to just over 2% of revenue and to around 3% from 1986 to 1989. The 1990s saw a remarkably sharp increase with the average share in discretionary expenditure for the period 1990-1993 (the last year for which we have actual or provisional actual figures) being 6.0% while the estimate for 1993 itself was around 7.4%. Budget estimates for 1994 suggest that this rate could reach 6.5% of total discretionary expenditure. However, since expenditures on foreign representation is among the expenditure items that often experiences expenditure over-runs, it is likely that the actual share will outstrip the budgetary allocation for 1994. The fairly high and rising expenditure on account of foreign affairs, in part, reflects the fact that a much higher proportion of this function's expenditure is denominated in foreign currency and therefore the local cost of a fixed level of service will rise more rapidly than would the cost of other sectors where a larger proportion of total expenditure is on non-tradables. Nonetheless if we compare this to other areas of expenditure we see that the share of resources going to foreign affairs is now equivalent to one third of the budget for health and almost two thirds of the domestic resource allocation to the transport and communications sector.

5. *The Capital Budget*

1.34 Recurrent expenditure, excluding subsidies, has fallen by approximately 40% (relative to GDP) over the period from 1990 to 1993. Capital expenditure, on the other hand has fallen even more dramatically by over 60% relative to GDP. Moreover, while recurrent expenditure is anticipated to stabilize relative to GDP in 1994, capital expenditure is expected to fall even further. Most worrying is that the collapse in capital expenditure is from an already low level. Domestic capital expenditure which was 6.6% of GDP in 1990 fell to an estimated 2.4% in 1994. This compares poorly with the 1970s where the public sector investment rate (excluding donor funded capital formation) averaged 9.8% of GDP. To some extent the domestic-financed investment collapse is offset by foreign funded capital expenditure the inflow of which has averaged approximately 2% of GDP per annum,[5] but even with this augmentation, the level of public investment remains low and is probably insufficient to halt the deterioration of the existing capital stock.

1.35 The sectoral composition of the domestic capital budget since 1990 has been relatively constant, rarely deviating from an allocation of 58% to economic sectors, 18%

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5 The rate of implementation of foreign funded capital expenditure has been low in recent years, barely exceeding 50% of the original budget estimates in 1992 and 1993.

to social sectors and 25% to administrative sectors. However, as a result of a very marked reduction in the level of agricultural expenditure relative to the budget, the economic sector's share for 1993 fell to only 45% of the total. It is important to note that this allocation applies only to domestic financed capital expenditure. Based on data for 1992 and 1993,[6] however, there is evidence that the donor funded capital support broadly reflects the government's own allocation. Over the two years, indicative allocations to the economic sectors accounted for 67% of the allocation of project funds, with the social sectors receiving 16% and the administrative sectors (including a large proportion of provision for long-term technical assistance, capacity building and training) receiving 27%.

1.36 In the past, many countries, including Zambia, have devoted a large proportion of the capital budget to activities which have proved to be extremely wasteful. "White-elephant" projects proliferated while on-going support to unproductive activities consumed a major share of the capital budget and often placed heavy demands on both the government's recurrent budget and on the economy's foreign exchange budget. The capital transfers to Zambia Airways are the most visible but certainly not the only examples of such capital allocations that are of dubious productivity. In a sensible rationalization of public expenditure such activities should be cut, and the resources thereby saved, re-allocated to other activities. If it were the case that the reduction in capital expenditure was accounted for solely by the elimination of such projects then the contraction of the capital budget would be a sign of success rather than of concern. However it would be unwise to take too sanguine a view of the overall collapse in public capital expenditure particularly in the light of its impact on economic growth and the complementary between public capital expenditure and the return to private investment.

D. Balancing Revenue and Expenditure

1.37 There are many different budget concepts, which provide different perspectives on the balance between revenue and expenditure. To simplify the present analysis, this chapter focuses on (i) the overall cash balance, which defines the financing requirement and (ii) government saving.

