Document of
The World Bank

FOR OFFICIAL USE ONLY

Report No: P-7379-ZA

REPORT AND RECOMMENDATION

OF THE PRESIDENT

OF THE

INTERNATIONAL DEVELOPMENT ASSOCIATION

TO THE

EXECUTIVE DIRECTORS

ON A PROPOSED

FISCAL SUSTAINABILITY CREDIT

OF SDR 105.5 MILLION (US $140 MILLION EQUIVALENT)

TO THE

REPUBLIC OF ZAMBIA

May 31, 2000

FISCAL YEAR OF BORROWER

January 1 - December 31

CURRENCY EQUIVALENTS

Currency unit: Zambian Kwacha (K)
US$1 = 2654 Kwacha (Average exchange rate of April 2000)

WEIGHT AND MEASURES

Metric system

ABBREVIATIONS AND ACRONYMS

AAC	Anglo-American Corporation
ATAF	Automatic Tariff Adjustment Formula
BOZ	Bank of Zambia
CAS	Country Assistance Strategy
CEC	Copperbelt Electric Corporation
CEM	Country Economic Memorandum
CG	Consultative Group
CIR	Country Implementation Review
CMU	Commitment Monitoring Unit
DB	Defined Benefit Plan
DC	Defined Contribution Plan
EC	European Commission
ESAC	Economic and Social Adjustment Credit
ESAF	Enhanced Structural Adjustment Facility
EU	European Union
FSC	Fiscal Sustainability Credit
GDP	Gross Domestic Product
GOZ	Government of Zambia
HIPC	Heavily Indebted Poor Countries
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IFMIS	Integrated Financial Management Information System
IMF	International Monetary Fund
LASF	Local Authorities Superannuation Fund
MOFED	Ministry of Finance and Economic Development

Vice President:	**Callisto Madavo**
Country Director:	**Michael Sarris**
Sector Manager:	**Philippe Le Houerou**
Team Leader:	**Hinh Dinh**

MOH	Ministry of Health
MOLA	Ministry of Legal Affairs
MTEF	Medium-Term Expenditure Framework
NAPSA	National Pension Scheme Authority
NPS	National Pension Scheme
OAG	Office of the Auditor General
OECD	Organization for Economic Cooperation and Development
PAYG	Pay-As-You-Go
PCF	Pneumoconiosis Compensation Fund
PER	Public Expenditure Review
PFP	Policy Framework Paper
PRGF	Poverty Reduction and Growth Facility
PRSP	Poverty Reduction Strategy Paper
PWAS	Public Welfare Assistance Scheme
PS	Permanent Secretary
PSC	Public Service Commission
PSCAP	Public Service Capacity Building Project
PSPF	Public Service Pensions Fund
PSREP	Public Sector Reform and Export Promotion
PSRP	Public Service Reform Program
SIP	Sector Investment Program
USAID	United States Agency for International Development
WCF	Workers' Compensation Fund
ZANACO	Zambia National Commercial Bank
ZCCM	Zambia Consolidated Copper Mines Limited
ZNOC	Zambia National Oil Company Limited
ZESCO	Zambia Electricity Supply Company
ZNPF	Zambia National Provident Fund
ZNTB	Zambia National Tender Board
ZPA	Zambia Privatization Agency
ZR	Zambia Railways
ZRA	Zambia Revenue Authority
ZSIC	Zambia State Insurance Corporation

ZAMBIA
FISCAL SUSTAINABILITY CREDIT

Table of Contents

This operation has been prepared by a team led by Hinh Dinh (Principal Economist and Task Team Leader) and comprising Abebe Adugna (YP, AFTM1); Heinz Bachmann (Consultant); Aniruddha Bonnerjee (Economist, HDNSP); Gulam Dhalla (Consultant); Steve Gaginis (Disbursement Officer, LOAAF); Leonid Koryukin (Research Analyst, AFTM1); David Lindeman (Advisor, HDNSP); Thuvara Nayar (Consultant); Mushiba Nyamazana (Economist, AFMZM); David Wilton (Principal Financial Specialist, AFTPF); Aberra Zerabruk (Senior Counsel, LEGAF); and Johannes Zutt (Operations Officer, AFC02). Mmes. Debra Cubitt and Cristina Cheptea, AFTM1 are the Team Assistants. The Peer Reviewers are Messrs. Shantayanan Devarajan (DECRG), Paul Levy (LCC7C), and Malcolm Holmes (PRMPS).

ZAMBIA
FISCAL SUSTAINABILITY CREDIT (FSC)

SUMMARY

Borrower:	Republic of Zambia
Implementing Agency:	Ministry of Finance and Economic Development
Amount and Terms:	SDR 105.5 million (US$140 million equivalent) on standard IDA terms with 40 years maturity
Description:	This Credit aims to help Zambia sustain fiscal progress achieved in recent years by: (i) expanding fiscal adjustment beyond the central government to other public sector entities (state-owned enterprises, pension funds, and the Bank of Zambia); and (ii) reestablishing fiscal discipline through improvement in the predictability, accountability, and transparency of public spending. In line with the poverty reduction strategy articulated in the recent Country Assistance Strategy (CAS), the proposed Credit would address poverty reduction objectives in two important ways. First, at the general level, the Credit directly contributes to the maintenance of a stable macroeconomic framework conducive to economic growth by ensuring that fiscal progress achieved in the last few years will be long-lasting. Second, the proposed reforms in budget management will help ensure that public expenditures, especially social expenditures, will reach the poor in the most effective way.
Benefits:	The main benefits of the FSC are macroeconomic stability, a sustainable fiscal position, higher economic growth, and more efficient, effective and equitable public expenditures, each of which is expected to have a significant and long lasting impact on poverty reduction.
Risks:	There are substantial risks associated with this program. The first source of risk is that the reform program may falter because of major policy reversals, external shocks, and/or limited institutional and managerial capacity. The second source of risk is

	failure by the authorities to take specific reforms supported by the Credit due to opposition from vested interest groups. These risks have been mitigated by the strength of the Government's ownership and commitment to implement the proposed measures, by the Government's significant up-front actions, and by its active role in informing the public about the benefits of reform and in consulting the private sector and donors in the reform process.
Disbursement:	The proposed Credit will be disbursed through the Bank of Zambia. Disbursement will be in three tranches. The first tranche (US$45 million) will be released at effectiveness. The floating tranche (US$50 million) will be released when the specific conditions related to reforms in the petroleum sector are met. The second tranche (US$45 million) will be disbursed when the specific conditions associated with its release are met, which is expected to be around August 2001.
Project ID Number:	ZM-PE-39016

REPORT AND RECOMMENDATION OF THE PRESIDENT OF THE INTERNATIONAL DEVELOPMENT ASSOCIATION TO THE EXECUTIVE DIRECTORS ON A PROPOSED FISCAL SUSTAINABILITY CREDIT TO THE REPUBLIC OF ZAMBIA

1. I submit for your approval the following report and recommendation on a proposed development credit to the Republic of Zambia for SDR 105.5 million (US$140 million equivalent) in support of its economic reform program. The Credit would be on standard IDA terms, with an amortization period of 40 years, including a grace period of 10 years.

2. The proposed Fiscal Sustainability Credit (FSC) would be the eighth structural adjustment credit to Zambia since the clearance of Zambia's arrears to the World Bank in March 1991. The objective of this Credit is to continue IDA's support of Zambia's reform program, which aims to reduce poverty by restoring macroeconomic stability, promoting sustained and diversified growth, improving governance and enhancing the delivery of vital social services. The Credit has two major components: (a) reduction of the overall public sector (quasi-fiscal) deficit and (b) improvement of fiscal management in Zambia. To reduce the quasi-fiscal deficit, the proposed Credit will support measures to reduce the deficits of several state-owned enterprises, of the Bank of Zambia, and of the pension system. To improve budget management, the Credit will support measures to increase predictability, accountability, and transparency in public spending.

3. In line with the poverty reduction strategy articulated in the recent Country Assistance Strategy (CAS), the proposed Credit would address poverty reduction in two important ways. First, at the general level, the Credit directly contributes to the maintenance of a stable macroeconomic framework conducive to economic growth by ensuring that fiscal progress achieved in the last few years will be long-lasting. Second, each of the components of the Credit will have a specific and direct impact on poverty. Reducing the quasi-fiscal deficit will help ensure adequate funding to help the poor and other vulnerable groups, in addition to mobilizing domestic savings to finance higher investment and growth. Reforming budget management will ensure that the Government's budget priorities on social development and poverty alleviation will be faithfully reflected in actual cash releases.

I. THE ECONOMY

A. BACKGROUND

4. From the time of its independence in 1964 to the early 1990s, Zambia's economic policy was characterized by pervasive state intervention in factor and product markets and by large-scale state ownership of productive assets. The effects of these devastating policies were not immediately evident because the country had use of resources generated by the production and export of copper. But when the world copper price began to decline, the inefficiencies of the economy became more evident as domestic incomes and output came under increasing downward pressure. The Government attempted to offset

the decline in copper earnings by borrowing heavily from abroad. This was insufficient to halt the economic decline and Zambia's economy and income levels fell rapidly in the 1980s, while the country became heavily indebted.

5. The new Government that took office in 1991 launched a program of economic stabilization and liberalization designed to reverse the country's economic decline and put it on the path of sustainable growth (Box 1). Prices were decontrolled and subsidies eliminated, inflation was brought down significantly, market forces were allowed to determine the exchange and interest rates, quantitative restrictions on imports were eliminated; and the tariff structure was compressed and simplified. Parastatal monopolies have ended, crop marketing was liberalized, and a far-reaching privatization program has made good progress. The central government budget deficit (after grants and debt rescheduling) declined from 7 percent of GDP in 1991 to 2.3 percent in 1997, although it rose again to about 4 percent in 1998-1999. The privatization of non-mining public enterprises has continued at a rapid pace, with over 80 percent of companies/units privatized by December 1999, out of a total portfolio of 282.

6. While the government has been quite successful in implementing this program, the economy has responded slowly, with average annual growth of less than 1 percent in 1994-1998 compared to 3 percent growth of the population. Furthermore, macroeconomic stability has not been fully achieved. While inflation has declined from close to 200 percent in 1992-1993 to about 20 percent by 1997, it has remained between 20 and 30 percent since then. Moreover, the decline in GDP in 1998 after growth had resumed in 1996 and 1997 shows that Zambia has not yet attained sustained economic growth.

B. RECENT ECONOMIC DEVELOPMENTS

7. Following two successive years of economic growth in 1996 and 1997, the economy slowed down in 1998 due to a combination of internal and external shocks. Much of this slowdown can be attributed to weak performance in the copper mining sector, and in particular, to operational and financial problems at the copper parastatal, Zambia Consolidated Copper Mines (ZCCM), which was, until its privatization on March 31, 2000, the largest public sector company in Zambia. A 25 percent drop in the copper price, together with delays in ZCCM's privatization, substantially reduced copper production and export revenues in 1998. At the same time, adverse weather conditions contributed to a reduction in agricultural output, especially maize production. As a result, in 1998 GDP declined by about 2 percent in real terms. Poor performance in copper and agriculture contributed to a fall in foreign exchange earnings, which was exacerbated by a reduction in balance of payments support. Together, these events led to a depreciation of the Kwacha by over 60 percent during the year. The current account deficit (after transfers) widened to about 11 percent of GDP, while official foreign exchange reserves fell from two months of imports at end-1997 to less than two weeks of imports by end-1998. Inflation rose to about 30 percent by year end, reflecting in part the pass-through effects of the Kwacha depreciation. Although the government exercised fiscal restraint on recurrent expenditures, capital expenditures increased at a time when balance of payments support declined. The central government budget deficit (on a cash basis, after grants) increased from 2.3 percent of GDP in 1997 to 4.4 percent of GDP in 1998.

8. The economy recovered in 1999, aided by good weather and a relatively stable exchange rate. Nevertheless, GDP grew by only 2.4 percent because of the continuing adverse effects of the delays in ZCCM privatization. Increased production of maize, rice, mixed beans, and cash crops (seed cotton and soybeans) contributed to a 13.7 percent growth in the agricultural output. Overall economic growth would have been higher if not for the decline in mining output (25 percent) and modest growth in the manufacturing sector (3 percent), where the sources of growth were mainly in food, beverages and tobacco. Despite a fall in foreign exchange earnings due to copper exports and to lower than expected balance of payments support, the authorities managed to adhere to stringent fiscal and monetary policies. This policy framework, combined with a relatively stable exchange rate (compared to 1998), contributed to a decline in the end-of-period inflation, from 31 percent in 1998 to about 21 percent in 1999.

9. Despite a decline in central government revenues (caused mainly by factors related to the delays in ZCCM privatization), the Government continued to pursue a tight fiscal policy throughout 1999, with the result that the central government budget deficit (on a cash basis, after grants) declined slightly, to 4.0 percent of GDP from 4.4 percent of GDP in 1998. At the same time, largely because ZCCM and its suppliers experienced financial difficulties in meeting their tax obligations in 1999, total tax revenue fell from 18.1 percent of GDP in 1998 to about 17.1 percent of GDP. The shortfall in revenues was balanced by sharp cuts in expenditures: current expenditures fell from 17.3 percent of GDP in 1998 to just 15.0 percent of GDP in 1999. This tight fiscal policy was accompanied by a stringent monetary policy, as money and quasi-money grew at the same pace as nominal GDP. On the external side, tightened imports compensated for the drop in export earnings. As a result, the current account deficit (after transfers) declined from 11 percent of GDP in 1998 to about 9 percent in 1999.

