Comments on the Effects of Trade Deficit and High Debt Stock on the performance of the Budget

ZICA, JANUARY 2019

1.0 INTRODUCTION

The Zambia Institute of Chartered Accountants (ZICA) is a professional membership body whose function among others is to advise Government on matters of economic and national development. The Institute received an invitation from the Clerk of the National Assembly to submit comments to the Budget Committee on the effects of Trade Balance Deficit and High Debt Stock on the performance of the Budget. The Committee also requested the Institute to submit comments on Maximizing Revenue Collection from Mines in Zambia.

2.0 The Effects of Trade Balance Deficit

The Balance of payments is a topical issue and continues to be a popular subject of economic and political discourse in many circles. The balance of payments can formally be defined as the statistical record of a country's international transactions over a certain period of time presented in the form of double-entry bookkeeping. Examples of international transactions include import and export of goods and services and cross-border investments in businesses, bank accounts, bonds, stocks and real estate.

3.0 Importance of Balance of Payment

Understanding the Balance of Payments, is worthwhile for the following reasons:
Firstly, the balance of payments provides detailed information concerning the demand and supply of a country's currency. This entails that if a country imports more than it exports, then this means that the supply of domestic currency is likely to exceed the demand in the foreign exchange market. One can thus conclude that the domestic currency would be under pressure to depreciate against other currencies. On the other hand, if a country exports more than it imports, then the domestic currency would be likely to appreciate.

Secondly, a country's balance of payment data may signal its potential as a business partner with the rest of the world. If a country is grappling with a major balance-of-payment difficulty, it may not be able to expand imports from the outside world. Instead, the country may be tempted to impose measures to restrict imports and discourage capital outflows in order to improve the balance of payment situation. On the other hand, a country experiencing a significant balance of payment surplus would be more likely to expand imports, offering

marketing opportunities for foreign enterprises, and less likely to impose foreign exchange restrictions.

Thirdly, balance-of-payments data can be used to evaluate the performance of the country in international economic competition. Suppose a country is experiencing trade deficits year after year, this trade data may then signal that the country's domestic industries lack international competitiveness.

To interpret balance-of-payments data properly, it is necessary to understand how the balance-of-payments account is constructed.

Generally speaking, any transaction that results in a receipt from foreigners will be recorded as a credit, with a positive sign, in the country's balance of payments, whereas any transaction that gives rise to a payment to foreigners will be recorded as a debit, with a negative sign. Therefore, credit entries in the Zambian balance of payments result from foreign sales of our locally produced goods and services, goodwill, financial claims, and real assets. Debit entries, on the other hand, arise from Zambian purchases of foreign goods and services, goodwill, financial claims, and real assets.

Since the balance of payments records all types of international transactions a country consummates over a certain period of time, it contains a wide variety of accounts. However, a country's international transactions can be grouped into the following three main types:

1) The current account;
2) The capital account; and
3) The official reserve account.

4.0 The current account

The letter requests us to comments on the trade deficit, so this Paper will be restricted to the current account which is the source of the trade deficit.

The current account includes the export and import of goods and services. It is divided into four finer categories: merchandise trade, services, factor income, and unilateral transfers.

Merchandise trade represents exports and imports of tangible goods such as copper, sugar, tobacco, gemstones, cotton, fuel, wheat, clothes, motor vehicles, computers, and so on.

Services is the second category of the current account, include payments and receipts for legal, consulting, and engineering services, royalties for patents and intellectual properties, insurance premiums, shipping fees, and tourist expenditures

Factor income is the third category of the current account, consists largely of payments and receipts of interest, dividends, and other income on foreign investments that were previously made.

Unilateral transfers is the fourth category of the current account which involves unreciprocated payments. Examples include foreign aid, reparations, official and private grants and gifts.

Major drivers of Trade deficits

In our view, the major driver of trade deficit in Zambia is the uncompetitive manufacturing industry and lack of value addition to most of the raw materials that the country produces. In this regards the Country is a net importer of most products needed to support commerce and industry. Further, cheap products from China have made local products to be uncompetitive. Others include:

- ✓ Weak Industrial or manufacturing base as the country depends on the imported products;
- ✓ The country export raw materials or unprocessed products thereby depriving the country the maximum benefit in terms of forex;
- ✓ Failure to diversify the economy as the country still depends on copper export, which makes up over 80% of our exports. The country need to invest in agriculture and tourism. The government needs to show serious political will towards the implementation of the diversification programme;
- ✓ Barriers to trade also affect the balance of exports and imports for our country for example the export ban imposed on maize;
- ✓ The Government should focus on promoting local production by improving access to farming inputs and finance for small-scale farmers as a way of diversifying the economy. A number of initiatives can be used to promoting the cultivation of other crops such as fruits, soya beans, cow, peas, groundnuts, mixed beans and cassava. These crops offer a huge potential income source as they are of high value. One of the major hindrances to the cultivation of these crops is lack of

market information and limited access by small-scale farmers as the majority of these farmers are rural based, with little or no education; and
- ✓ The country need to market various water bodies which can improve tourism and if developed can be used to export power.