1. *Overall Cash Balance*

1.38 Over the five year period 1987-1991, the Government ran an overall cash deficit averaging 6% of GDP. Looking at 1990 and 1991 in Table III, the deficit was higher, reaching about 7% and 11%, respectively. Only one fourth of the large financing requirement was covered, on average, by external net borrowing. The remainder was financed by domestic borrowing, including substantial inflationary borrowing from the Bank of Zambia.

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6 NCDP Economic and Technical Cooperation, Donor *Assistance to Zambia*, (September 1993).

1.39 The overall cash balance improved in 1992 due to both a reduction in expenditures and an improvement in the revenue performance, but still it maintained a deficit of 5% of GDP. In 1993 the Budget statistics show a deficit of 5.2% of GDP, resulting from heavy domestic interest expenditures and poor revenue performance. These figures however overstate the deficit because the revenue figures exclude non-project grant revenue. Using balance of payments statistics from BOZ, one finds that non-project grant support totaled approximately 3.8% of GDP. Adding this to total revenue reduces the overall cash deficit for 1993 to 1.3% of GDP.

1.40 The Budget for 1994 calls for an overall cash deficit of 0.5% of GDP. This deficit is to be financed by domestic non-bank borrowing via a net sale of Treasury Bills to cover a portion of domestic interest expenses. The actual deficit is likely to be about 1.5% of GDP due to heavier-than-programmed interest expenses caused by poor revenues at the beginning of the year and poor recovery of funds provided for crop financing.

1.41 Beginning in 1995, the Treasury's objective is to operate a balanced budget, in terms of the overall domestic cash balance. Domestic revenue would cover all expenditure other than external interest payments and foreign-financed capital expenditures (which would be covered by net external financing). Domestic interest expenses would decline to between 1% and 2% of GDP as interest rates return to normal levels, so a primary domestic surplus of this magnitude will be required to balance the overall domestic budget.

2. *Government Saving*

1.42 The excess of recurrent revenue (including grants) over recurrent expenditure represents the Treasury's contribution to national saving. This contribution averaged -4.1% of GDP during the period 1987-1991, which means that the Treasury was absorbing saving rather than contributing to the nation's accumulation of assets.

1.43 Domestic savings (excluding transfers) based on data in Table III indicates that 1990 and 1991 registered dissavings. The dissaving in 1991 was particularly sharp as a result of sharp increases in wage and subsidy outlays preceding the elections. In 1992 government domestic saving turned positive, reaching 2.78% of GDP. This however was not maintained in 1993 as a marginal dissaving was recorded following the large bill on account of interest payments, despite the drop in the share of wages and the elimination of consumer subsidies. Domestic fiscal savings was projected to reach 4.4% in 1994. Starting with the 1994 Budget, the need for fiscal savings is being addressed seriously and the Treasury is actually aiming at contributing to capital formation. Projecting to 1997, the Government's objective is to balance the domestic budget. If it is to maintain the target established in the 1994 budget of allocating 25% of domestic expenditure to capital formation, then with domestic revenue rising to 20% of GDP, these fiscal targets imply that government domestic saving will be approximately 5% of GDP by the end of the period.

E. Forecast of Revenues and Indicative Expenditure Shares, 1995-97

1. *Prospects for Improving Tax Administration*

1.44 The effectiveness of tax administration in Zambia was seriously hampered over the past decade. The causes are many, including: inadequate funding, uneconomic penalties, low pay, an absence of professional management, expanding loopholes due to ad hoc exemptions and overall poor morale in the revenue departments. The problems were accentuated by declining compliance by taxpayers who were struggling to cope with deteriorating economic conditions and high tax rates.

1.45 Beginning in 1992 the Government adopted two major initiatives to turn the situation around. The first initiative was to professionalize tax administration by removing the tax organization from the civil service. The second initiative was to introduce modern information technology systems.

1.46 The Zambia Revenue Authority (ZRA) was launched on 1st April, 1994. From there on tax administration is being professionally managed. Officers benefit from competitive conditions of wages and discipline is enforceable without recourse to cumbersome civil service procedures. Early evidence indicates that the ZRA has succeeded in ending the perennial crisis in revenue flows. Still, considerable scope remains for further improvement in collection efficiency.