10. Despite these considerable economic hardships, progress continued on a number of policy fronts. In January 1999, the Anglo-American Corporation (AAC) signed a Memorandum of Understanding with the Government for the purchase of the Nampundwe mine and the Konkola, Nchanga and Nkana Divisions of ZCCM. In March 1999, the Government agreed on a new Policy Framework Paper with the Bank and the IMF, and the IMF approved a new three-year Enhanced Structural Adjustment Facility (ESAF) (now Poverty Reduction and Growth Facility (PRGF)) program. In April, the Government concluded a debt rescheduling agreement with the Paris Club. Progress on the Public Service Reform Program (PSRP) continued, and the Bank released the Floating Tranche of the Public Sector Reform and Export Promotion (PSREP) Credit in early July 1999. Nonetheless, in the last half of 1999, a further delay in the privatization of ZCCM and consequent delays in related balance of payments support increased the vulnerability of the economic reform program and adversely affected the Government's ability to meet some of the PRGF's targets, particularly on the external side.

11. In 2000, there has been significant improvement. On March 31, AAC completed the purchase of the Nampundwe mine and the Konkola, Nchanga and Nkana Divisions of ZCCM. As lesser mining interests formerly owned by ZCCM have also been sold to

private investors, most of the assets in this sector are now in private hands[1], paving the way for new management and new investment. In early April 2000, the Bank released the Second Tranche of the PSREP. Discussions between the Government and the IMF have also continued, and in May 2000, the Government reached understandings with the Fund on the first review of the PRGF and on a program for 2000. At the same time, the Government also discussed with World Bank and IMF staff its interim Poverty Reduction Strategy Paper (PRSP) and the debt sustainability analysis that will be included in a preliminary Heavily Indebted Poor Countries (HIPC) Initiative document which will be presented to the Boards of the Bank and the Fund shortly.

12. Given its debt overhang and developmental needs, Zambia remains extremely dependent on external assistance, particularly for balance of payments support. This is exacerbated by Zambia's dependency on copper exports and the declines in copper prices. While net foreign direct investment has been encouraging (about $165 million in 1999), foreign aid has declined in recent years. Zambia's external debt reached about $6.9 billion by end-1999, nearly twice the level of its GDP. Initial analysis shows that even with sound economic policies and concessional borrowing only, Zambia's external debt will remain unsustainable. Hence Zambia's entry into the HIPC debt relief initiative is essential. Work on a detailed debt sustainability analysis has begun and Zambia could be brought to a decision point in late 2000/early 2001.

13. The key policy reforms after the completion of ZCCM's privatization relate to fiscal management and the judicious use of limited financial resources to maximize the impact of public programs. Improving overall government transparency and accountability through capacity building and institutional strengthening will help enhance the investment climate and build external confidence. The Government also needs to secure from external partners higher and more stable flows of balance of payments support as well as debt relief and long-term financial assistance. As the CAS points out, following a decades-long decline in the contribution of copper mining to the economy, it is more clear than ever before that Zambia's future lies in diversifying and expanding economic opportunities beyond copper, through learning new skills and producing globally competitive goods and services, particularly in agriculture and tourism where the potential is greatest.

II. ZAMBIA'S ADJUSTMENT PROGRAM

14. During the 1990s, Zambia pursued an ambitious program of structural reforms aimed at removing the constraints to sustainable, diversified growth, improving public sector efficiency and governance, and increasing access to basic services and poverty interventions. Key elements in this reform process were: (i) decontrol of agricultural prices and liberalization of maize marketing; (ii) privatization of state enterprises; (iii) public sector downsizing, while redirecting expenditure toward the social areas; (iv) removal of exchange controls and floating of the Kwacha; (v) liberalization of the banking sector; and (vi) removal of quantitative restrictions on imports and exports, as

[1] The only remaining ZCCM asset still in the Government's hand is the Nkana metallurgical assets. No buyer has emerged for these assets, which are now being managed by AAC.

well as the reduction of the level and dispersion of customs tariffs. Many of these reforms produced positive results (Box 1).

Box 1: Main Economic Reforms since 1991

The reform program launched in 1991 has brought substantial macroeconomic stabilization and moved Zambia significantly toward a market economy:

- The primary deficit of the central government has declined from 7 percent of GDP in 1991 to 1 percent in 1999.
- Annual inflation has been reduced from 170 percent in 1991-92 to about 25 percent in 1998-99.
- Tax collection has risen sharply following the establishment of an autonomous Zambia Revenue Authority (ZRA). A value-added tax (VAT) was introduced in July 1995.
- Exchange rates have been liberalized and are now market-determined.
- Quantitative restrictions on imports and all export bans have been removed. The maximum tariff rate has been reduced from 100 to 25 percent and most raw materials are now subject to zero tariffs. Most tariff exemptions have been eliminated. Duty drawback and bonded warehouse schemes have been improved.
- A new Investment Act was passed in 1993. The Investment Center has been reorganized, and new measures were implemented to streamline investment approvals.
- A Public Service Reform Program (PSRP) has been actively pursued since 1993. By the end of 1999, the PSRP had led to a reduction in the size of the civil service from 137,000 to about 102,000 public employees. The restructuring of 14 ministries was also completed.
- The sale or liquidation of about 80 percent of public entities offered for sale, including ZCCM, has been completed.
- Prices were decontrolled and subsidies eliminated; in particular, agricultural prices and maize marketing have been liberalized.
- Interest rates have been liberalized. The financial sector has been reformed. The Development Bank of Zambia has ceased new lending and insolvent institutions have been liquidated.
- Other sector policies were also implemented (see Annex E).

15. Annex E provides details on the evolution of policy reforms in Zambia since 1992. With most of the first-generation reforms implemented (Box 1), including the privatization of its most important assets, ZCCM, Zambia is now ready to tackle the long term second-generation structural problems that have prevented the Government from managing the economy more effectively, achieving sustained growth, and reducing poverty over the long run. The Government's medium-term program is outlined in the latest Policy Framework Paper dated March 1999. In addition, as part of the CAS consultations, the Government prepared a paper detailing guiding principles and priority actions for its development program and its cooperation with the Bank and other partners. These development principles can be grouped into three strategic areas – removing constraints to sustainable, diversified growth; improving governance; and increasing

access to basic services and direct poverty interventions. The economic reform program entails policy measures in the following areas:

16. **Privatization and Parastatal Reforms:** In 1992, Zambia initiated a program to privatize public enterprises that accounted for some 80 percent of GDP and employed 140,000 workers. By end 1999, the list of non-mining enterprises to be privatized had grown to 282 entities, of which 235 (83 percent) have been divested. However, it took until March 31, 2000, to privatize most of the significant assets of ZCCM, an action that is crucial for mobilizing the new investment, technology and management needed to develop the copper sector. The delays in privatizing ZCCM, given Zambia's heavy dependence on copper, meant that ZCCM's losses, which amounted to between US$15 million and US$20 million a month over 1997-1999, remained a major source of fiscal stress to the Government, and a major impediment to potential economic growth. The sale of ZCCM's remaining major mining assets marked a new era for Zambia. Almost all copper assets are now in private hands.

17. **Public Sector Reform:** To stem declines in the cost-effectiveness of the public service, the Government adopted a Public Sector Reform Program (PSRP) in 1993 aiming, *inter alia*, to reduce nonmilitary public employment, decompress public sector salaries, and improve performance management systems. A limited hiring freeze, instituted in August 1997, resulted in the size of the nonmilitary public service dropping from 137,000 in 1997 to about 102,000 by end-1999. Within this significant downsizing, efforts have been made to maintain adequate service delivery by protecting front-line service providers (e.g. nurses, teachers, police) from retrenchment. Reforms have also included measures to improve political and economic governance. The Government presented a comprehensive governance program to donors at the May 1999 Consultative Group meeting that builds on past actions (e.g. the establishment of the Anti-Corruption Commission, training of justices, auditing and public tender reforms) and is closely tied to PSRP measures aiming to raise the morale and performance standards of civil service.

18. **Trade Liberalization and Exchange Policy:** Extensive reforms within the external trade regime commenced in 1992 and have continued throughout the decade. Most licensing and quantitative restrictions on imports and exports have been eliminated while the tariff structure has been compressed and simplified. The level and dispersion of customs duty rates, which ranged from zero to 100 percent prior to 1991, by 1998 ranged from zero to 25 percent with only three non-zero rates. Average import duties have been reduced to less than 15 percent, consistent with Zambia's commitments under the Cross-Border Initiative (CBI). Complementing these changes, Government has decontrolled foreign exchange and allowed the exchange rate to be fully market determined.

19. **Fiscal Reforms:** The Government has made considerable progress in meeting its objectives of removing distortions in the tax system and improving revenue performance. On the direct tax side, many discretionary exemptions have been removed, thus broadening the base and permitting a lowering of tax rates. On the indirect tax side, a complex and distortionary sales tax regime was replaced by a value-added tax (VAT) in 1995, and the average level and dispersion of tariffs has been significantly reduced. Tax administration has been enhanced by the establishment of the independent Zambia

Revenue Authority (ZRA) in 1994. Progress on expenditure policy and management has been slower. The reduction in the central government deficit has been mainly through expenditure compression enforced by a cash budgeting system introduced in 1993. However, the procedures for allocating, controlling and monitoring expenditures have not been consistently applied, and there have been insufficient underlying expenditure policy reforms. As a result, large domestic spending arrears have accumulated; the structure of government expenditure has been skewed away from the social sectors, recurrent expenditures and infrastructure investment; the allocation of resources between and within ministries has frequently been arbitrary and non-transparent; and there has been increasing resort to off-budget financing and quasi-fiscal activities. Fiscal problems also remain in the wider public sector, including local governments, state-owned enterprises, and pension and special funds. This Credit will address many of these outstanding problems.

20. **Financial Sector Reform:** Because of longstanding portfolio problems in several state-owned financial institutions, the main priority in the financial sector has been strengthening prudential oversight of the banking system. On November 1, 1997, the new national payments system went into effect through the transfer of the operation of the clearinghouse to commercial banks. The Development Bank of Zambia also stopped undertaking direct lending and now limits its activities to loan recovery. By early 1998, one distressed bank was taken over by a larger bank, while four others were put under receivership. In addition, the Bank of Zambia (BOZ) has moved to strengthen commercial bank regulation and supervision and has gazetted regulations on large loan exposure, insider lending, and provisioning.

21. **Sectoral Reforms:** Many sectoral reforms are being supported by donors and IDA through sector investment programs (SIPs), which are under implementation for agriculture, roads, health, basic education, and water supply. Zambia's agriculture SIP supports agricultural liberalization. Prior to 1993, Zambia heavily subsidized agriculture, with maize-related subsidies alone accounting for more than 16 percent of the national budget. Since then, the agriculture sector has been largely liberalized, input supply and crop marketing have been privatized, prices have been set in free and open markets, and restrictions on domestic and international trade have been removed. Almost all agricultural public enterprises have been privatized, and private sector participation in the marketing and distribution of agricultural inputs is encouraging. Despite recurring drought and volatility in the international prices of its primary export commodities, the share of agriculture in total GDP has been increasing compared to the mining, wholesale and retail sectors. Agricultural exports in real terms have increased each year since 1994, and now constitute over half of total exports. Nevertheless, serious constraints remain in increasing the use of improved technology, particularly fertilizer and seed, and the smallholder sector remains extremely vulnerable to risks of drought and animal disease.

22. A ten-year Road Sector Investment Program (ROADSIP) was launched in 1997 to improve and rehabilitate the road network and eliminate the maintenance backlog. The program aims to rehabilitate and maintain over 50 percent of the main road network, as well as priority feeder roads. Government efforts will emphasize greater private sector participation, improved control and prioritization of road sector expenditures, and revenue mobilization through a Road Fund. In addition, the upcoming private

concessioning of Zambia Railways (which will be supported by an IDA project) will facilitate the movement of goods.

23. In the health sector, reforms center around decentralization of decision-making and responsibility for service delivery to levels of government closer to the recipient of services. Reforms are also currently underway in the areas of nutrition and public welfare. Over the past year, an extensive study of the National Food and Nutrition Council (NFNC) was undertaken, and the Government has developed an agenda for reform including redirecting the functions of NFNC to be more of a catalyst than a service provider, and providing it with adequate resources. The Public Welfare Assistance Scheme (PWAS) is to help the poorest of the poor, including widows, orphans, the aged and the handicapped, deal with short-term disasters.

24. HIV/AIDS epidemic has posted a severe danger to Zambia's development. About 20 percent of the nation's adult population are HIV infected; 29 percent in urban and 14 percent in rural areas. HIV/AIDS related morbidity and mortality have risen rapidly and have had a significant impact on population growth and life expectancy. It is estimated that population growth in 1999 was only less than 2 percent, compared to a normal growth rate of 3 percent in the absence of AIDS. Life expectancy has been reduced from 50.5 years in the 1980s to 42.6 in 1998. The deaths due to AIDS have created 550,000 orphans and caused the loss of productive capacity in thousands of households. The AIDS epidemic can push poor households from acute or seasonal poverty to chronic poverty. The proposed Credit contributes to the country's overall effort of combating the HIV/AIDS epidemic by enhancing macro stability, improving the efficiency and equity of public expenditures, and increasing access to basic social services.

III. THE PROPOSED FISCAL SUSTAINABILITY CREDIT

A. BACKGROUND AND CONTEXT

25. The lack of economic growth and macrostability in Zambia has its roots in public finances. In early 1998, the Bank undertook a comprehensive analysis and assessment of Zambia's overall public finance situation and outlook. Its main conclusions, presented in a report,[2] were two-fold. First, while the central government budget deficit had declined markedly during the 1990s, the overall fiscal position of the public sector did not improve as the Government was not able to control the non-central government components of the public sector. Of these components, the most important deficits have been those of state-owned enterprises, the Bank of Zambia, pension funds, and local governments. Second, this slow progress on the fiscal front has been due in part to the lack of sufficient funds and delays in the privatization program and in part to inefficiencies in the budget management process, including arbitrary cuts, *ad hoc* decision-making in response to cash shortfalls, and above all, a cash rationing system that creates distortions at the micro level.