According to Trading Economics and Bank of Zambia data, Zambia recorded a trade deficit of (1,759) ZMK Million in September of 2018. Balance of Trade in Zambia averaged -100.37 ZMK Million from 2003 until 2018, reaching an all-time high of 1,484 ZMK Million in January of 2011 and a record low of -2,678 ZMK Million in October of 2015.

Some statistics on trade deficit

Month	**Oct, 2017**	**Jan 2018**	**April 2018**	**Jul 2018**	**Sept 2018**
Trade Deficit	(1,006)	(972)	(2,066)	(828)	(1,759)

Source: Trading Economics and Central Statistical Office

5.0 Measures that can be taken to reduce trade balance deficit

The growing trade and current account deficits in Zambia should be of concern to policy makers because it makes the country vulnerable to external shocks and more importantly, has negative consequences for employment and poverty reduction efforts.

1. According to a report by UNCTAD (2014b), Manufacturing has historically been the driver of economic growth and structural change. It opens opportunities for economies of scale, technological progress and learning. It is therefore important for Government to put in place industrial policy and systems that will improve the productivity of major industries such as Manufacturing, Tourism and Farming;

2. The country needs to invest in the development of productive capacities such as adequate infrastructure, in particular reliable water and electricity supply, access to an effective and efficient labour force and reliable transport system that will support the industry base;

3. There is need for deliberate policies that will promote value addition to resources, instead of producing and exporting raw materials through progressively strengthening their backward and forward linkages with the economy. This could be a big recipe for employment creation and import substitution. For example, agriculture activities

could provide inputs to tourism, to large retailers, and to manufacturing activities, especially food processing. Manufacturing activities that provide inputs to agriculture (e.g. fertilizers, agriculture equipment) could also be progressively developed;

4. There should be support to micro, small, and medium-sized enterprises which are essential sources of job and important actors in the process of linkage building. Securing them access to affordable loans should be a priority. Policy instruments can include requiring banks to devote a share of their lending to productive capacity building by such excluded categories, public guarantees for certain types of lending, direct provision of credit by public financial institutions

6.0 Effects of the Trade Deficit

The current account deficit or trade deficit implies that the country used up more output than it produced. By implication Zambia imports more than it exports to international trading partners. Under the circumstances, a country running a perpetual trade deficit must finance its current account deficit either by borrowing from foreigners or by drawing down on its previously accumulated foreign wealth. Therefore, a current account deficit represents a reduction in the country's net foreign wealth.

Financing current account deficit through borrowing is unsustainable because large interest payments leave very little for the country to spend on capital investment and social welfare. This is because borrowing is unsustainable in the long term and the country will be burdened with high-interest payments. A Case in point is Russia which in 1998 was unable to pay its foreign debt back. Other developing countries such as Brazil and many African countries have experienced similar repayment problems.

We must state that if a country is experiencing a trade deficit because of the import demand for capital goods that are necessary for economic development projects, in this case, the trade deficit can be self-correcting in the long run because once the projects are completed, the country may be able to export more or import less by substituting domestic products for foreign imports. However, the problem comes in if the trade deficit is the result of the country importing consumption goods and services as is the case with Zambia. Under the circumstances the situation may not correct itself. Therefore, this persistent current account

deficit may imply that the country is relying on consumer spending and the economy is becoming unbalanced between different sectors and between short-term consumption and long-term investment.

Further, with large current account deficit, the Country is running the risk of depreciation of the value of our currency unless there are sufficient capital flows to finance the deficit as is the case with the United States which has consistently run trade deficit but always posts surplus on the capital account. In the absence of a health capital, the exchange rate will fall to reflect the imbalance of foreign flows of funds. A depreciation in the exchange rate will cause import inflation for consumers and firms who rely on imports of raw materials and other products. Following a depreciation of the domestic currency and the resultant rise in import prices, domestic residents may still continue to purchase imports because it is difficult to change their consumption. With higher import prices, Zambia spends more on imports.