1.47 Efforts to integrate modern information technology into the tax system are also coming on stream, in phases, starting in 1994. The effect on collection performance can best be explained with a few examples. Even though the system is still being developed, the Sales Tax Division can now identify missing tax returns and alert inspectors very shortly after the filing deadline. The computer calculates penalties and interest charges automatically. Similar procedures will soon be in place for monitoring P.A.Y.E. and company tax payments. Computerized cross-checking by SGS (Societe Generale de Surveillance) is helping customs to identify many instances of under-invoicing. As the functions expand, the computerization program will support corresponding improvements in procedures and personnel allocations.

1.48 A separate administrative improvement, adopted in the 1994 Budget, is the introduction of market-based interest charges on late payments. As a result, non-payment of tax is no longer a cheap source of working capital.

1.49 As in the past, it is quite possible to collect income tax revenue which is much higher than the present level (as a percentage of domestic factor income). The same applies to domestic indirect taxes (as a percentage of private consumption expenditure). In contrast, import tax revenue is very high by historical standards. Indeed, the Government has stated its intention to lower customs duty rates. The resulting revenue loss will offset at least part of the gain from improving tax administration.

1.50 In summary, material changes in tax administration are taking shape in 1994. These administrative reforms will significantly improve the effectiveness of tax collection in the near term.

2. *Prospects for Broadening the Tax Base*

1.51 Several factors will work to broaden the income tax base (relative to GDP) over the next few years. The most important will be restoration of economic growth. This enhances the base for company tax because company profits tend to rise more than proportionally in an upturn (and fall more than proportionally in a downturn). The base for P.A.Y.E should also expand when real wages begin to rise and the modern sector begins creating jobs again. The tax base will also expand when the tax-computerization program reaches the stage of cross-matching income tax, sales tax and import tax records, as well as cross-matching tax records with car registrations and land transfers. These could be re-inforced by closing the loopholes through subsequent reforms in the tax laws.

1.52 The base for sales tax will broaden when VAT is introduced. The revenue effect, however, will be neutral at best in the short-term, since introducing VAT will also reduce tax cascading and widen the scope for input tax credits, but could be positive if enough new goods and services are brought into the net.

1.53 Changes in the base for import taxes depend on the ratio of imports to GDP and the scope of exemptions from import tax. The first element is unlikely to rise and may even decline if ZCCM does not implement the Konkola Deep project in time to offset production losses from older mines. At the same time, the share of exempt imports may rise as recovery stimulates imports of capital goods covered by investment licenses. In fact, the Mines and Minerals Act of 1994 will expand the scope for exemptions for the mining sector. Another potentially large reduction in the import tax base is the imminent entry of South Africa into PTA/ COMESA and the Cross Border Initiative. Many goods bear zero duty under the preferential PTA schedule. Consequently, many more imports will qualify for zero duty once South Africa enters the Agreement.

1.54 In summary, the income tax base should expand relative to GDP over the next few years, but this will be offset at least in part by shrinkage in the import tax base. Changes in the base for domestic indirect tax cannot be expected to yield any appreciable additional revenue in the short-term but could increase eventually. Hence, any increase in tax revenue is dependent primarily on improvements in tax administration, and rationalization of the tax system to reduce the scope for evasion..

3. *Anticipated Changes in the Tax Rates*

1.55 An important tenet of the tax reform program is to establish a stable and predictable tax environment to reduce the uncertainty which in the past discouraged investment and productive effort. Thus, the Government intends to maintain the basic structure of income tax rates.

1.56 For other taxes and duties, the intention is to implement further rate cuts, fiscal conditions permitting. The "temporary" increase in sales tax to 23% as of 1st December, 1993, should be reversed. The same applies to the increase to 125% in excise duty rates on alcohol and tobacco products, which took effect at the same time. These rates may have passed the point where they become counterproductive in terms of generating revenue. One significant rate increase which might be considered is the tax and duty on fuel and energy, which are much below the regional average. (In Zambia, excise duty accounts for 33% of the tax-exclusive pump price of premium petrol; the corresponding average for Africa is 72%). It should be noted that the tax rate for VAT has not yet been determined, but the main objective will be to set the rate so as to avoid a revenue loss.