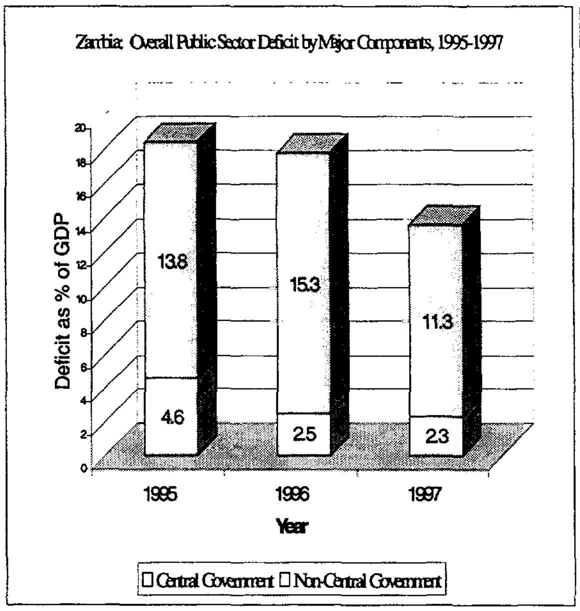
26. Fiscal adjustment is critical to Zambia for a number of reasons. First, without a comprehensive effort to address the root causes of the permanent and intense fiscal stress

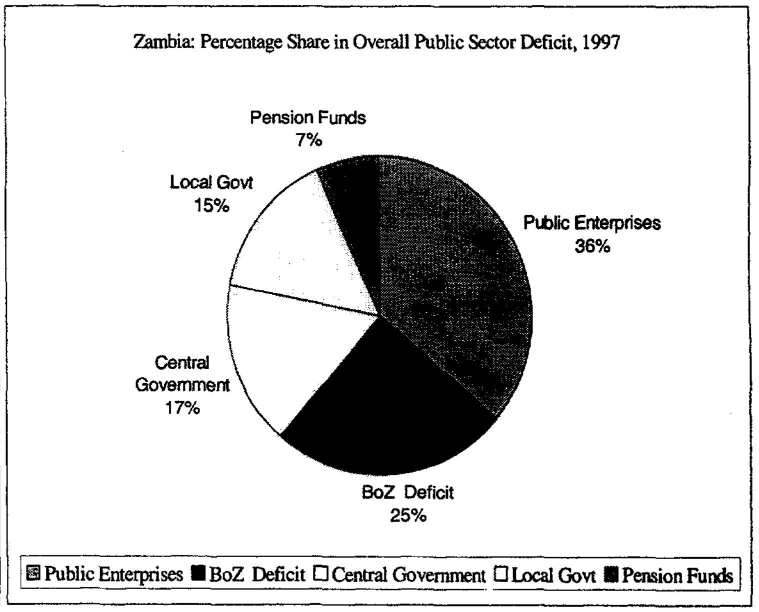
[2] Zambia: Fiscal Management Report, World Bank Report 18552-ZA, November 19, 1998.

that has characterized the Zambian economy for several decades now, it is doubtful that investment and economic growth will return. Second, the breakdown of fiscal discipline has resulted in the budget losing its central role as an instrument in the allocation of resources according to the country's priorities. Recent evidence from the upcoming Public Expenditure Review (PER) shows that public expenditures have had very little impact on poverty and economic growth. Third, as discussed below, even with the best adjustment efforts, Zambia cannot tackle the fiscal problem alone. Zambia's debt burden needs to be reduced to a manageable level, while adequate funding and technical assistance at all government levels need to be provided on a sustained basis. Debt relief and assistance is likely to be realized only when the Government has demonstrated serious efforts to tackle fiscal problems on a sustainable basis.

27. Compared with other low and middle-income countries, Zambia's domestic revenue performance is good, with revenues representing about 18 percent of GDP on average. Expenditures are dominated by external debt service, the single largest expenditure item. Since the early 1990s, the budget deficit of the central government has declined despite a sharp reduction in copper revenues and grants. Adjustment has oscillated widely, though, with bouts of sharp fiscal adjustment followed by prolonged periods of inaction and worsening deficits. This pattern of fluctuating deficits has been caused mainly by poor management of expenditures, as revenues were relatively stable throughout this period. Given that Zambia's tax revenues are already relatively high for a low-income country, prospects for a significant increase in total revenues are not favorable. Fiscal adjustment will thus have to depend largely on improved control over expenditures, in addition to the restructuring of internal and external debt.

Figure 1: Zambia: Evolution and Composition of Overall Public Sector Deficit





28. It is estimated that the overall public sector deficit (quasi-fiscal deficit) -- which includes the central government deficit plus the deficits of local governments, extrabudgetary accounts, state-owned enterprises, and the Central Bank -- amounted to about 13.6 percent of GDP in 1997 (Figure 1). The central government deficit accounted for 2.3 percent of GDP and was financed by Treasury bills purchased mainly by banks; the remainder of the overall public sector deficit was financed through arrears, monetization, and implicit asset depletion. The cost of quasi-fiscal activities undertaken by the central bank amounted to at least 3.5 percent of GDP.

29. While data availability does not allow an up-to-date calculation of the total public sector deficit for 1998 and 1999, preliminary indications show that this deficit has widened since 1997. The fiscal positions of public institutions that lie outside the central government have remained very weak. State-owned enterprises continue to represent a huge drain on public resources. Operating losses of the largest state-owned enterprise, ZCCM, rose from about 3.4 percent of GDP in 1997 to 9 percent of GDP in 1999, before it was finally privatized. Similarly, the operating deficit of the Zambia Electricity Supply Company (ZESCO) amounted to 1.6 percent of GDP in 1999. These losses will be borne by the budget. At the same time, local governments have been adversely affected by declining grants from and rising arrears of the central government. The country's pension funds are also suffering from the enormous level of government arrears and the fact that their investment portfolio has failed to perform. At the end of 1998, the accrued-to-date liability of the Public Services Pension Fund stood at over US$500 million.

30. So far, the Government has relied heavily on the cash budget to restore fiscal discipline. The cash budget system was introduced in 1993 as a temporary device which aimed to impose a hard constraint on spending by linking monthly expenditures closely to actual revenues received during the month. Over the years, this practice has evolved into an *ad hoc* system where a special committee within the Ministry of Finance meets several times a month to determine cash releases to ministries and other budget heads, in line with revenues collected. The current cash rationing system as implemented in Zambia has been fraught with problems, including non-transparency, *ad hoc* budget decisions throughout the years that bear no relation to the original budget, inefficiencies in government operations[3], and sub-optimal allocations of scarce budgetary resources. It is likely that today the cash budget's positive impact on stability is more than offset by its negative effects on growth and poverty reduction.

31. Clearly, fiscal sustainability in Zambia can only be reached if fiscal progress- both quantitatively and qualitatively- is achieved at all levels of government. This, in turn, is only possible if the Government, with the assistance of the international community, can identify and implement a realistic program of fiscal adjustment aimed at:

(a) Reducing the quasi-fiscal deficit, including deficits arising from state-owned enterprises, pension funds, local governments, and the Bank of Zambia; and

[3] The prices that the Government has to pay for purchases of materials and supplies are higher than those paid by the private sector. For more details on these issues, see "The Cash Rationing System in Zambia", AFTM1, March 2000.

(b) Reestablishing fiscal discipline and effectiveness of public expenditures through improving the predictability, transparency and accountability in public spending and gradually moving from the cash budget to a medium-term expenditure framework (MTEF).

32. The privatization of ZCCM on March 31, 2000 was a significant step toward bringing the quasi-fiscal deficit under control: ZCCM's operating deficit rose to about 9 percent of GDP in 1999. In addition, the difficult and complex problems of reducing local government deficits have recently begun to be analyzed in a comprehensive study on Fiscal Decentralization in Zambia.[4] While the Government is in the process of reviewing the recommendations of that study, an IDA project (the Public Sector Capacity Building project (PSCAP)) has already begun to help build capacity at the local level to tackle decentralization issues. IDA will also provide support for a local development fund program (supported by IDA's Zambia Social Investment Fund recently approved by the Board) which will support capacity-building and local development initiatives, particularly in rural areas. In addition, the agriculture, health, and education sector investment programs are based on decentralized management and implementation structures. It is expected that future Bank operations, especially projects that are more suitable to address the long-term issues of improving local and municipal finances, will support Government efforts in reducing the fiscal deficits of local governments. In parallel, the Government is continuing its efforts, supported by the IMF's PRGF, to reduce the central government budget deficit.

B. REDUCING THE QUASI-FISCAL DEFICIT

1. PUBLICLY OWNED ENTERPRISES

Objectives

33. The most important part of the overall quasi-fiscal deficit (shown in Figure 1 above) arose from the financial losses of ZCCM. The sale of ZCCM therefore constituted a major step in the direction of reducing the *flow* of the overall public sector deficit in Zambia. However, the liabilities of ZCCM (that is, the *stock* of debt) estimated at about US$588 million as of March 2000—still need to be settled. In addition, more needs to be done to privatize the remaining state-owned enterprises, particularly of key utilities such as the Zambia Electricity Supply Company (ZESCO), Zambia National Oil Company (ZNOC), Zambia Railways (ZR), and other commercial and financial entities that are being held in the current portfolio of the Zambia Privatization Agency (ZPA). Without these further measures, it will be difficult, if not impossible, for the Government to substantially bring down its non-financial public sector deficits. Moreover, privatization of these public enterprises should lead to improved efficiency of these sectors—an objective that is key to the development of the private sector in Zambia over the medium to long-term.

---

[4] See Oliver Sassa et al., Fiscal Decentralization and Local Government Finance in Zambia, June 1999. A study directed by the World Bank, financed by DANIDA with support from USAID.

34. The financial situation of ZESCO has rapidly deteriorated over the years. By the end of 1999, ZESCO owed about US$180 million to the Government in tax arrears, as it had not been able to pay its taxes for a number of years, for several reasons. First, ZCCM was not paying its electricity bills to the Copperbelt Electric Corporation (CEC), a private company which buys bulk electricity from ZESCO and transmits it to the Copperbelt for distribution to the mines and other consumers. The build-up of arrears by ZCCM to CEC set off a chain of effects. In the absence of revenues from ZCCM, CEC was not able to pay ZESCO, and so ZESCO was not able to pay its taxes to the Government. Second, ZESCO's revenues have been adversely affected both by inadequate tariffs and by payment arrears of the central Government and other public sector agencies such as the Water Authorities. Third, ZESCO's billing system has experienced serious problems with computers and software, leading to delays and errors in billings and collections. Fourth, ZESCO has not yet completed the internal cost-reducing measures needed to restore financial viability. So far, some progress has been made. In particular, the privatized mines are paying their electrical bills; systemic problems in billings and collections are being resolved (with billings, which used to lag service by three to four months, now nearly current); and in February 2000, ZESCO and the GRZ agreed to set off CEC/ZCCM debt against ZESCO's tax liabilities owed to the GRZ, thereby making ZESCO current on its tax liabilities. Even so, significant balances remain outstanding from earlier ZCCM debt to the company and it remains important for ZESCO's financial sustainability that the Government settles at least part of this debt.

35. Even more important than settling ZCCM arrears is the implementation of a viable financial plan that ensures that ZESCO will not find itself in the same financial situation again. To that end, the Government has committed itself to unbundling and privatizing ZESCO. In October 1999, the Cabinet directed the Zambia Privatization Agency (ZPA) to prepare a plan for ZESCO's privatization. Moreover, President Chiluba, in his speech welcoming Parliament in 2000, reaffirmed this commitment. To realize this objective, the Chief Executive of ZPA recently requested USAID to assist in the preparation of a comprehensive study of strategic options and recommendations for private sector participation in ZESCO. This study, which is expected to be concluded in early 2001, will propose a strategy for a full restructuring of the sector, including privatization.

36. In the petroleum sector, where the Government's objective is to liberalize the sector in an orderly fashion, little progress has been made. Despite its current monopolistic position in the procurement, ownership and bulk storage of feedstock and in the transportation, processing and marketing of petroleum products, the Zambia National Oil Company (ZNOC) has been facing financial difficulties. ZNOC has incurred arrears to TAZAMA, the company in charge of the TAZAMA pipeline from Dar es-Salaam, Tanzania to Ndola, and possibly to other public entities. These financial losses can only be contained if ZNOC is taken out of the petroleum processing and marketing business. Moreover, under the current arrangement, Zambia is losing a considerable sum of money annually through a combination of inefficiencies in the operations of ZNOC, the Indeni oil refinery, and the TAZAMA pipeline. To meet petroleum product demand of 452,000 mt/year, Zambia until April 1999 imported about 486,000 mt/year of crude oil/product mixture through the TAZAMA pipeline from Dar-es-Salaam, Tanzania, for refining at the Indeni refinery in Ndola. According to Bank studies, this system has cost Zambia about US$6 million per annum in operational inefficiencies. A fire in the Indeni refinery

in April 1999 has rendered that facility inoperable and forced Zambia to import petroleum products, at high expense, by road and rail. Further study has shown that converting the pipeline to product mode will reduce oil transport costs and may yield significant oil exporting opportunities (as products can be offloaded at any pumping station along the pipeline).

