FACTSHEET

Leveraging Consumer and Producer's Voices in Policy Reforms' (LECOP)

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Fuel Subsidy Removal in Zambia

PARTNERS

EAZ

ACF

The Voice – in many languages

The overall objective of this Factsheet is to contribute to a deeper understanding of the nature and dynamism of the fuel subsidy removal on the Zambian economy (carried out in early 2013).

It seeks to evaluate the welfare implications of the fuel subsidy reform implemented in Zambia by assessing the impact of the fuel subsidy removal on key sectors of the economy. The Factsheet assesses the reform process against best practice, discusses issues that need to be addressed when designing subsidy reforms to enhance success and assesses the extent to which the reform process has stakeholders buy-in.

Subsidy removal generally has inflationary impacts on the economy as evidenced by high prices for commodities. However, in case of Zambia – it was introduced at a time when the economy was doing relatively well and in line with the single digit inflation target under the Southern African Development Community (SADC) macroeconomic convergence framework, thus the timing of the removal of the fuel subsidy in Zambia can generally not be faulted.

Since inflation is mainly driven by food products, the impact was felt by all regardless of income and location. However, as seen by the inflation trends, the economy has already adjusted to inflation as it is beginning to come down. Even if the trend eventually comes back to normal, the damage in terms of impact on poverty would be permanent.

The application of the subsidy was non-discriminatory and not targeted hence it had an effect on the entire economy and across all rungs of society

While those households who are relatively better off financially would consume more fuel and thus would be the first to feel the full impact of the subsidy removal. Based on the research undertaken by CUTS and its partners – Agriculture Consultative Forum (ACF), Economics Association of Zambia (EAZ), and Zambian Voice (ZV), findings from the field suggest that the impact was actually more on the low income households than the high income households in Zambia. The application of the subsidy was non-discriminatory and not targeted hence it had an effect on the broad spectrum of the economy. This was largely due to the indirect effects of the subsidy removal, which in this case proved to be more critical than the direct effects of increase in the fuel budget to consumers.

All products, including the basic commodities and transport, saw their prices rising as a result of inflation, and poor consumers, including those that do not use much petrol and diesel were affected. Thus, it is not surprising that the survey results reveal that the low-income earners lost about 29.9 percent of their average income to the subsidy removal while the high income earners only lost about 12 percent, despite them consuming more fuel. It is apparent

The survey results reveal that the low-income earners lost about 30 percent of their average income to the subsidy removal while the high income earners lost about 12 percent

that in Zambia, it is largely the ability to absorb price shocks that matter most when it comes to the impact of policies on the citizens.

In other words, although it was largely the high income earners who were directly benefiting from the fuel subsidy; the removal of the subsidy affected those who were ill-equipped to withstand the inflationary pressures more than those directly benefiting. There is an urgent need for the government to find potential ways of compensating the poor for their loss in income due to the subsidy removal. The measures contained in the 2014 Budget Statement can go a long way in filling this gap.

The removal of the fuel subsidy also resulted in a loss of savings for households of about 19 percent. Given the importance of savings as a tool for mobilising investment, there is a potential for this to affect the level of investment for the Zambian economy. Thus unless government increases its expenditure to offset the likely decrease in investment, the fuel subsidy removal can result in a decrease in the country's GDP.[1]

It is thus important to ensure that savings from the subsidy removal are channelled towards government expenditure, especially towards infrastructure and social services to ensure that through the multiplier effect, there would be a trickledown effect to the poor's income, which could also restore lost savings.

The impact on GDP could also be seen through the manner in which manufacturers have responded to the removal of the fuel subsidy. Despite its importance in the manufacturing process, the survey results show that the manufacturers responded by reducing the consumption of diesel significantly.

Such a significant reduction in diesel consumption was likely to reduce output, unless the diesel was being used for non-critical items. But despite scaling down use of diesel, manufacturers still saw the share of fuel in their total costs increasing by about five percent. Given that there were no corresponding increases in prices of the same magnitude (as revealed by annual and month on month inflation trends), then manufacturing firms may have absorbed most of the costs to stay in business.

The manufacturing sector, which contributes significantly to GDP at about 8.3 percent per year, is likely to contribute lower rates in 2013 due to the removal of the fuel subsidy. Thus GDP would also be expected to take a knock due to this development.

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It was largely the government that has to boost GDP through increasing its expenditure using resources that would have been used to cater

1 *Under the national income identity, GDP= C+I+G+(X-M), where GDP is gross domestic product, C is consumption, I is investment, G is government expenditure, X represent exports while M are imports. A fall in I which is compensated by an increase in G would thus be expected to restore GDP to its current level.*
(Based on CSO figures for 2011 and 2012, released in the August monthly bulletin)

for subsidies. The expected increase in expenditure in infrastructure and social protection system that are provided for in the 2014 Budget Statement are good avenues for increasing government expenditure.