7.0 Ramifications of High Debt stock on the Budget Performance

During the Budget presentation the Minister of Finance announced that Government's external debt stock as at end-June 2018 was US$9.4 billion, representing 34.7 percent of GDP from US$8.7 billion as at end-December 2017. Further, it was reported that the stock of domestic debt in the form of Government securities amounted to K51.9 billion as at end- June 2018 representing 19.2 percent of GDP, compared to K48.4 billion as at end-December 2017. Domestic arrears amounted to K13.9 billion by end-March 2018 from K12.7 billion as at end-December 2017.

The Institute appreciates that debt is an important source of finance for development and is key for poverty eradication as well as improvement in infrastructure. However, we are of the view that it needs to be prudently managed. In the last eight years we have seen the rapid accumulation of debt which has put the country in the spotlight resulting in Zambia being classified as "high risk of debt distress" by the World Bank and IMF. If not properly managed the debt burden will constrain the economy and development progress. It is important that as the country builds-up of debt, there should also be equivalent increase in the productive assets of the economy to assist in repayment of interest obligations. In this regard we welcome the Minister's announcement that Government is in the process of instituting Public Investment Management Reforms to establish a comprehensive system for the appraisal of projects in order to ensure value for money. We hope that the new approach, will closely link investment and responsible borrowing.

High Debt Stock has significant impact on the Budget Performance as the huge amount of domestic revenue is spent on servicing large interest payments leaving very little for the country to spend on productive capital investments and social welfare. As can be seen from the table below, a number of economic functions have seen a reduction in the 2019 Budget while there is increase by over 100% in External Debt Payments from K7.3billion in 2018 to K14.9 billion in 2019. There has been a reduction in Budget Allocations to the following economic functions and clearly this can be attributed to increased interest repayments.

8.0 Impact High Debt Stock on Budget Performance

i) Debt has depleted our reserves as the country is using the reserves to pay its liabilities, which have led to the deterioration in forex reserves. This deterioration in the forex reserves is reflected in value of the kwacha. In December 2018, the kwacha hit an all-time high this year of $11.90 to a dollar, which is 18% depreciation in a twelve-month period;

ii) We are heading for a crisis as a country is in debt distress even if the government does not want to admit.

iii) The Government will need to raise more taxes and levies which will destroy industries and we will all be affected this effect has already started being felt from the raising of fuel levy, electricity tariffs and Mineral Royalty tax.

EXPENDITURE BY FUNCTIONS OF GOVERNMENT

Function	K 2019 Budget	K 2018 Budget	% Change
External debt Payments	14,947,077,126	7,268,795,020	106
Domestic Debt Payments	8,626,278,083	6,972,268,260	24
Compensation and Awards	200,000,000	303,363,990	(34)
Roads Infrastructure	6,501,672,380	8,660,314,680	(25)
Farmer Input Support Programme	1,428,000,000	1,785,000,000	(20)
Strategic Food Reserves	672,000,000	1,051,200,000	(36)
Rural Electrification Programme	182,461,999	441,000,000	(59)
Environmental Protection	875,101,216	951,352,080	(8)
Climate Change Resilience	213,035,243	457,574,620	(53)
Drugs and Medical Supplies	900,082,236	1,200,227,400	(25)
Recreation, Culture and Religion	297,272,319	451,160,740	(34)
School Infrastructure	258,806,582	740,060,456	(65)
Skills Development Funds	163,993,697	176,698,000	(7)
Social Protection	2,187,059,905	2,301,259,752	(5)
Social Cash Transfer	699,494,400	721,180,000	(3)
Food Security Pack & Public Welfare Assistant Scheme	110,880,000	140,000,000	(21)

Source: 2019 and 2018 Budget Speeches

9.0 Maximising Collections from the Mines in Zambia

Mineral Royalty is a payment received as consideration for the extraction of minerals
Holders of the following mining rights are liable to mineral royalty on minerals produced under their respective licenses:

i) large scale mining license ,
ii) large scale gemstone license,
iii) small-scale mining license,
iv) small scale gemstone license, and
v) artisan's mining right,

For purposes of Calculating Mineral Royalty tax, it is based on either the norm or gross value of the minerals as follows:

1. Gross value is applicable to the following minerals:

i) Industrial Minerals
ii) Energy Minerals
iii) Gemstones

Under this method of calculation, Mineral Royalty is calculated based on the Gross Value of the minerals produced. For purposes of computing Mineral Royalty, **'gross value'** is defined as “the realised price for sale ***Free on Board*** at the ***point of export*** in Zambia or ***point of delivery*** within Zambia”