37. So far, the operating costs of Indeni and ZNOC have been passed on to consumers in the form of higher retail prices. Zambia would be clearly better off if the Government offered for sale a majority controlling interest in the refinery, the pipeline and the Ndola product terminal, as a package, to a strategic partner or group of partners, allowing the winning partner, on taking possession of the controlling interest, to determine whether the pipeline will be operated in crude mode or in product mode. Meanwhile, any work on rebuilding the refinery and/or other facilities would be deferred until the new owner takes possession of the assets. The Government should also make definite steps to liberalize petroleum product prices, and approve open and equal access to the pipeline facilities by all licensed marketers. At the same time, imports of petroleum products should also be open to all marketers so that the Indeni refinery operation is either made competitive or closed down. It is also important to establish a robust payment mechanism for TAZAMA so that TAZAMA is under no obligation to provide service to non-paying entities.

38. In the railways sector, although the Government is no longer providing a direct operating subsidy to Zambia Railways (ZR), it has from time to time been forced to write off its loans to the company as ZR has never been in a position to service them. In addition, continuous neglect of maintenance by ZR has led to a gradual deterioration of assets to such an extent that a substantial injection of private or public capital is necessary to prevent the company from collapsing altogether. To that end, it is necessary to create conditions for involvement of the private sector in the operation and management of key railway functions as well as open up railway infrastructure to more than one operator after an agreed period of exclusivity for the concessionaires in order to (i) enhance competitiveness of rail operations; and (ii) reduce Government's financial support to the railway sector.

Proposed measures under the FSC

39. Concerning ZCCM's liabilities, the Government has reached an agreement with all parties on the amount of ZCCM debt and cross-debt to be settled and has begun to implement an action plan to speedily clear these arrears.

40. Concerning ZESCO, the following measures have been implemented:

- An agreement has been reached between the Ministry of Finance and Economic Development (MOFED), ZESCO, and CEC on the amount of debt and cross-debt to be settled, including an action plan to clear the arrears in an orderly manner;
- Electricity tariffs have been raised by 25 percent effective April 2000; and
- Future retail tariffs will be adjusted according to revenue requirements as agreed with IDA as well as to the approved Automatic Tariff Adjustment Formula (ATAF). An

agreement has been reached between ZESCO and the Electricity Regulatory Board (ERB) on the specific modalities of the operation of the ATAF formula.

In addition, the following steps will be taken in order to help ZESCO achieve financial viability:

- Implement further measures to reduce ZESCO's operating costs. ZESCO's cost reduction measures have so far mainly focused on outsourcing of non-core activities; tighter control of telephone, transport and fuel expenditures; and effective freezing of new recruitment. New measures over the next twelve months will include restrictions on salary increases; divestiture of residential properties; and restructuring of the current short-term borrowings into medium-term loans;

- Improve billing and revenue collection;

- Conduct a study to investigate options for privatization and to review the legislative and regulatory framework to establish an enabling environment for private sector participation; and

- Adopt a suitable privatization option, based on the above study and in consultation with IDA.

41. In the petroleum sector, the Government recently cleared the arrears that Zambia National Oil Company (ZNOC) had with TAZAMA. Furthermore, to improve efficiency of the petroleum sector, the Government has decided to offer for sale a majority controlling interest in the refinery, pipeline and terminal, as a package, to a strategic partner or group of partners. The winning partner, on taking possession of the controlling interest, will determine whether the pipeline will be operated in crude mode or in product mode. Meanwhile, any work on rebuilding the refinery and/or other facilities will be deferred until the new owner takes possession of the assets. The Government intends to implement the following measures to restructure the petroleum sector:

- Issue bidding documents for the transfer of a majority controlling interest in the package to a strategic partner or group of partners that will be required to operate the assets in accordance with market principles;

- Establish a robust payment mechanism for TAZAMA to ensure that it is remunerated in full and in a timely manner for its services. The mechanism could also include a procedure whereby TAZAMA would be remunerated with products which it could dispose of for its own account;

- Fully liberalize imports (so that all oil marketing companies could import petroleum products directly) and retail prices of petroleum products; and

- Limit the role of ZNOC to manage and control strategic reserves of petroleum products (leaving all commercial operations to oil marketing companies) equal to thirty days of average national use.

For Zambia Railways (ZR), the Government has implemented the following measures:

- Approved (at the Cabinet level) the private concessioning of ZR infrastructure and selling/leasing of locomotives and rolling stock in order to: (i) overcome problems associated with public ownership and management, viz., inefficiency, over-investment, waste, excess employment, and financial losses; and (ii) provide the much needed capital to address problems of deferred maintenance and upgrading of the track;

- Rationalized staff levels at ZR, in consultation with IDA. Retrenchment has reduced staff levels from almost 5,900 to about 3,300.

In addition, the Government plans to implement the following measures:

- Reform the regulatory framework. The safety and environment-related regulation for the railways, currently exercised by ZR itself, is inadequate and unsatisfactory. There is a need to establish an autonomous regulatory body to enforce technical and economic regulations more effectively. This body would be expected to deal with, among other things, fair competition, and fair trade practices;

- Wind up or restructure ZR. Since ZR will no longer have a role once the freight and passenger services are concessioned, the company should be either restructured to operate as an asset holding company or wound up within a short period after the concession becomes operational.

2. BANK OF ZAMBIA DEFICIT

Objectives

42. As a result of fiscal stress, the Bank of Zambia (BOZ) has undertaken substantial quasi-fiscal activities in recent years. These activities have largely been in response to domestic financial and external payments crises (especially related to declining copper prices) which created the need to support distressed financial institutions, cover losses on guaranteed public sector liabilities denominated in foreign currency, provide subsidized credit to public entities or to failing state-owned enterprises, and provide overdrafts to commercial banks. The effects of these activities have contributed to high inflation (as BOZ losses are monetized) and a high cost of debt financing by the Government (as a very weak Central Bank balance sheet reduces the Central Bank's ability to conduct open market operations and causes market inefficiencies). A careful analysis of the money and bond markets in Zambia[5] shows that interest rates on government debt are currently biased upward by volatile short-term interest rates and frequent shortfall of bids in treasury bill auctions

43. A comprehensive solution to the BOZ deficit should address three issues. First, since the root causes of this deficit lie in the real sector, i.e., the state-owned enterprises and the lack of budget discipline, unless problems in the real sector are addressed, and/or

[5] Zambia: Money, Bond, and Foreign Exchange Markets, AFTM1, September 1999.

the Central Bank is completely independent from the Government, the quasi-fiscal deficit will always remain as a symptom. The proposed Credit addresses this issue through measures dealing with publicly owned enterprises outlined above. Second, a number of policies could be implemented to reduce the risk of new contingent or actual liabilities developing on the books of the Bank of Zambia. The Credit proposes to limit BOZ exposure to potential future losses, especially overdrafts to weak banks and guarantees to state entities. Third, the operations of BOZ could be enhanced to minimize the fiscal cost of Government debt finance. In this respect, the Credit proposes: (i) to improve efficiency in cash management; (ii) to reduce the uncertainty premium in domestic interest rates; and (iii) to improve MOFED's and BOZ's debt management. The last three measures are briefly reviewed below.

44. Improve efficiency in cash management. The Government of Zambia is currently losing a considerable sum of money through inefficient cash management that creates an arbitrage opportunity for the commercial banks. Line ministries are funded throughout the month via regular transfers from their accounts at BOZ to "mirror accounts" at commercial banks whenever they need to make payments. As checks drawn by line ministries on their accounts at commercial banks are credited to their recipients' accounts with a delay of at least four days (and up to 10 days for payments outside Lusaka), these accounts always show substantial balances on which commercial banks pay no interest. At the same time, to maintain monetary control, the Bank of Zambia must sell treasury bills to sterilize the injection of liquidity caused by the funding of the commercial bank accounts. The commercial banks then purchase treasury bills, which currently yield around 37 percent, using funds made available by line ministry deposits on which the banks pay no interest. Furthermore, the Zambia Revenue Authority does not bank its receipts regularly over the month, causing a build-up of government deposits in the commercial banks. If revenue were transferred promptly to the Government's account at the Bank of Zambia, the average volume of treasury bills on issue would decline.

45. Balances in commercial bank accounts could be minimized: (i) if BOZ changed its cash management practice in relation to line ministries' accounts held at commercial banks (for example, if transfers of funds from line ministries' BOZ accounts to their mirror accounts at commercial banks were made four days after the corresponding checks have been written rather than one day before); and (ii) if the Zambia Revenue Authority banked revenue daily with the Bank of Zambia. The arbitrage opportunity would be further reduced if commercial banks were required to pay interest on line ministries' deposits at a rate equal or close to the treasury bill rate, as is the case in South Africa. Efforts to introduce an electronic payment system would also help to resolve this issue.

46. Reduce the uncertainty premium in domestic interest rates. Interest rates on government debt are currently biased upward by volatile short-term interest rates and the frequent shortfall in bids at treasury bill auctions. The volatility of short-term interest rates in turn is due to intra-month fluctuations in the quantity of liquidity available to the banking system while the shortfall in bids at auctions is due to a mismatch between the quantity of bills offered and the funds available to purchase them. Both volatility and auction shortfalls would be reduced if the quantity of treasury bills offered for tender was based on a broader number of factors affecting system liquidity during the week, not just maturing treasury bills (as is the case today). In particular, volatility would be reduced if

accommodation policy were less aggressively penal. Auction shortfalls would be reduced if the Bank of Zambia actively managed the pattern of liquidity to ensure that adequate funds were always available on the day of settlement to pay for treasury bills sold at tender. Auction participation is reduced by lack of certainty as to the availability of funds on the day of settlement. There are several methods by which this can be remedied. For example, to ensure funding, the Bank of Zambia could supply sufficient funds through open market operations on the day of settlement.

47. Debt management: The absence of an integrated strategy for sovereign debt and cash management has contributed to the government's inability to efficiently finance itself in the domestic market. The MOFED has put considerable effort into improving the recording and servicing of external debt. This provides a base for extending capacity into integrated recording of all debt and developing a debt strategy for Zambia. Domestic debt is presently recorded by the Bank of Zambia, which reports to MOFED, but MOFED does not have its own database of domestic debt with which to monitor the overall exposure and integrate domestic and external debt management. Creating a unified database on all debt at MOFED is the first prerequisite for developing the risk management function in sovereign debt management for Zambia.

Proposed measures under the Fiscal Sustainability Credit

48. The BOZ has prepared amendments to the Banking and Financial Services Act (1994) to enhance its power to sanction, take control of, and de-license banks and has submitted these amendments to the Cabinet's Legislation Committee for approval. The Government will make provision in all future budgets to indemnify the Bank of Zambia for any probable loss on new guarantees that will be called upon. These actions will help avoid any future losses by BOZ caused by support of distressed financial institutions, provision of overdrafts to commercial banks, and guaranteed public sector liabilities denominated in foreign currency. Furthermore, a plan has been prepared by BOZ and MOFED to alter cash management practices in relation to ministerial accounts held at commercial banks so as to minimize the arbitrage opportunity that presently exists. Given these proposals, the Government intends to take the following measures:

- Submit to Parliament proposed amendments to the Banking and Financial Services Act (1994) to enhance the BOZ's powers to sanction, take control of and de-license banks;

- Make provision in all future budgets to indemnify the Bank of Zambia for any probable loss on new guarantees that will be called upon;

- Adopt a cash management method, agreed by BOZ and MOFED, to minimize the arbitrage opportunity presently created by ministries' accounts at commercial banks;

- Reduce the uncertainty premium in domestic interest rates. Specifically, the BOZ will reduce volatility in the overnight interest rate from current levels and increase participation in treasury bill auctions by making an appropriate mix of modifications to: (i) liquidity management operations (to create a smoother daily path of excess reserves); (ii) accommodation policy (to reduce the extreme nature of the penalty for failure to meet liquidity requirements); and (iii) the reserve maintenance period (to reduce the sensitivity of banks to daily fluctuations in reserve money); and

- Create, within MOFED, a unified and integrated database for recording and monitoring external and domestic debt, including monitoring the timeliness of debt service payments.

3. PENSION REFORM

Objectives

49. Annex G surveys the existing pension schemes in Zambia, analyzes their weaknesses based on the latest actuarial evaluations, and sets out a vision for both systemic and non-systemic pension reform options in the country. Reforming the existing pension schemes should be an immediate Government priority for the following reasons: First, as discussed above, arrears on pension schemes are a contingent liability of the Government and need to be controlled. Government is the ultimate guarantor of the public pension schemes, and its arrears to the Public Services Pension Fund (PSPF) and the Local Authorities Superannuation Fund (LASF) have been rising at an alarming rate over the past years and threaten the country's fiscal solvency and sustainability. Second, the Public Service Reform Program (PSRP) calls for an effective delivery of safety nets to complement the civil service retrenchment process. A well planned pension reform would help to support and complement the PSRP staff retrenchment program, and thereby contribute to the political sustainability of the economic reform program. Third, a pension reform should help domestic resource mobilization through capital market development. In particular, it could help reduce the crowding out of private sector investment through releasing resources which would have otherwise been used to finance the government budget deficit. Furthermore, it could help to mobilize financial saving, and efficiently channel such savings into productive investment. Higher economic growth could in turn be achieved through greater mobilization of savings. Finally, a pension reform will help labor market mobility by allowing for portability of pension benefits as and when individuals change jobs.

50. There are six major pension schemes in Zambia. All of these schemes have been undermined by very low coverage, fundamental flaws in benefit-design and revenue-collecting mechanisms, excessive administrative costs and a lack of autonomous investment policy and proper fund management. The two most important pension schemes are the Public Service Pensions Fund (PSPF) and the National Pension Scheme (NPS). Together they account for over 95 percent of total statutory membership and over 80 percent of all schemes including the occupational schemes. These two schemes are also the most important in terms of need for urgent reforms.