The impact on GDP could also be seen through the manner in which manufacturers have responded to the removal of the fuel subsidy by reducing their consumption of diesel significantly

The same is also true based on the likely impact on agriculture and wholesale and retail sectors. Agriculture constitutes about 3.6 percent of GDP, while the wholesale and retail trade constitutes about 14 percent. Since some wholesalers and retailers reduced their fuel consumption by an average of 27 percent, this is likely to reduce their mobility and hence their trade volumes. The fact that the average expenditure on fuel by wholesalers and retailers increased by about six percent following the subsidy removal could also imply that the business is less profitable, which might scare away potential entrants.

The same analogy was true for farmers, as some of them reduced their consumption of diesel by an average of 40 percent, which could result in reduced yield. This was also worsened by the fact that the removal of the subsidy saw the costs of fuel as a proportion of total costs increasing by about seven percent. This might also discourage some farmers and hence impact negatively on output.

If the government fails to use the savings from the subsidy wisely, a fall in GDP is likely. However, there is a lot of scope for the government to intervene wisely in the market. The fact that the subsidy actually took more resources than what was allocated to social protection gives the need for increasing social protection funding. An indication to increase social protection allocation and spending has been initiated.

The government fails to use the savings from the subsidy wisely, a fall in GDP is likely

Given the negative impact on the poor, priority should be given to projects where such spending would make a difference to the lives of the poor, which include healthcare and education. Thus, there is need for strategic mitigating measures to compensate for the loss to the poor. This can include targeted cash transfers and free education and healthcare as well as facilitating a more efficient public bus transportation system. The implementation of measures identified in the 2014 National Budget Statement, thus, is important.

The reform process was not adequately managed, if international best practice is anything to go by. There does not appear to have been a comprehensive reform plan, which would have spelt clear long term objectives on the removal of the subsidy, to enable stakeholders to measure whether the reform would be a success or not. Experience of other (especially of developing countries) could have been looked at to draw lessons.

There is need for strategic mitigating measures to compensate for the loss to the poor

Such a plan should have been shared with all stakeholders to ensure transparency in the whole process. Related to this, the removal of the subsidy should have been preceded by a thorough study on likely impact which would have served as an input into the mitigating

strategies and a public awareness campaign to ready the citizens for this shock. This does not appear to have been done.

Results from stakeholder consultations undertaken by CUTS & its partners reveal that there was little support for reforms from most of the stakeholders, as the majority are not happy about reforms. This could have been avoided had a clear communication strategy been mapped out prior to the subsidy removal, which would also have seen government winning support for reforms. Thus, it was critical to consult widely with all stakeholders for their input into the issue that is central to their welfare. Stakeholders from business, civil society and consumers do not appear to have been consulted during the exercise. Consultations would have given the opportunity for a win-win situation and democratised the process, which might have probably resulted in a gradually implemented subsidy removal programme with minimum impact on stakeholders.

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Now that the measures have already been introduced, reversal of the decision might not be to the best interest. Although some stakeholders are still calling for the reversal of the decision, the economic system appears to have adjusted well to the subsidy removal, as revealed by the stabilisation in inflation.

In addition, the subsidy was already proving to be unsustainable, given the pressure it was putting on government resources. The government was already struggling with a fiscal deficit, which stood at 2.9 percent of GDP in 2012. Expenditure on the fuel subsidy had grown from only 0.1 percent of GDP in 2010 to about 0.7 percent in 2012.

The unsustainability of the fuel subsidy was also reflected on the expenditure on the subsidy as a ratio of total revenue; this had increased from only 0.7 percent in 2010 to about 3.6 percent in 2012. Thus, on the economic front, the subsidy removal can be justified. What needs to be adequately managed is the social front, where effective planning, communication and mitigation is called for.

Dialogue with stakeholders will still help, where government can also try to seek buy-in and cooperation while the transition from a subsidised regime to one towards rule-based price mechanism takes place

It is also not too late for the government to engage stakeholders and explain what it intends to do to ensure that the negative effects of the subsidy removal are contained. Dialogue with stakeholders will still help for, where government can also try to seek buy-in and cooperation while the transition from a subsidised regime to one towards rule-based price mechanism is taking place.

This Factsheet has been prepared by CUTS International Lusaka as part of the Leveraging Consumer and Producer's Vocies in Policy Reforms' (LECOP) project, which involved research undertaken jointly by CUTS, ACF, EAZ and ZV.