1.57 Turning to import tax, the Government is committed to a policy of phased reductions over the next five years. The intended outcome is to halve the present rate structure of 20%, 30% and 40%. The 20% "uplift" on import sales tax will also be eliminated.

1.58 These rate reductions for indirect tax and duty can only be achieved if, and to the extent that revenues exceed the target due to improved tax administration and buoyant tax bases. With regard to mineral taxes, the Government has no intention of increasing the newly re-introduced royalty rate of 3% (but 5% on precious metals).

1.59 In summary, there is no scope for boosting the revenue yield through increasing tax rates, without deviating from the guiding principles of the tax reform program. Of course, deviations from the tax reform program may be unavoidable from time to time, but they should be minimized to ensure predictability in the tax structure. Any such deviations should not become permanent features of the tax structure.

4. *Prospects for Parastatal Dividends and Other Tax Revenue*

1.60 The yield from non-tax revenue fell by 5% of GDP from the early 1970s to the early 1990s. A major reason for this loss of revenue is the decline in parastatal dividend payments. In 1993, dividends amounted to under 0.2% of GDP -- about half of the figure achieved in the early 1970s. This is a striking result when one considers that the roster of government-owned companies expanded greatly over the same period. Clearly, the Government has earned a poor return on its investments. Indeed, the return has often been negative as support payments sometimes exceeded dividend revenues.

1.61 Three developments will influence parastatal dividend revenue over the next few years. The first is privatization. As companies are privatized, any dividends will accrue to the new owners rather than to the Treasury. The effect will be especially pronounced when companies with substantial profits (such as Zambia Sugar, National Breweries and Chilanga Cement) are taken off the roster. Of course GRZ will gain by receiving payments for the sale of shares. The best use of the revenue so generated will have to be carefully assessed, but it need not be used to cover ordinary expenditures.

1.62 The second development is that parastatal profitability should improve as the economy recovers from its long downturn and as interest rates decline to more normal levels. Now that subsidies and price controls have been removed and competition is being encouraged, parastatal companies have to establish economic pricing, cut costs, improve quality and strengthen marketing. If even a sub-set of parastatals succeed in raising profits, this will enhance dividend flows to the Treasury.

1.63 Thirdly, the Treasury is working to establish more effective systems for ensuring timely and satisfactory payoffs from profitable parastatals. This effort can potentially double dividend revenues, other things being equal.

1.64 On balance, the privatization of successful parastatals will offset much of the dividend gain which could otherwise accrue from improved profitability and more adequate payoffs. While dividend income will never be a major revenue source, it should contribute marginally more over the next few years than has been the case in the recent past.

1.65 Likewise, many fees and levies have failed to keep pace with inflation over the past decade, and have deprived the Government the higher revenue that is due to it. In 1994 the Government has introduced a unified, formula-based approach to updating fees and levies, based on the date each charge was initially established and the cumulative price increase since that time. Some charges have to be adjusted by as much as 1500 times. The new approach is not yet fully operational, because it involves modifying literally thousands of charges and getting many dozens of government units to implement the new fees and levies. The extent to which the adjustments can raise revenue is rather modest, however, because the most important fees and levies have already been adjusted and will not be increased further by the new adjustment formula.

1.66 On balance, non-tax revenue should stabilize in the neighborhood of 1% of GDP. It may be noted that that figure was more than twice higher through most of the 1980s. There are two reasons to set sights lower at this time. First, the largest single source of non-tax revenue in the 1980s was from SITET penalties levied on foreign exchange violators. This revenue is no longer available. Second, real incomes have fallen so widely that fees and levies cannot reasonably be as high in real terms as they were ten years ago.

5. *Projections of Revenue and Expenditures through 1997*

1.67 Taking into account all of the above considerations, the Government expects revenue for the period 1995-97 to follow the time path shown in Table V. Total revenue will rise to 20% of GDP. Of this, non-tax revenue will account for 1% of GDP and the balance will come from taxes.