51. The Public Service Pensions Fund (PSPF) is highly insolvent, and its accrued-to-date liability stood at over US$500 million (or about 15 percent of GDP) as of end December 1998. Its financial problems are attributable to a distorted benefit formula, the Government's failure to pay its statutory contributions to the Fund, the lack of a separation between employment-related benefits and pension benefits, and the lack of administrative and computing facilities. PSPF is in serious financial difficulties and

cannot continue in its present form. While some short-term improvements are possible, they cannot possibly bring about a satisfactory long-term solution. For a number of reasons related to Zambia's Constitution (discussed further below), a long-term solution can only be achieved through setting up a new pension scheme for civil servants. The opportunity to create a unified, financially viable national pension scheme lies in the newly created National Pension Scheme (NPS). However, the NPS as it currently stands has several weaknesses including poor design, weak governance structure and investment policy, and very high administrative costs.

52. The National Pension Scheme Authority (NAPSA) is the administrative agency responsible for implementing and operating the new NPS. NAPSA was made effective February 1, 2000, incorporating all the formal ZNPF staff (1,093 personnel). By doing so, NAPSA has taken the responsibility of honoring the collective bargaining agreement negotiated by the Zambia National Provident Fund (ZNPF) in 1998.

53. NAPSA has already undertaken a series of preparatory steps towards administrative cost reduction through implementing a staff redundancy plan. In particular, experienced consultants have undertaken an evaluation of NAPSA's optimum human resource requirements and in this context prepared a detailed organogram showing job positions for NAPSA's efficient operation. Based on this study, NAPSA submitted a preliminary staff retrenchment plan to the Bank for its review. As a result of the Bank's review, the Bank and the GRZ agreed that the GRZ would undertake the following steps to implement the program:

- Prepare a detailed organogram indicating each position required to operate NAPSA efficiently and the job description and corresponding skills requirement for each position;

- On the basis of the above, identify the number of positions that can be filled by existing ZNPF/NAPSA staff, the number of personnel that should be retrenched and the number of personnel with specialized skills to be hired from outside ZNPF/NAPSA;

- Determine the cost of retrenchment on the basis of the number of personnel retrenched, the collective bargaining agreement of 1998, and the Employment Act;

- Determine the overall cost of the program after estimating the cost of minor training for existing staff (as required) and recruiting new personnel with specialized skills; and

- Initiate a counselling and training program for the retrenched staff.

A detailed program will be prepared on the above basis for the Bank's review prior to Credit effectiveness. The Government will provide NAPSA with resources up to USD 5 million needed to finance the cost of retrenchment and will consult with IDA on the terms and conditions of the subsidiary loan agreement it will enter into with NAPSA. This subsidiary loan agreement will be approved by the NAPSA's Board of Trustees.

54. Given the tremendous challenges ahead, combined with the country's current limited capacity and lack of adequate data, it will be impossible to overhaul the entire pension system in the country overnight. However, a first well-defined segment of the pension reform program is addressed by the proposed Credit (FSC). In particular, the goals of pension reform under the FSC will be two-fold: to establish and implement a financially sound National Pension Scheme (NPS) while at the same time improving the financial viability of the Public Service Pensions Fund (PSPF). This focus is justified both by the urgency of the problems at hand, and by the need to extend previous World Bank efforts in assisting the Government of Zambia to develop a unified national pension plan.

Proposed Measures under the Fiscal Sustainability Credit

55. *The Public Service Pensions Fund.* In principle, restoring the financial solvency and sustainability of the PSPF would require that the benefit and contribution formulae of the Fund be revised, the Government pay its outstanding liabilities, and employment-related benefits be separated from pension benefits. In practice, these measures are unlikely to impact the financial position of the Fund in any significant and long-lasting way because of a constitutional barrier. While revisions to the benefit and contribution formulas could include: (a) reducing the benefit rate; (b) raising the length of service before retirement; (c) raising the retirement age; (d) raising the contribution rate; and/ or (e) reducing the commutation factor, changing the first three parameters would not effect those who have begun their careers prior to 1996 because their pension benefits are protected by Zambia's Constitution. Reforms in these areas would, therefore, require amendments to the pension provisions in the Constitution which would require a two-thirds majority vote in Parliament as well as approval in a popular referendum. Given the constitutional hurdle, the best course of action appears to be to phase down the PSPF over the long-term, while consolidating and improving NPS to make it fair and cost-effective and to allow portability (i.e. compatibility) with the private sector. The new national pension scheme will then house the new civil servants joining the labor force.

56. In the short-run, in order to stem further financial losses to the PSPF, it is proposed that the Government clear the arrears to the Fund and begin to implement some or all of the principal recommendations of the Actuarial Report of the Fund, published in 1999. To partially clear its arrears to the Fund, the Government has already allocated K26 billion in the 2000 budget. The Actuarial Report recommendations include: (i) raising the Government's contribution rate to a higher percentage of pensionable emoluments; (ii) using a revised commutation table; (iii) reducing commutations to one-third; (iv) making no benefit improvements without consulting the actuary; (v) charging a market interest rate if an employer delays its contributions; (vi) making all contribution payments within 30 days as required by Section 31 of PSPA; (vii) converting receivable assets of the Fund into tangible assets such as treasury bills and government bonds; and, (viii) conducting an actuarial valuation every year for the next 3 years. These measures can help improve the financial position of the Fund in the short-term, but are by themselves not sufficient to bring about a lasting solution to the financial insolvency of the PSPF without amendments to Zambia's Constitution.

57. *The National Pension Scheme*: In 1996, the Government enacted a law creating a National Pension Scheme (NPS) for all existing members of the Zambia National Provident Fund (ZNPF) and new entrants, including both federal and municipal employees joining the civil service. The provisions of the National Pension Scheme Act of 1996 (NPS Act 1996) allow for the creation of a mandatory NPS that would harmonize all the existing plans. The NPS Act 1996 was made effective on February 1, 2000, and the National Pension Scheme Authority (NAPSA) has been put in charge of running the day-to-day operations of the scheme. As shown in detail in a technical paper[6], although the NPS Act 1996 is a good starting point for building a social security system, in its current design it is not comprehensive enough to provide adequate income protection.

58. Proposed specific policy measures on how to improve the new NPS include the following short-term measures:

- Adopt financially sound contribution and benefit parameters for NPS.
- Establish a transparent governance structure and prudential investment guidelines for NPS.
- Reduce NPS's administrative costs, principally through implementing a redundancy plan prepared for NPS, based on recent optimal human resources evaluation.

59. In addition to these short-term measures, the following medium to long-term measures are critical for the success of a well-run pension system in Zambia:

- Undertake a training and human resource upgrade for core staff of NPS, strengthen its information and database system, and decentralize NPS in order to ensure provincial access to pension services.
- Strengthen the occupational pension schemes. (The effort to create a unified, financially viable national pension system should be complemented, to the extent possible, by measures to strengthen the functioning of current occupational schemes that would complement the statutory schemes. This will enhance the pension benefits from the mandatory schemes. Proposed changes that are required to revamp the different occupational schemes are summarized in Annex G.)
- Move the NPS towards a multi-pillar system and rely on three pillars[7] to produce an adequate income and provide about 60 to 70 percent replacement rates of pre-retirement salaries for a full career worker. (This system would have several advantages over the currently proposed national pension plan: it supplements the existing system; integrates both poverty reduction goals and income replacement

---

[6] See Pension Reforms in Zambia: An Analysis of Issues and Policy Options, AFTM1, March 28, 2000.

[7] The first pillar will be a defined benefit plan based on a pay-as-you-go (PAYG) basis. The second pillar will be run on a defined contribution (DC) basis with decentralized fund management. Based on salaries in the range of 2 to 4 gross average wages, this pillar would provide a vehicle for long term savings mobilization in Zambia. Individual (pension) accounts will be privately managed and held in segregated trust accounts under appropriate custodianship. It is expected that this scheme will be regulated and supervised by an agency to be determined by the GRZ. The third-pillar would allow for voluntary risk sharing activities between employees and employers.

goals; and allows for better risk diversification, labor market mobility, improved compliance and improved financial markets, all of which would enhance efficiency and broader macroeconomic goals such as increased national savings and investment.)

60. Together, these short and long-term measures are expected to ensure the financial viability and sustainability of the NPS and help create a unified national pension scheme that will absorb new civil servants in the future. The focus of this Credit will primarily be on implementing the short-term measures.

4. SUMMARY

61. The above measures will go a long way towards reducing Zambia's quasi-fiscal deficit and helping to restore macroeconomic stability. At the end of this adjustment period, Zambia's quasi-fiscal deficit will no longer contain losses of publicly-owned enterprises and arrears to pension funds. The overall public sector deficit will be cut significantly from an estimated 20.1 percent of GDP in 1999 to about 8 percent of GDP in 2001, assuming that the magnitudes of the other components of the over-all fiscal deficit (e.g., local government, extra-budgetary funds, etc.) remain the same.

C. FISCAL MANAGEMENT

Objectives and Overall Strategy

62. The ultimate goals of the Credit's fiscal management component are to improve the predictability, accountability and transparency in public spending in order to help restore the credibility of the voted budget and resolve the problem of lack of fiscal discipline in budget execution. At the same time, the proposed measures would help Zambia move toward a more conventional budget system, based on a strategic policy and expenditure framework where line ministries are provided with greater responsibility for decisions related to resource allocation and use.

63. As discussed above, until now, Zambia has relied on the cash budget (or cash rationing) system to restore fiscal discipline. The cash budget was originally designed as a temporary, short-term measure to reintroduce financial discipline by linking monthly expenditures closely to actual revenues received during the month, excluding any new borrowing from the Central Bank. To this end, a special committee within the MOFED meets several times a month to decide on cash releases to ministries and other budget heads by major expenditure categories in line with revenues collected.

64. A recent World Bank economic report[8] has analyzed in detail this cash budget system. It concluded that the way the cash budget has been implemented and managed has greatly reduced the efficiency of government operations, led to a sub-optimal allocation of scarce budgetary resources, and raised the prices Government has to pay for its purchases of materials and supplies. This in turn has had an increasingly depressing effect on economic growth and poverty reduction programs.

[8] See The Cash Rationing System in Zambia, AFTM1, March 2000.

65. The efficiency of government operations has been severely affected by the erratic, unpredictable, and widely fluctuating manner in which cash was released each month to line ministries. This is particularly true for Recurrent Departmental Charges (RDC, called 'operations and maintenance' in other countries), grants, and capital expenditures, and to a lesser extent, for wages and salaries. For the Government as a whole, monthly cash releases for RDC fluctuated by over 50 percent nearly half of the time during 1996-98; for individual ministries these fluctuations were much larger and many ministries went through months without any allocation for RDC at all. This situation has made it virtually impossible to run a ministry or any other public service efficiently. It makes it risky to plan any activity more than a few weeks ahead and virtually impossible to execute given tasks at the most efficient and appropriate time. Activities are initiated when money becomes available and not when they ought to be undertaken; they are often interrupted for lack of cash releases, to be resumed later at additional costs; and purchases of vital supplies are made without the necessary cash release in hand (hence illegally), resulting in over-commitments, unpaid bills, arrears, and higher prices charged by suppliers.

66. The large swings in cash releases to individual ministries were caused mostly by similarly large swings - in the opposite direction—by cash releases to other ministries. The introduction of the current cash rationing system rapidly led to the almost complete demise of the annual budget as the determinant of government expenditures and its replacement by the monthly cash releases. In turn, this opened the floodgates to all kinds of requests for urgent increases in cash releases to certain ministries, often triggered by short-term political considerations and immediate needs.

67. In addition, the collapse of budget discipline after introduction of the cash budget stimulated and facilitated a substantial reallocation of government expenditures during the course of budget implementation. A detailed comparison of actual expenditures with original budget appropriations for the year 1997, the latest year for which data is available, reveals massive and systematic changes in expenditure priorities from economically and socially relevant ministries towards general public services (such as Home Affairs) and from the purchase of materials and supplies to wages and salaries. As a result, actual public expenditures turned out to be considerably less development-oriented than the budget enacted at the beginning of the year. Less obvious but not less important was the shift in priority from the purchase of materials and supplies (RDCs) to payment of wages and salaries. Among other things, this explains the shortage of funds for school meals, drugs in hospitals, road maintenance materials and supplies, and agricultural extension services.

68. In the longer run, to fully achieve its development objectives, Zambia should aim to phase-out the cash budget system completely and revert to a more regular budget implementation system. In the short term, under the proposed Credit, it can take a number of measures to improve the predictability, accountability, and transparency in public spending.

Proposed Measures under the FSC

69. To improve predictability in spending by line ministries and autonomous government agencies (budget heads), the cash release system will be modified by introducing the concept of a quarterly cash allocation plan:

- On the basis of projected revenues and other inflows into the government account at the Bank of Zambia, MOFED prepares within the last 10 working days of the previous quarter a cash allocation plan. This plan, which will amount to 80 percent of the Budget (Yellow Book) allocation for the corresponding three months, will be subdivided into three monthly cash releases. MOFED will inform every spending agency of their projected cash allocation (broken down by Personal Emolument (PE), RDC, Grants, and Capital Expenditures) by issuing the cash allocation plan in the Treasury Circulars. This will allow spending agencies to start planning their activities for the entire quarter. Nonetheless, actual cash releases will continue to be made on a monthly basis. Preparation of the quarterly cash allocation plans and of the monthly cash releases will be done by the existing cash release committee in MOFED enlarged by a representative of MOFED's Macroeconomics and Policy Analysis Directorate.

- A set of rules will be issued indicating how reductions in cash allocations are to be implemented if such reductions are deemed necessary. Among other things, these rules would aim at protecting the social sector ministries from *ad hoc* transfers of their budget allocations to other ministries and at protecting the economic sector ministries from *ad hoc* transfers of their domestically-financed budget allocations for project capital expenditures. In addition, budget allocations to the social sector ministries will total at least 36 percent, and domestically-financed project capital expenditures of the economic sector ministries at least 12 percent, of the discretionary budget. Compliance with this measure would be monitored by specific targets for cash releases to the priority ministries, thereby strengthening and expanding the Bank's efforts to redirect public spending to social services, begun successfully with the 1994 ESAC.