2. Norm value is applicable to the following:

i) Base metals (Including copper)
ii) Precious metals

For purposes of computing Mineral Royalty, **'Norm Value'** means:

i) the monthly average London Metal Exchange cash price per tonne multiplied by the quantity of the metal or recoverable metal sold;
ii) the monthly average Metal Bulletin cash price per tonne multiplied by the quantity of the metal sold or recoverable metal sold to the extent that the metal price is not quoted on the London Metal Exchange; or
iii) the monthly average cash price per tonne, at any other exchange market approved by the Commissioner – General, multiplied by the quantity of the metal sold or recoverable metal sold to the extent that the metal price is not quoted on the London Metal Exchange or in the Metal Bulletin; and

Norm price' means the monthly average:

i) London Metal Exchange cash price per tonne of the metal or recoverable metal sold;
ii) Metal Bulletin cash price per tonne of metal sold or recoverable metal sold to the extent that the metal price is not quoted on the London Metal Exchange; or
iii) Cash price per tonne, at any other exchange market approved by the Commissioner – General of the metal sold or recoverable metal sold to the extent that the metal price is not quoted on the London Metal Exchange or Metal Bulletin.

10.0 New Mineral Royalty Regime

Effective, 1st January, 2019, the Income Tax Amendment Act, 2019 has increased mineral royalty rates by 1.5 percentage points of the norm value at all levels of the sliding scale and further introduce two tiers of mineral royalty rates of 8.5% and 10% of the norm price of copper that will apply when price reaches $7,500 and US$9,000 per metric tonne or higher as highlighted below:

Table 1: 2019 Mineral Royalty Rates

Mineral Royalty Tax Scale	2019	2018
Less than $4,500	5.5%	4%
$4,500 < $6,000	6.5%	5%
$6,000 < $7,500	7.5%	6%
$7,500 < $9,000	8.5%	N/A
$9,000 ≥	10%	N/A

Table 2: Contribution of Mineral Royalty and Mining Corporate Income Tax to Zambia's Domestic Revenue collection

Year	2011	2012	2013	2014	2015	2016	2017
MRT	868	1,458.6	1,7607	1,766.9	3,749.1	3,053.1	2,435
CIT	2,473.9	2,610.03	1,084.7	1,473.5	418.2	1,289.5	1,067.5
Mining Revenue as a % of Tax Revenue	17.7%	19.7%	12.3%	11.8%	14%	14%	9%

Comparison of Zambia's MRT Regime with other Mining Countries

In the table below, we provide a comparison of some of the rates applicable in other countries and clearly shows that with the proposed regime, Zambia will rank highly among its peers in the mining industry. For all mining countries that have been looked at, Mineral Royalty is deductible for computation of Corporate Income Taxes for Mining Companies. Effectively, this makes Zambia as an outlier as far the deductibility of Mineral Royalty is concerned.

Regional Comparison

Country	Zambia	Central Republic of Congo	DRC	Ghana	South Africa	Botswana	Tanzania
MRT	5.55% – 10%	3%	2%	5%	0.5% - 7%	3%	4%
Deductible	No	Yes	Yes	Yes	Yes	Yes	Yes
CIT	30%	30% / 34%	30% - 40%	25% - 35%	28%	22%	30%

Source: PwC Global: Corporate income taxes, mining royalties and other mining taxes comparison

Global Comparison

Country	Zambia	Argentina	Indonesia	Kazakhstan	India	Brazil	Ukraine	Chile	China	US	Russia	Australia
MRT	5.55 – 10%	3%	4%	5.7%	4.62%	2%	5%	0% - 14%	0.5 – 4.0%	0 - 5%	8%	2.7% - 5%
Deductible	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
CIT	30%	35%	25%	20%	32% - 42%	34%	21%	18.5%	25%	35%	20% - 15.5%	30%

Source: PwC Global: Corporate income taxes, mining royalties and other mining taxes comparison

The Case of Chile

For Chile, The tax base for the Specific Mining Tax is the net taxable income determined for the First Category Tax with certain non-operational revenue additions and deductions.

1. Annual sales of less than 12,000 metric tonnes of fine copper are exempted from Mining Industry Tax;

2. For annual sales ranging between 12,000 and 50,000 metric tonnes of fine copper, a marginal rate ranging from 0.5% to 4.5% is applied over the taxable operational mining income (equivalent to an effective tax burden of 0.04% to 1.93%).
3. Annual sales over 50,000 metric tonnes of fine copper are subject to an effective tax burden ranging from 5% and 14% over the taxable operational mining income.
4. First Category Tax (or corporate tax) paid by the company on that revenue can be credited.
5. The High mineral Royalty is compensated by a low Income Tax rate is at 18.5%

11.0 Financial Impact of MRT on Mine operations

i) Value base difference

Mineral Royalty is based on the price quoted on the London Metal Exchange. While the use of the LME prices addresses the concerns on transfer pricing, it does not take into account the actual sales made especially for low grade minerals.

ii) Cash flow disparities

The standard terms on the sale of minerals are that the mines only receive payment after confirmation of delivery by the buyer. Delivery takes up to 120 days due to shipping logistics. On the other hand, mineral royalty is due and payable within fourteen days after the end of the month in which the sale of minerals is done.