1.68 Income tax revenue will rise to 8 of GDP, from an estimated 5.1 in 1994. Company tax and P.A.Y.E. will each account for 3 of GDP, while mineral company tax and other income tax will each generate 1 of GDP. The primary reason for the increase in revenues will be the buoyancy of the tax base (relative to GDP) as taxable incomes and company profits recover from their depressed state. Further improvements in tax administration will add to the revenue gain, due to activities of the ZRA and completion of the tax computer program.

1.69 Indirect domestic tax revenue will be fairly stable at 6.0 of GDP in 1997, compared to an estimated 5.9 in 1993. As explained above, the introduction of VAT in 1995 will broaden the tax base, but this will be matched by reductions in tax rates, which are presently above desired levels.

1.70 Taxes on trade are expected to decline to 5 of GDP, from 6 in 1993. This decline is due to programmed reductions in customs duty rates, including reductions which are dictated by the PTA/COMESA agreement and the Cross Border Initiative.

1.71 Non-tax revenue will rise back to 1 of GDP, from 0.7 expected in 1994 (to 5 of total non-grant revenue from 3.6 ; respectively). This increase will arise from adjustments to fees and levies, along with improved dividends from parastatals.

1.72 As already stated, the Government intends to balance the domestic overall budget (excluding foreign grants on the revenue side and foreign debt service and capital expenditures) over the period between 1995 and 1997. As a consequence expenditure targets for the period from 1995 to 1997 are not independent. The total level of discretionary expenditure will therefore depend solely on the realized level of revenue and the level of domestic debt service.

1.73 On the basis of the Government's revenue projections, total domestic expenditure will rise to 20 of GDP by 1997, generating an additional one or two percentage points of GDP in available resources. It is anticipated that the amount used to cover domestic debt-service expenses should decline to 1 of GDP by 1997. Thus, the target for the "primary" balance in 1997 is 1 of GDP. After allowing for domestic debt-service, the allocation to public services and capital projects will therefore total 19 of GDP.

TABLE V

Revenue Trends 1990-93, With Projection To 1997

A: AS GD

YEAR	INCOME TAX PAYE	Company Tax	Mineral CompTax	Other IncTax	TOTAL IncTx	INDIRECT TAX DOMESTIC Excise	Domestic SalesTx	TOTAL IndirTx	TAX ON TRADE Customs Duty	Import SalesTx	Import LicLevy	Mineral ExpTx	TOTAL TradeTx	TOTAL Tax Revenue	TOTAL Non-tax Revenue	Non-Grant RecurRev
1990	1.0	3.2	3.1	0.5	7.8	2.8	1.9	4.7	2.9	3.8	0.4	0.0	7.1	19.5	0.9	20.5
1991	1.7	2.8	1.5	0.5	6.6	3.6	2.1	5.7	2.9	2.8	0.5	0.0	6.1	18.4	0.7	19.1
1992	3.4	2.3	1.7	0.4	7.8	2.7	2.2	5.0	2.5	2.8	0.7	0.0	6.0	18.8	0.8	19.7
1993	2.5	1.8	1.0	0.5	5.7	2.4	2.4	4.8	2.6	2.9	0.1	0.0	5.5	16.0	1.0	17.0
1994 \p	2.2	1.8	0.5	0.6	5.1	2.9	3.0	5.9	3.5	3.4	0.0	0.0	6.9	17.9	0.7	18.6
1995 \p	2.4	2.2	0.8	0.8	6.1	3.0	3.0	6.0	3.0	3.0	0.0	0.2	6.2	18.3	0.8	19.1
1996 \p	2.7	2.5	1.0	1.0	7.1	3.0	3.0	6.0	2.5	2.7	0.0	0.4	5.6	18.7	0.9	19.6
1997 \p	3.0	3.0	1.0	1.0	8.0	3.0	3.0	6.0	2.0	2.5	0.0	0.5	5.0	19.0	1.0	20.0
AVG 1990-94	2.1	2.4	1.6	0.5	6.6	2.9	2.3	5.2	2.8	3.2	0.3	0.0	6.3	18.1	0.8	19.0
AVG 1995-97	2.7	2.6	0.9	0.9	7.1	3.0	3.0	6.0	2.5	2.7	0.0	0.4	5.6	18.7	0.9	19.6