- A mid-year budget review will be undertaken by MOFED following present procedures for the preparation and submission of supplementary estimates.

70. To improve accountability in public spending, the following measures will be implemented to strengthen commitment control and sanctions:

- MOFED will cut back quarterly cash allocations to over-committed ministries and redistribute saved funds to ministries operating within their commitment ceilings. In addition, for over-committing ministries, MOFED will impose strict controls on expenditure commitments (e.g., by imposing a freeze on the signing of new project contracts by the delinquent ministry until expenditure commitments are reduced and by strictly enforcing the existing rule by which total outstanding expenditure commitments are limited to 10 percent of the annual warrant;

- Controlling officers of line ministries will submit regular, accurate, and comprehensive monthly reports on total outstanding commitments (both new and ongoing) on a timely basis (within 15 days after the end of each month). Non-compliance with this rule will result in MOFED withholding monthly cash releases. As an additional security against spending overruns, any unused quarterly contingency should continue to be used to pay arrears in capital expenditures or else carried forward to the following quarter. At the end of the year, any unused contingency could be used to retire Government debt;

- The Commitment Monitoring Unit (CMU) will monitor over-commitments carefully and use information on expenditure commitments in the quarterly cash planning exercises. The CMU will be required to prepare monthly reports summarizing the situation of commitments, cash outlays, and payment arrears and provide these to MOFED managers. Quarterly reports will be distributed widely, including copies to ministries. For all ministries that exceed commitment limits or accumulate new expenditure arrears, the quarterly reports will attach obligatory written explanations by controlling officers of ministries as to the reasons why these adverse developments have taken place; and

- Controlling officers will be held personally accountable to enforce the new financial regulations, which will specify clearly the sanctions and penalties to these officers and delegated officials who fail to fulfill their responsibilities. To this end, the Finance Act is being revised to include appropriate sanctions and penalties for controlling officers who fail to fulfil their responsibilities. The revisions have been completed and are under consideration within MOFED. They will subsequently be sent to Cabinet for approval, and after Cabinet approval, a draft will be sent to the Ministry of Legal Affairs (MOLA) for legal drafting and subsequent presentation to Parliament.

71. To improve <u>budget transparency and governance</u>, and to facilitate monitoring, the following measures will be implemented:

- Within a month after the end of each quarter, MOFED will publish a quarterly report on Government expenditures in the monthly *Macroeconomic Indicators* report, which would include a comparison between actual cash releases by spending agency and major expenditure category with the quarterly cash allocation plan and with original budget allocations. Among other things, these reports would show from which ministries funds have been taken away to finance new expenditure requests by other ministries;

- Furthermore, government financial statistics will be strengthened as an instrument for fiscal analysis by providing expanded information on extra-budgetary funds, contingency claims, quasi-fiscal activities, and financing plans, including the projected level and composition of central government debt. As a next step, information about the major state-owned enterprises, including their income statements, will be published in the annual *Economic Report* issued by MOFED. In addition, the Yellow Book will include two summary tables. The first one ("Government Domestic Operations") will show aggregate revenues and expenditures by broad category[9] and the second ("Annual Government Expenditure Summary") will show expenditures by budget head and broad category, including preceding year actuals and present year allocations. Finally, the monthly *Macroeconomic Indicators* report will include a table showing the level and composition of external and domestic government debt.

- The Office of the Auditor-General (OAG) will be equipped with adequate financial resources to carry out audits of government accounts within a year of the end of the year. The OAG will be called upon to investigate and report to parliament on spending agencies that continue to make over-commitments.

72. The proposed new budget implementation system is assumed to start in mid-2000 after the proposed Credit has become effective. A mid-year budget review will be undertaken in June 2000[10]. The findings of this review will be used to formulate supplementary budget estimates, in accordance with long term priorities as set out in the Yellow Book, for subsequent submission to Parliament.

73. The short-term adjustment program under the proposed credit, as summarized above, will be complemented by a number of activities to be undertaken by other organizations (EU, IMF) and IDA projects and activities (e.g., PER, PSCAP). Bilateral donors and other international organizations have supported measures to ensure that financial regulations are enforced, commitment authority respected and sanctions applied. These activities have a longer-term focus and will help to prepare and smooth the way for an eventual full replacement of the cash budget (i.e. cash *rationing* system) by a regular budget system.

<u>Measures in the Longer Term:</u>

74. When the new Government introduced the cash budget system in early 1993, this system was conceived as a temporary, emergency measure to deal with an acute, serious problem of overspending and run-away inflation the authorities found impossible to control in a more conventional way. Seven years later, the emergency has largely disappeared but the system is still in place. While opinions differ about the extent to which the cash budget helped in reducing government expenditures, budget deficits, and inflation, there is general agreement that in the longer term, the present cash rationing system has to be replaced by a more conventional budget system, based on a strategic policy and expenditure framework where line ministries are provided with greater responsibility for decisions related to resource allocation and use. An important objective of this framework is to increase the predictability of both policy and funding so that ministries can plan ahead and programs can be sustained, while providing line agencies with a hard budget constraint and increased autonomy, thereby increasing incentives for the efficient and effective use of funds.

75. There is general agreement that this new system should take the form of a Medium-Term Expenditure Framework (MTEF). Such a system will establish a stronger link

[9] On the revenue side, income tax, VAT, import tax, non tax revenue, and grants . On the expenditure side, wages, interest on domestic and external debt, RDC, grants, and capital expenditures.
[10] This would be the 1st formal mid-year budget review in Zambia.

between government priorities and the budget within a sustainable spending envelope, highlight the tradeoffs between competing objectives, and increase transparency and predictability during budget implementation. Designing and implementing such a system, however, is expected to take three to four years. In the interim, there is urgent need to correct some of the most glaring shortcomings of the present system. As described in more detail above, the FSC focuses directly on interim measures only. This narrow focus is justified by the fact that the longer-term issues are addressed simultaneously by other projects, either already approved or in the future lending program. Thus, the FSC provides an urgently needed short-term input into a medium-term effort. An important role in the medium and long term effort will be played by the Public Service Capacity Building Program (PSCAP), an Adaptable Program Lending (APL) operation recently approved by the Board, focusing on the medium-term adjustment of Zambia's fiscal system through three successive phases.

76. Each of the three main components of PSCAP's first phase, rightsizing and pay reform; public service and policy management; and financial management, accountability and transparency is linked to the preparation of a budget based upon a MTEF process. Activities include development of the MTEF-based budget system; a computer-based system of funds management and accounting (the Integrated Financial Management Information System, IFMIS), and a strategy for government institutions to be phased-out of the "cash-budget" system. Progress in each of these areas will be crucial for sustaining implementation of subsequent phases and objectives of PSCAP. Piloting of the MTEF and IFMIS will commence in at least three key ministries.

77. At the end of Phase one, the feasibility and effectiveness of the MTEF and IFMIS pilots will have been demonstrated, and necessary modifications introduced. Phase two activities will focus on rolling-out these systems to all ministries. In tandem, the "cash budgeting" practice will be phased-out, resulting in restoration of a budgeting and cash disbursement system that will make available to public service managers a predictable flow of resources and provide autonomy for spending decisions within the stipulated sector policy and strategic priorities. During phase three, full automation and integration of the budgeting, treasury management and accounting systems will be achieved in the framework of the IFMIS. The various systems that make up the accountability framework will be in operation (e.g., MTEF, policy/planning system, budget/planning system, financial system, establishment control system, internal/external audit systems, procurement control system) and strong links between the different systems will be in place.

78. In parallel to efforts to improve the cash budget and fiscal management in the short-term (proposed under the FSC) and the long term (under the PSCAP), the Government of Zambia is also undertaking jointly with the World Bank a Public Expenditure Review (PER) to tackle issues of budget formulation and resource prioritization and allocation across and within key sectors. The PER is a participatory process involving other development partners such as donors and civil society, and it is intended to provide the GRZ with information necessary to improve the allocation and effectiveness of public spending. Here, effectiveness is meant to satisfy two criteria: First, to ensure that the approved budget reflects the kind of spending most likely to achieve the societal goals of reviving growth and reducing poverty and its social

consequences; and second, to ensure that the budget execution process is properly managed so that expenditures translate into the goods and services intended or that they reach the poor. The PER is expected to contribute directly to the Poverty Reduction Strategy Paper that the GRZ will be producing later this year. A significant feature of the study is the integration in a more explicit way of the analysis of issues in public expenditures, poverty and growth in Zambia. In that regard, the Government has expressed a desire that the PER should not be a one-off but a continuous exercise to be linked with the preparation of the annual budget. Hence, the joint PER 2000 will identify gaps and issues for future study, including plans and provisions for a Government-led PER for 2001.

D. POVERTY IMPACT

79. In line with the poverty reduction strategy articulated in the recent Country Assistance Strategy (CAS), the proposed Credit will address poverty reduction objectives in Zambia in several ways. Most generally, the Credit directly contributes to the maintenance of a stable macroeconomic framework by ensuring that fiscal progress achieved over the last few years in Zambia is consolidated even further, and that the prospects for sustained growth and poverty reduction are improved. Inflation has been shown to hurt the poor more than the rich. Reduction of the quasi-fiscal deficit of the non-financial public sector through rationalization of state owned enterprises should improve the efficiency of the public sector, and help the development of the private sector for which availability and provision of efficient public services are often crucial. Over the medium to long-term, such development should improve the prospects of expanded real income and employment opportunities, and therefore lead to poverty reduction in Zambia. Improved fiscal management will also help: (i) reduce the Government's costs of purchasing goods and services; (ii) increase the cost-effectiveness of government operations; (iii) channel more resources into economically and socially important government ministries and services; and (iv) improve delivery of vital economic and social services that would be beneficial to the poor. The pension reform will help restore the pensioners' legitimate rights to pension benefits, and help reduce old age poverty directly. Over the medium to long-term, the financial viability and efficiency of the major pension funds in Zambia should prove beneficial to the Central Treasury, as the Government is not only the ultimate guarantor of the Public Services Pension Scheme, but also unlikely to successfully avoid bearing any financial losses associated with the newly proposed National Pension Scheme.

E. BOARD PRESENTATION AND TRANCHE RELEASE CONDITIONS

80. The full program of actions to be supported by the proposed Credit is set out in the FSC Matrix (Annex H). Within this program, a subset of key actions has been identified as conditions for <u>effectiveness</u>, when the first tranche of the proposed credit would be released (expected in July 2000); other actions have been identified as conditions for the release of a <u>second tranche</u> (expected about August 2001); and still others have been identified as conditions for the release of a <u>floating tranche</u> (with release occurring whenever the associated conditions are met). This floating tranche addresses the restructuring of the petroleum sector, where progress depends on political decisions, including Cabinet decisions, which cannot be easily tied to a particular timeline. The

maintenance of a satisfactory macroeconomic framework as described in the Letter of Development Policy (Annex J) will be necessary to release all three tranches.

81. **Conditions for Board presentation**: Prior to Board presentation, the Government will:

For state-owned enterprises:

- Agreed on the amount of debt and cross-debt of ZESCO up to March 31, 2000 (by auditors acceptable to the relevant parties);
- Agreed (by ERB) and applied (by ZESCO) a 25 percent tariff increase for electricity in April 2000;
- Agreed (by ERB and ZESCO) on the specific parameters of the approved Automatic Tariff Adjustment Formula for adjusting retail tariffs in the future;
- Approved (at the Cabinet level) the concessioning of Zambia Railways as recommended by ZPA; and
- Agreed with IDA on the Zambia Railways staff rationalization plan.

For the Bank of Zambia:

- Submitted to the Cabinet Legislative Committee proposed amendments to the Banking and Financial Services Act 1994 to enhance the Bank of Zambia's powers to act promptly and effectively to sanction, take control of, and de-license banks; and
- Submitted (by BOZ and MOFED) a plan to alter cash management practices in relation to ministerial accounts held at commercial banks so as to minimize the arbitrage opportunity that presently exists.

For pension reform:

- Agreed with IDA on staff retrenchment plans at NAPSA[11], including clear and transparent retrenchment criteria prepared by the management of NAPSA;
- Issued NAPSA statutory instruments to reflect parameters as contained in the proposed regulations with respect to contribution rates, including contribution ceiling and floor; and
- Submitted to IDA draft NAPSA statutory instruments concerning benefit formulas, minimum pension guarantee, required length of service, and accrual rate, as submitted by the Ministry of Labour and Social Security to the Ministry of Legal Affairs.

For fiscal management:

---

[11] This refers to employees who were transferred from Zambia National Provident Fund.

- Agreed with IDA on the technical details of implementing the proposed changes in budget management as described in paragraphs 69-72 above.

82. **Conditions for effectiveness**. Prior to effectiveness, the Government will have completed the following action:

For pension reform:

- Issuance of NAPSA statutory instruments in the official Gazette to reflect parameters as contained in proposed regulations with respect to benefit formulas, minimum pension guarantee, required length of service, and accrual rate.

83. **Conditions for Second Tranche Release**: Prior to the Second Tranche Release, the Government will have:

For State Owned Enterprises:

- Commenced implementation of a debt settlement plan for ZESCO;
- Approved (at the Cabinet level) the selected ZESCO privatization strategy and implementation plan, in consultation with IDA, based on recommendations of the study to be undertaken by ZPA; and
- Established a regulatory body to enforce technical and economic regulations for the railways and agreed with IDA on the restructuring or winding up of Zambia Railways.