The high mineral royalty tax obligations will therefore have severe cash flow consequences on the mines as they will be expected to make the royalty payment, well before payment is received.

ii) Additional Cost burden on the mines

Since the royalty is applied to turnover rather than profits and is now non-deductible for Income Tax purposes, there will no longer be any form of tax relief for mining costs. Therefore, this will raise the marginal cost of extracting minerals, as they are based on the volume or value of production without deduction for cost.

Way Forward Conclusion

It is evident that both Government and the Mine Operators have competing interests as far as sharing of the risks and rewards of mineral development is concerned. Either party want to maximize rewards and shift as much risk as possible to the other.

Our view is that the two parties must reach a common comprise that will ensure the Mines are not overburdened by the new Tax Regime to the point of affecting the viability of mines operations. Government must develop reasonable tax regime that will ensure the government receives at least adequate payment for its mineral resources without necessarily hurting the industry. As an Institute, we would like to see a win – win situation and wish to make the following recommendations:

1. As per global practice Mineral Royalty must allowed to be deductible for Income Tax Purposes. The current regime makes Zambia the only country that disallows deduction of Mineral when computing taxable profit;
2. Government consider staggering some of the proposed tax measures over a period to minimise the shocks on tax payers. We are of the view that fiscal mistakes of past years cannot all be corrected in one fiscal year without hurting business operations. In this regard, we propose that measures such as the Sales Tax System be on hold until thorough consultation and research is done to establish the impact on businesses and the economy;

3. Government must enhance the capacity of the Mineral Value Monitoring Project in order to enhance the capacity to track the mineral production and remove suspicion of perceived under declarations;
4. Enhance accountability and transparency at all points in the mineral extraction process from the determination of what resources are available, on how to extract them, to how revenues are raised and publication of tax payable by mining companies and also ensure publication of aggregate collection for each tax type by sector,

12.0 Conclusion

While it is an undeniable fact that Zambia needs to optimize its returns on mineral resources. It is our view that the new tax regime adopted will make Zambia highly uncompetitive on both the International and Regional scale. So the country will find it difficult to attract and retain credible mining investments. We understand that Government is facing severe fiscal challenges and is desirous to increase its stake in revenue from mineral resources. However,

the proposed Mineral Royalty measures are short term in nature as they are only focused on the top line. Our view is that the proposed Mineral Royalty regime is not only drastic but harsh and is bound to severely hurt the Mining companies and would affect global competitiveness of our mining industry. Tax contributions from the industry need not be looked at in isolation but from the broader contribution through employment creation, supplier benefits and other support sectors.

While we support the notion that the mining sector must contribute its share to the national treasury, we think that the contribution must be reasonable and fair. As such we would prefer a gradual and phased approach to changes to the mining tax regime to enable the affected parties to prepare and plan. The drastic mineral royalty regime will affect long-term investment hence jobs creation and investor confidence in the sector. Hiking corporate taxes in the mining sector may seem to be good in the short term but it is likely to impact on the country's global competitiveness, and thus pose negative effect on the sector activity and in turn on employment. Mining companies carry out the various exploration and development activities prior to production over a long period of time, at high cost and in some cases with a high level of risk and uncertainty as to future commercial benefits. It is thus a unique industry that must be accorded special attention and requires stable fiscal policies. We also note the adverse tendency to legislate and introduce harsh conditions whenever there is failure to address the tax challenges in the Sector. We do not think that introducing punitive fiscal measures is the solution. Rather the panacea lies in engagement with a few errant mining houses, building administrative capacity in the tax Authority and reviewing the tax system to meet the best practice in revenue collection from the sector. In the long run the increases in the Mining tax will make the country very uncompetitive consequently forcing Mining companies to avoid investing in the country or put the mines on care and maintenance.

Further, in addressing the budget deficit, we think that Government the focus should not just be on introducing new taxes that will overburden citizens and the business. Overtaxing citizens and businesses will hurt the economy in the long as these players will have little no disposable income to support commerce and expansion of business. Rather, Government must undertake a comprehensive review of it public expenditure to identify areas of wastage and possible defer some of the planned public expenditure that may not of an urgent matter. Further, though the austerity measures were announced, the Institute is desirous to see how much has been saved from these measures and what other measures can be included.

13.0 References

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