B: AS TOTAL NON-GRANT REVENUE

YEAR	INCOME TAX PAYE	Company Tax	Mineral CompTax	Other IncTax	TOTAL IncTx	INDIRECT TAX DOMESTIC Excise	Domestic SalesTx	TOTAL IndirTx	TAX ON TRADE Customs Duty	Import SalesTx	Import LicLevy	Mineral ExpTx	TOTAL TradeTx	TOTAL Tax Revenue	TOTAL Non-tax Revenue	Non-Grant RecurRev
1990	4.7	15.5	15.1	2.6	37.9	13.	9.4	23.0	14.2	18.5	1.9	0.0	34.5	95.4	4.6	100.0
1991	9.1	14.8	8.0	2.5	34.4	18.	11.1	29.8	15.0	14.7	2.4	0.0	32.1	96.4	3.6	100.0
1992	17.2	11.7	8.9	2.0	39.7	13.	11.4	25.3	12.5	14.5	3.7	0.0	30.7	95.8	4.2	100.0
1993	14.5	10.5	5.8	2.8	33.6	14.	14.2	28.2	15.0	16.9	0.4	0.0	32.4	94.2	5.8	100.0
1994 \p	11.8	9.5	2.9	3.1	27.3	15.	16.2	31.7	18.7	18.6	0.0	0.1	37.4	96.4	3.6	100.0
1995 \p	12.6	11.5	3.7	4.2	31.9	15.	15.7	31.4	15.7	15.7	0.0	1.0	32.5	95.8	4.2	100.0
1996 \p	13.8	12.8	4.6	5.1	36.2	15.	15.3	30.6	12.8	13.8	0.0	2.0	28.6	95.4	4.6	100.0
1997 \p	15.0	15.0	5.0	5.0	40.0	15.	15.0	30.0	10.0	12.5	0.0	2.5	25.0	95.0	5.0	100.0

Source: Budget Office

1.74 The projected level of interest costs is difficult to forecast accurately, and the level of interest costs by 1997 will depend not just on the level of interest rates which may be safely assumed to decline towards "world" interest rates but also on the funding policy adopted by government and whether the commitment to stabilize the nominal debt stock from 1995 onwards can be adhered to.

1.75 As a consequence, it is possible that the target for interest costs of 1 of GDP, which is half the level of interest paid in the pre-liberalization period, will not be achieved so that total discretionary resources will be lower than 19 of GDP. In other words, the government must accept that as a share of GDP there is little likelihood of any significant increase in public resources. Unless there is a dramatic increase in real GDP growth or revenue productivity improves by more than is expected, discretionary Government expenditure will remain limited for the foreseeable future. This will in turn limit the Government's scope to significantly shift expenditure priorities within the overall resource constraint.

1.76 It was noted above that the progress achieved in expenditure reduction since 1990 is unlikely to be maintained. Therefore the scope for effecting significant resource shifts from recurrent to capital expenditure and from administration to the social sectors therefore depends on the capacity of the Government to achieve resource savings through the public sector reform program and improvements in fiscal management.

F. Conclusions and Recommendations

1. *Revenue Mobilization*

1.77 Since 1992, Zambia has made a good start in turning around its revenue mobilization performance through increased tax rates and improved tax administration. Although the tax reform is not yet complete and requires further fine-tuning, it has introduced a tax system which is relatively fairer, more buoyant, simpler and more economically efficient. The impact was re-enforced by measures taken to professionalize tax administration, computerize the tax system and charge market-based penalties for late payment. As a result, the revenue performance since the second-quarter of 1994 has started to improve.