For the GRZ regarding the BOZ:

- Submitted to Parliament proposed amendments to the Banking and Financial Services Act (1994) to enhance the BOZ's powers to sanction, take control of and de-license banks;
- Agreed to make provision in all future budgets to indemnify the Bank of Zambia for any probable loss on new guarantees that will be called upon; and
- Created, within MOFED, a comprehensive and unified database for recording and monitoring external and domestic debt, including monitoring the timeliness of debt service payments.

For the BOZ:

- Adopted a cash management method, agreed by MOFED, to minimize the arbitrage opportunity presently created by ministries' accounts at commercial banks.

For pension reform:

- Submitted to IDA evidence on staff retrenchment, including an audit satisfactory to the Association and carried out by an independent agency acceptable to the Association, showing that NAPSA had implemented its Redundancy Plan;

- Published in its official Gazette prudential investment guidelines for NAPSA, with such guidelines involving a statement of principles, policies and objectives, rather than a specific statement of asset categories and so forth, to be reviewed and agreed by IDA;

- Completed an actuarial evaluation of NPS to determine (i) the viability of a second-pillar component; and (ii) the relative size of contributions that constitute individual accounts; and

- Commenced a study on insurance markets and annuities in Zambia and other selected countries.

For fiscal management:

- Completed the mid-year budget review for 2000;

- Protected the share of social sector ministry budget allocations (at least 36 percent of the discretionary budget) in the 2000 budget, as revised following the mid-year review; and

- Implemented, to the satisfaction of IDA, measures to improve the predictability, accountability, and transparency of public spending, as described in paras. 69-72 above.

84. **Conditions for Floating Tranche Release**: Prior to the release of the floating tranche, the Government will have:

For the petroleum sector:

- Issued bidding documents for the transfer of a majority controlling interest in the package of the Indeni refinery, TAZAMA pipeline and Ndola terminal to a strategic partner or group of partners that will be required to operate the assets in accordance with market principles;

- Established a robust payment mechanism for TAZAMA to ensure that it is remunerated in full and in a timely manner for its services. The mechanism could also include a procedure whereby TAZAMA would be remunerated with products which it could dispose of for its own account;

- Fully liberalized imports (so that all oil marketing companies could import petroleum products directly) and retail prices of petroleum products; and

- Limited the role of ZNOC to manage and control strategic reserves of petroleum products (leaving all commercial operations to oil marketing companies) equal to thirty days of average national use.

F. IMPLEMENTATION ARRANGEMENTS AND ASSISTANCE

85. The proposed Credit of U$140 million will assist Zambia in meeting its external financing requirements in 2000 and will facilitate the retrenchment of redundant employees of NAPSA to enable its efficient operation. The Credit will be disbursed through the Bank of Zambia with US$45 million available at effectiveness; US$45 million tied to the second tranche with specific conditions in the areas of pension reforms, Bank of Zambia's deficit, and budget management; and US$50 million tied to the floating tranche with specific conditions in the area of petroleum sector reforms.

86. **Disbursement**: Disbursement arrangements will follow the Bank Operational Directive of February 8, 1996 on the Simplification of Disbursement Rules under Structural Adjustment and Sectoral Adjustment Loans. The Borrower shall open, (prior to furnishing to the Association the first request for withdrawal from the Credit Account) and thereafter maintain in the BOZ, a deposit account in US dollars on terms and conditions satisfactory to the Association. All withdrawals from the Credit Account shall be deposited by the Association into the Deposit Account. If after deposited in this account, the proceeds of the Credit are used for ineligible purposes (i.e. to finance items imported from non-member countries, or goods in the standard negative list), IDA will require the Borrower to either (a) return that amount to the account for use for eligible purposes; or (b) refund the amount directly to IDA, in which case IDA will cancel an equivalent undisbursed amount of the Credit. Funds disbursed under the proposed Credit will be released against satisfactory implementation of the program set forth in the Credit. This includes compliance with stipulated floating tranche conditions, and progress shown in carrying out the program set forth in the Letter of Development Policy from the Government (see Annex J).

87. **Reports:** The Borrower will (a) furnish to IDA semi-annual reports on the exact amounts received into the Deposit Account; (b) furnish to IDA the details of an FSC Account into which the local currency equivalent of the Credit proceeds will be credited; (c) furnish to IDA a report of the equivalent in local currency of withdrawals from the Deposit Account showing that the FSC Account has been credited accordingly; and (d) furnish to IDA semi-annual reports on receipts and disbursements from the Deposit Account.

88. **Audit:** The MOFED will arrange for the audit of the Deposit Account, upon request by IDA in accordance with auditing standards and terms of reference acceptable to IDA and by auditors acceptable to IDA. The MOFED will make the report on the audit of such records available to the IDA within four months of the close of the Government's fiscal year.

89. Administrative capacity remains a constraint on the Government's ability to achieve the objectives of its economic recovery program. The Bank has been assisting the Government's efforts to upgrade this capacity while recognizing that the direction of

this program must remain firmly in Zambian hands. Several IDA-assisted projects are directed primarily at capacity building, including the Financial and Legal Management Upgrading Project (which includes administrative strengthening of public procurement), the Privatization and Industrial Reform Technical Assistance Project, the recently-completed Economic Recovery and Investment Promotion Technical Assistance Project, and the Public Sector Capacity Building Project (PSCAP). All investment projects have major components addressing capacity issues, particularly the sector investment operations in health, agriculture, roads, and basic education. Use has also been made of the Institutional Development Fund in building capacity in advance of project investments. Considerable technical assistance is being provided in the public sector management area by other donors and by UNDP, and a possible follow-up capacity-building operation by the Bank is under consideration. The IMF has provided technical assistance to the Government on budget management since 1995, and a Resident Advisor has been posted in MOFED. A technical assistance mission was mounted in March 2000 to assess progress in budget management. The policy measures supported by the FSC are in line with the recommendations of that mission. The EC has also provided technical and financial assistance in budget management and pension reform. Currently there are two advisors from the EU working on budget management issues at the Ministry of Finance.

G. BENEFITS AND RISKS

90. The primary benefit of this Credit will be the advancement of policy reforms in the critical areas of reducing the overall public sector deficit and improving budget management. These reforms should help restore macroeconomic stability, accelerate economic growth and improve the impact of public expenditures on the poor. The measures related to pension reforms should help the old and vulnerable segments of the population while improving the mobilization of savings needed for long term economic growth. Measures related to the cash budget should help improve the efficiency and equity of public expenditures while restoring fiscal discipline.

91. There are substantial risks associated with this program. The first source of risk is that the Government's reform program as a whole could falter. This could result from major policy reversals and/or the impact of major external shocks, including a continuing shortfall in external donor support because of either economic or governance-related concerns. It could also result from Zambia's limited institutional and managerial capacity, which may slow execution of the program. It could also result from a lack of commitment on the part of the Government. After all, fiscal adjustment has been tried before in Zambia with no tangible progress due to a combination of factors including external shocks, lack of political will and lack of capacity. This risk could be mitigated by a number of actions. First, the commitment of this Government to the proposed reforms under FSC has been affirmed at the highest level and a number of significant up-front actions have been taken. Second, many of the measures supported under this Credit and previous adjustment operations have strengthened the capacity of the Zambian economy to withstand external shocks, including the collapse in commodity prices. Third, the Government has been acutely aware of the role of external donors in the success of this adjustment effort and has engaged donors on discussions involving governance-related issues. Donor relationships will be further consolidated during the

next Consultative Group meeting, now scheduled for july 2000. Fourth, efforts have been made to provide technical assistance to reduce the problems of capacity in implementing the fiscal adjustment program.

92. The second source of risk for this Credit concerns the possibility that the specific reforms supported under it are not undertaken, either because of opposition from vested interest groups, or because the long lag time which makes it difficult to sustain reforms. This risk is mitigated by the confirmation of political commitment at the highest level, by the active policy dialogue that the Bank has been able to conduct with the Government, and by the nature of our future financial support. More importantly, most of these long term reforms, especially in the pension area and publicly owned enterprises, have been initiated by the Government so that the ownership and the commitment of the Government to implement the proposed measures are very strong. In the case of fiscal reforms, a cautious design was adopted to ensure that while improvements on the efficiency and equity aspects of expenditures are made, fiscal discipline will be observed. Finally, on NPS, there is a risk that the agenda and timetable for reforms could pose political problems. To mitigate this risk, the Government will continue consultations with all major stakeholders during the formulation of its action plan and implementation of the program, and rely on continued support from the Bank and other external partners for technical assistance. Furthermore, as discussed above, a portion of this Credit is earmarked to support the retrenchment plan of NAPSA. This should help reduce the social cost of the proposed reforms.

IV. BANK STRATEGY AND CURRENT OPERATIONS

93. **Linkages with CAS**: The FSC helps to realize the CAS goals in Zambia in several ways. First, the Credit helps to achieve the goal of good governance through: (i) improving transparency and accountability in budget management and (ii) increasing public sector efficiency and capacity. Second, by helping to achieve macroeconomic stability, the FSC would be instrumental in realizing sustained and diversified growth in Zambia over the medium to long-term. Finally, to the extent that sustained growth remains the best way to reduce poverty, fiscal solvency and sustainability is a precondition for poverty reduction in the country.

94. **Linkages with previous adjustment operations**: The proposed adjustment operation builds on previous programs in several ways. First, the FSC continues to build on efforts initiated under previous adjustment credits to assist the Government in its privatization program. Second, the FSC helps to strengthen macroeconomic management by improving the predictability, accountability, and transparency of government expenditure in the short run, and sustainability of the consolidated government budget in the medium to long-run. Third, the FSC builds upon progress made under a number of other Credits, including the PSCAP, to ensure that: (i) financial resources are efficiently allocated and utilized, and that the budget process will move to a Medium Term Expenditure Framework (MTEF); (ii) financial management policies, procedures, and processes are improved; and (iii) capacity developed in MOFED to monitor and supervise expenditure processes; (iv) accountability and transparency are achieved in budget

processes through publication of government's sectoral budget allocations; and (v) expenditures in social sectors will continue to be protected..

95. **Current Bank Assistance Strategy**: The long-term objective of the Bank's work in Zambia is to increase incomes and living standards for the vast majority of Zambians who are poor. The challenge for the current CAS is to get Zambia on a sustainable growth path that directly leads to more rapid growth and poverty reduction in the future.

96. In the area of macroeconomic management, the major thrust of Bank-supported activities is in fiscal management, financial sector reform, and debt relief. Assisting Zambia to obtain HIPC debt relief will be a major activity, with the expectation that Zambia will reach the decision point in late 2000/early 2001 and a completion point as soon as possible thereafter. During the CAS period (2000-2002), PFPs will be replaced by Poverty Reduction Strategy Papers (PRSP), formulated by the Government, with collaboration from IDA and the IMF, and in consultation with other external and internal development partners. Concerning private sector efficiency and competitiveness, the entire Bank Group, including IDA, IFC, and MIGA, has an important role to play. Support for the Zambia Privatization Agency will continue under the Public Sector Capacity-Building Project, and further steps toward the privatization of key utilities will be supported under the next adjustment operation. IDA will also support the Government's environmental mitigation efforts to clean up past environmental problems.

97. In the areas of transparency and accountability, the Government's governance program highlights capacity-building and reform efforts towards increased transparency and discipline in the use of public resources. Public auditing and procurement improvements began under the Financial Management and Legal Upgrading Project (FILMUP). This work will be continued and intensified under the Public Sector Capacity Building Program (PSCAP) and is one of the program's central themes. It will be complemented by the fiscal management reform work supported by the current Credit. Zambia is also considering joining GCA (Global Coalition for Africa) efforts and programs to combat corruption, and the Country Team will facilitate this to the extent possible.

98. Capacity building efforts are ongoing under the sector investment operations, and public sector reform was the major theme of the FY99 adjustment operation. Comprehensive public sector reform in Zambia - including retrenchments, improving incentives, performance management, training, and revamping a wide array of personnel-related systems – will take a number of years. The current Credit will help strengthen the pension institutions to facilitate a more efficient and equitable retrenchment of public sector employees. Work will continue under the multi-partner PSCAP. Strengthening local government is a priority for the Zambian Government, but the policy framework is not yet complete. Work on an overall local government and decentralization policy has been ongoing for some time and could be supported by future IDA adjustment lending. In the meanwhile, IDA is providing support for a Local Development Fund program – the successor to both the Social Recovery Fund and the Rural Investment Fund – which will support capacity-building and local development initiatives, particularly in rural areas. The Zambia Social Investment Fund project was approved by the Board on May 25, 2000.

V. COLLABORATION WITH IMF

99. The programs of the Bank and Fund in Zambia have been closely coordinated since assistance to Zambia resumed in 1991. Balance of payments needs are jointly agreed among the Bank, the Fund, and the Government as part of the PFP (now PRSP) and Consultative Group processes. Bank proposals on trade, taxation, spending allocations, privatization, public service reform, fiscal and quasi-fiscal management, and related structural policy benchmarks are coordinated with the Fund's fiscal targets, while the Fund's macroeconomic benchmarks are developed in close consultation with the Bank. A Policy Framework Paper for 1999-2001 was approved by the Bank and Fund Boards in March 1999, and an interim PRSP will be prepared by July 2000. In March 1999, the IMF approved a new three-year ESAF (now PRGF) program. However, in the last half of 1999, the delay in the privatization of ZCCM and consequently, in related balance of payments support, increased the vulnerability of the economic reform program and adversely affected the Government's ability to meet some of the PRGF's targets, particularly on the external side. Discussions on the PRGF have since continued, and in May 2000, the Government reached understandings with the Fund on the first review of the PRGF and on a program for 2000.