1.78 Taking into account the preferred mix between private and public provision of services, the Government's goal is to maintain the share of domestic revenue at 20%of GDP during 1995-97. In 1994, total revenue is expected to be close to the desired medium-term target (or very short of the target depending on the GDP estimate used). The Budget of 1995, as well, sets such a target for the year. The outstanding tax policy changes for the medium-term aim at improving the fairness and efficiency of the system by introducing new types of taxes (especially VAT), and removing the anomalies in the existing system and reducing the tax rates (example import duties) without affecting the aggregate revenue impact radically. Yet, in this process, the importance of the various revenue sources will change: the share of income tax and non-tax revenue are expected to rise; indirect tax revenue is expected to stabilize, while revenue from foreign trade taxes is expected to fall.

1.79 It is recommended that MOF (and relevant ministries):

(a) implement VAT which is, at least, neutral in its effect to revenue mobilization. Preparation has been underway for over a year to ensure a smooth transition from the existing sales taxes to VAT. Outstanding issues should be revolved as soon as possible to bring VAT on-stream in 1995;

(b) reduce the average level of customs duty, particularly on raw materials and inputs: There is an understanding to gradually reduce the import duty by half from the current 40 , 30 , and 20 on consumption, intermediate, and capital goods, respectively. It is important to adhere to the schedule agreed upon by MOF and the Bank so that the changes will be introduced on time. It would imply reducing import duty by 5%, particularly if the VAT is delayed. This could be supplemented by abolishing the up-lift factor.

(c) remove the anomalies in import duty: Final goods, such as those catering to the health and education sectors, are subject to lower (zero) duty rates, while inputs into their domestic production bear higher duty. Statutory Instrument 23 of 1994, issued to provide relief on import duty for these businesses, needs to be reviewed, modified, and strengthened to ensure that it achieves the purpose. It should also be extended to cover imports from PTA sources.

(d) increase the excise tax on petrol to a level comparable with neighboring countries;

(e) reform the system of land taxation;

(f) introduce capital gains taxation.

(g) introduce and increase the rate of user charges and fees, such as those for hospital services (particularly at UTH); higher education (particularly at the university); water and sanitation services in urban areas; and road users;

(h) review and strengthen the system of tax administration periodically. The revenue loss from tax rate reductions are expected to be offset by broadening the base and improvement in administration. It is therefore important to closely monitor the tax administration system and institute the required changes as and when necessary.

2. *Expenditure Allocation*

1.80 The sectoral and functional allocation of the budget and actual expenditure continue to favor unproductive sectors, lower priority sub-sectors and spending on less productive inputs, particularly personal emoluments.

1.81 Despite the sizable contraction, unproductive sectors such as administration, defense, and foreign affairs take a third to a half of public expenditures. On the other hand, programs in agriculture and transport fail to be implemented as a result of budgetary constraints. It is noteworthy that within a limited budget allocation, resources to certain public services in administration, such as the police force, the judiciary, etc. may have to be maintained at current levels or increased to create the environment and enforce the regulations for the productive sectors to conduct their business smoothly. But, the overall allocation, particularly for defense and foreign affairs, should be reviewed in light of recent changes in the geo-political environment that necessitated a large defense force and wider foreign representation.

1.82 The pattern of expenditure continues to be biased towards curative services against primary health; university against primary education; agricultural marketing and crop finance against research and extension; high technology water and sanitation services against low-tech rural services; and main roads against rural. Institutional changes are being introduced through the sectoral approaches that have been introduced in health or under consideration in agriculture. But, from the limited experience in the health sector, the intra-sectoral reallocation does not seem to have been given adequate priority. Each sector would contribute substantially to Zambia's growth and poverty reduction by changing the priorities and allocation of resources within the sector.

1.83 Personal emolument make a large claim on sectoral resources and leave insufficient resources for RDCs and capital expenditures. Despite its size, however, due to the increasing number of civil servants, the allocation to PEs fails to provide adequate and comparable remuneration with the private and parastatal sectors. While it is important that the allocation to RDCs and capital expenditures has to be increased to make it possible that necessary services are provided, it is unlikely that the size of personal emolument could be cut significantly to make room for the two other expenditure categories.

1.84 **It is recommended that GRZ:**

- **(a)** **determine the appropriate size of expenditures for administrative services and prepare a phased program to reach that level, taking into account the conclusions of PSRP. This would involve a review of the needs for defense and foreign representation;**

(b) increase the allocation of the total budget to productive sectors, particularly agriculture and transport, and maintain the social sector allocations at the levels of 1994;

(c) within the sectoral resource envelope, increase the share of expenditure devoted to primary health; primary education; water and sanitation services in rural and peri-urban areas; research and extension; and feeder roads construction and roads maintenance;

(d) increase the allocation to RDCs and capital expenditure, while decreasing or maintaining the allocation to personal emoluments constant. The sector investment approach currently under implementation in health and under design should facilitate the increase of RDCs and capital expenditure; while PSRP would resolve most of the problems with personnel matters and PEs.

Annex Table 1.7

GDP, Revenue and Expenditure: Nominal and Real

K Millions

YEAR	Total Revenue (Excl. Grants)	Total Nominal Expend.	Primary Nominal Expend.	Nominal GDP	GDP Deflator	Real Revenue	Real Expend.	Primary Real Expend.	Real GDP	% Share: EXP in GDP
1967	.....									
1968	306.10				67.30	454.83				
1969	401.20				82.70	485.13				
1970	432.40			1269	73.30	589.90			1731.24	
1971	360.70			1189	67.80	532.01			1753.69	
1972	315.20			1348	70.30	448.36			1917.50	
1973	395.50			1591	84.30	469.16			1887.31	
1974	712.00			1893	93.40	762.31			2026.77	
1975	462.00	821.60	779.30	1583	80.20	576.06	1024.44	971.70	1973.82	51.90
1976	451.70	726.70	666.10	1896	92.40	488.85	786.47	720.89	2051.95	38.33
1977	506.00	756.70	684.90	1986	100.00	506.00	756.70	684.90	1986.00	38.10
1978	557.90	748.60	658.50	2251	112.70	495.03	664.24	584.29	1997.34	33.26
1979	606.80	912.60	809.30	2660	137.30	441.95	664.68	589.44	1937.36	34.31
1980	784.70	1242.60	1115.80	3064	153.00	512.88	812.16	729.28	2002.61	40.55
1981	828.90	1310.50	1192.80	3485	164.62	503.52	796.08	724.58	2117.00	37.60
1982	850.10	1505.60	1356.00	3595	174.76	486.44	861.52	775.92	2057.11	41.88
1983	1046.70	1475.89	1282.09	4181	206.93	505.82	713.23	619.58	2020.49	35.30
1984	1097.30	1484.23	1279.83	4931	245.27	447.38	605.14	521.80	2010.44	30.10
1985	1569.50	2185.25	1779.15	7072	346.57	452.87	630.54	513.36	2040.57	30.90
1986	3054.70	5392.61	4084.41	12963	629.13	485.54	857.15	649.22	2060.46	41.60
1987	4290.10	5854.58	4826.58	19779	937.44	457.64	624.53	514.87	2109.90	29.60
1988	5213.00	8315.82	7187.32	30021	1334.22	390.72	623.27	538.69	2250.08	27.70
1989	9888.00	11808.73	10611.93	55181	2485.59	397.81	475.09	426.94	2220.04	21.40
1990	23212.90	31213.84	28833.70	113340	5126.70	452.78	608.85	562.42	2210.78	27.54
1991	41614.80	60047.73	55114.69	218276	10108.29	411.69	594.04	545.24	2159.38	27.51
1992	111915.40	119419.84	106441.90	569208	26576.17	421.11	449.35	400.52	2141.80	20.98
1993	241986.80	288337.69	218316.89	1423187	64603.59	374.57	446.32	337.93	2202.95	20.26
1994 (Budget)	396367.67	362271.53	337338.72	2131009	98843.49	401.01	366.51	341.29	2155.94	17.00
1994 (Revised)		440266.46	379532.70	2131009			445.42	383.97	2155.94	20.66