VI. RECOMMENDATION

100. I am satisfied that the proposed Credit would comply with the Articles of Agreement of the Association, and I recommend that the Executive Directors approve it.

James D. Wolfensohn
President

Washington, D.C.
May 31, 2000

Attachments

ANNEXES

A. SOCIAL INDICATORS OF DEVELOPMENT

B. KEY ECONOMIC INDICATORS

C. EXTERNAL FINANCING REQUIREMENTS

D. STATUS OF BANK GROUP OPERATIONS

E. EVOLUTION OF POLICY REFORM AGREEMENTS

F. ZAMBIA AT A GLANCE

G. PENSION REFORMS

H. MATRIX OF POLICY AGREEMENTS

I. PERFORMANCE INDICATORS

J. LETTER OF DEVELOPMENT POLICY

Zambia Social Indicators

	Latest single year			Same region/income group	
	1970-75	1980-85	1993-98	Sub-Saharan Africa	Low-income
POPULATION					
Total population, mid-year (millions)	4.8	6.7	9.7	627.3	3,536.4
Growth rate (% annual average)	2.9	3.1	2.1	2.2	1.4
Urban population (% of population)	34.8	39.7	39.4	33.3	30.5
Total fertility rate (births per woman)	6.9	6.9	5.5	5.4	3.1
POVERTY *(% of population)*					
National headcount index	..	..	68.0	..	..
Urban headcount index	..	..	..	..	..
Rural headcount index	..	..	..	..	..
INCOME					
GNP per capita (US$)	600	360	330	510	520
Consumer price index (1995=100)	..	0	183	128	136
Food price index (1995=100)	..	0	219	..	..
INCOME/CONSUMPTION DISTRIBUTION					
Gini index	..	..	49.8	..	..
Lowest quintile (% of income or consumption)		..	4.2	..	..
Highest quintile (% of income or consumption)		..	54.8	..	..
SOCIAL INDICATORS					
Public expenditure					
Health (% of GDP)	..	..	2.3	1.5	1.3
Education (% of GNP)	6.7	4.7	2.2	4.1	3.2
Social security and welfare (% of GDP)		0.5	..	..	..
Net primary school enrollment rate					
(% of age group)					
Total	..	89	72	..	86
Male	..	92	73	..	89
Female	..	85	72	..	82
Access to safe water *(% of population)*					
Total	..	48	43	..	..
Urban	..	70	64	..	..
Rural	..	32	27	..	..
Immunization rate					
(% under 12 months)					
Measles	..	49	69	58	80
DPT	..	58	70	53	82
Child malnutrition (% under 5 years)	..	..	24	..	..
Life expectancy at birth					
(years)					
Total	47	51	43	50	63
Male	46	50	43	49	62
Female	49	52	43	52	64
Mortality					
Infant (per thousand live births)	100	88	114	92	68
Under 5 (per thousand live births)	181	149	192	151	92
Adult (15-59)					
Male (per 1,000 population)	546	482	521	432	235
Female (per 1,000 population)	460	413	545	383	208
Maternal (per 100,000 live births)	..	..	650	..	..

2000 World Development Indicators CD-ROM, World Bank

ZAMBIA - KEY ECONOMIC INDICATORS

Indicator	Actual						Projected		
	1994	1995	1996	1997	1998	1999	2000	2001	2002
National accounts (as % of GDP)									
Gross domestic product[a]	100	100	100	100	100	100	100	100	100
Agriculture	15.5	18.4	17.6	18.7	21.2	24.6	24.6	24.2	23.8
Industry	39.8	35.9	34.8	34.2	29.1	24.5	28.7	29.3	29.8
Services	44.7	45.7	47.7	47.1	49.7	50.9	46.8	46.5	46.4
Total Consumption	92.6	87.8	94.7	90.6	96.1	101.1	89.1	86.0	83.9
Gross domestic fixed investment	11.3	12.5	11.2	13.1	14.8	15.9	18.0	21.3	23.3
Government investment	4.0	5.1	6.0	5.4	9.6	10.5	9.9	10.5	10.7
Private investment (includes increase in stocks)	4.3	10.8	6.8	9.2	6.7	7.0	9.7	12.3	14.1
Exports (GNFS) [b]	36.0	36.1	31.3	30.1	26.7	22.3	30.1	34.9	36.9
Imports (GNFS)	36.8	39.8	38.9	35.3	39.2	40.9	38.7	43.7	45.7
Gross domestic savings	7.4	12.2	5.3	9.4	3.9	-1.1	10.9	14.0	16.1
Gross national savings [c]	-0.2	4.6	-1.5	3.7	-3.6	-6.6	9.0	11.7	13.4
Memorandum items									
Gross domestic product (US$ million at current prices)	3347	3463	3273	3910	3240	3150	3443	3554	3829
GNP per capita (US$, Atlas method)	360	350	370	370	330	320	350	350	360
Real annual growth rates (%, calculated from 1994 prices)									
Gross domestic product at market prices	–8.6	-2.5	6.6	3.3	-1.9	2.4	4.0	5.0	5.0
Gross Domestic Income	-3.3	5.3	-1.2	0.8	-9.3	-5.3	15.9	5.3	5.4
Real annual per capita growth rates (%, calculated from 1994 prices)									
Gross domestic product at market prices	-11.1	-5.1	3.9	0.8	-4.1	0.2	2.0	2.9	2.9
Total consumption	..	-1.6	1.4	-5.3	-5.9	-2.5	0.0	1.0	2.1
Private consumption	..	-4.1	0.5	-5.9	-3.6	0.3	0.1	0.4	1.5

(Continued)

Zambia – Key Economic Indicators (Continued)

Indicator	Actual						Projected		
	1994	1995	1996	1997	1998	1999	2000	2001	2002
Balance of Payments (US$ millions)									
Exports (GNFS)[b]	1175	1316	1113	1223	919	842	1036	1241	1413
Merchandise FOB	1067	1186	993	1119	816	755	937	1131	1291
Imports (GNFS)[b]	1317	1518	1317	1521	1253	1169	1333	1554	1749
Merchandise FOB	1003	1194	1056	1218	971	871	1008	1166	1311
Resource balance	-142	-202	-204	-288	-334	-327	-297	-313	-335
Net current transfers	-19	-20	-17	-16	-27	-16	-18	-20	-23
Current account balance after grants	-60	-146	-123	-311	-355	-285	-161	-160	-160
Net private foreign direct investment	40	97	117	207	198	163	150	200	250
Long-term loans excl. IMF (net) before debt relief	-127	-104	-49	9	-45	141	53	38	-34
Other capital (net, incl. Grants, Debt relief, err. & omissions)	640	473	411	326	212	214	335	562	591
Change in reserves [d]	-155	-2	-52	-33	211	-19	-78	-342	-339
Memorandum items									
Resource balance (% of GDP)	-4.2	-5.8	-6.2	-7.4	-10.3	-10.4	-8.6	-8.8	-8.8
Real annual growth rates (YR94 prices)									
Merchandise exports (FOB)	1.8	-4.9	-0.1	12.2	-12.9	-5.9	9.3	16.1	9.8
Primary	-2.7	-10.4	-4.2	7.2	-14.8	-4.9	9.0	19.4	9.8
Manufactures	..	12.9	12.5	11.3	12.2	-2.3	10.1	10.3	10.2
Merchandise imports (CIF)	1.9	10.1	-7.5	21.5	-17.0	-11.2	11.9	14.5	10.2

(Continued)

Annex B
Page 3 of 3

Zambia – Key Economic Indicators (Continued)

Indicator	Actual						Projected		
	1994	1995	1996	1997	1998	1999	2000	2001	2002
Public finance (as % of GDP at market prices) [e]									
Current revenues	20.1	19.9	20.7	19.9	18.7	17.6	18.8	17.8	18.1
of which: tax revenues	18.7	18.2	19.0	18.8	18.1	17.1	18.5	17.4	17.7
Current expenditures	27.9	24.2	18.6	17.6	17.3	15.0	14.3	14.2	14.4
Current account surplus (+) or deficit (-)	-7.8	-4.4	2.1	2.3	1.4	2.6	4.5	3.5	3.8
Capital expenditure	4.0	5.1	8.7	7.6	11.3	12.5	16.6	14.8	14.1
Foreign financing	9.4	9.3	8.4	7.1	7.4	10.9	11.7	11.4	10.9
Monetary indicators									
M2/GDP	15.5	18.0	18.4	17.5	18.3	19.0	18.1	18.1	17.8
Growth of M2 (%)	74.8	55.3	34.4	24.0	22.6	29.2	25.1	15.5	12.9
Price indices(YR94 =100)									
Merchandise export price index	114.1	133.3	111.7	112.1	93.9	92.3	104.7	108.9	113.2
Merchandise import price index	124.5	134.7	128.8	122.2	117.5	118.6	122.7	124.0	126.4
Merchandise terms of trade index	91.6	98.9	86.7	91.7	79.9	77.8	85.4	87.8	89.5
Real exchange rate (US$/LCU) [f]	169.2	162.0	169.5	203.0	221.0	233.1	..	..	..
Consumer price index (% change)	53.6	34.9	43.1	24.5	24.4	26.8	22.9	8.4	8.2
GDP deflator (% change)	65.5	37.3	23.6	26.0	19.6	21.7	25.9	10.5	9.3

a. GDP at factor cost.
b. "GNFS" denotes "goods and non-factor services."
c. Includes net unrequited transfers excluding official capital grants.
d. Includes use of IMF resources and reserve changes of commercial banks ("-" denotes increase).
e. Central government.
f. "LCU" denotes "Local Currency Units." An increase in US$/LCU denotes appreciation.

Annex C
Page 1 of 1

ZAMBIA: External Financing Requirements (Millions of US$)

	1996	1997	1998	1999	2000	2001	2002
Exports of Goods and NFS	1113	1233	919	842	1036	1241	1413
Imports of Goods and NFS	1317	1521	1253	1169	1333	1554	1749
Other Current Account, excl. interest payments	-25	-26	-23	-6	-1	10	13
Current Account Balance, excl. Grants and Interest Payments	-229	-314	-357	-333	-298	-303	-323
Debt Service before new rescheduling	453	376	355	328	388	379	362
Gross Financing Requirements	682	690	712	661	686	682	685
Changes in Net Reserves 1/	-52	-33	211	-19	-78	-342	-339
Debt Relief and other 2/	107	128	-9	0	36	125	-40
Financing Requirements after Debt Relief and other	627	595	510	680	728	899	1064
Identified Financing	627	595	510	680	728	709	618
Official Grants	304	198	221	214	299	247	185
Official Loan Disbursements 3/	206	190	91	303	279	262	183
Direct Investment	117	207	198	163	150	200	250
Financing Gap	0	0	0	0	0	190	446
Memo item:							
IMF Purchases	0	13	0	14	27	139	139
IMF Re-purchase	0	0	0	0	0	232	235

1/ Includes IMF purchases and re-purchases
2/ Includes payments of arrears, debt relief, other capital flows and errors and omissions
3/ Excludes use of IMF resources

Status of Bank Group Operations (Operations Portfolio)

Project ID	Fiscal Year	Purpose	Original Amount in US$ Millions				Difference Between Expected and Actual Disbursements a/		Last PSR Supervision Rating b/	
			IBRD	IDA	Cancel.	Undisb.	Orig.	Frm Rev'd	Dev. Obj.	Imp. Prog.
P003258	1994	Financial & Legal Matters	0.00	18.00	0.00	1.61	1.68	0.79	S	S
P003252	1994	Petroleum Rehabilitation	0.00	0.00	0.00	0.00	0.00	0.00	HU	U
P003218	1995	Agriculture Sector I	0.00	60.00	0.00	20.30	24.06	1.20	S	S
P003239	1995	Health Sector	0.00	56.00	0.00	27.03	29.25	0.00	U	U
P003210	1995	Social Recovery II	0.00	30.00	0.00	0.47	4.12	0.00	S	S
P003241	1995	Urban Restrct. & Water	0.00	33.00	0.00	6.51	1.87	0.31	S	S
P040642	1996	ERIPTA	0.00	23.00	0.00	4.50	4.83	0.00	S	S
P044324	1997	Enterprise Development	0.00	45.00	0.00	37.74	33.01	0.00	S	S
P003253	1997	Environmental Support Program	0.00	12.80	0.00	10.44	4.65	0.00	S	S
P003236	1998	National Road	0.00	70.00	0.00	48.88	0.62	0.00	S	S
P035076	1998	Power Rehabilitation	0.00	75.00	0.00	70.46	56.96	0.00	S	S
P003249	1999	Basic Education Sector Inv. Prg.	0.00	40.00	0.00	32.64	12.88	0.41	S	S
P050400	2000	Pub. SVC CAP (PSCAP)	0.00	28.00	0.00	27.42	0.00	0.00	#	#
P063584	2000	Social Investment Fund (ZAMSIF)	0.00	64.70	0.00	63.31	0.00	0.00	#	#
		Total		**555.50**		**351.31**	**173.93**	**2.71**		

a/ Intended disbursements to date minus actual disbursements to date as projected at appraisal

b/ Following the FY94 Annual review of Portfolio performance (ARPP), a letter based system was introduced (HS – Highly Satisfactory, S - Satisfactory, U – Unsatisfactory, HU – Highly Unsatisfactory): see proposed Improvements and Portfolio Performance Rating Methodology (SecM94-901), August 23, 1994.

Note: Disbursement data is updated at the end of the first week of the month.

Annex D
Page 2 of 2

Zambia
Statement of IFC's
Held and Disbursed Portfolio
As of 4/30/00
(In US Dollars Millions)

		Held				Disbursed			
FY Approval	Company	Loan	Equity	Quasi	Partic	Loan	Equity	Quasi	Partic
1998	AEF Amaka Cotton	1.30	0.00	0.00	0.00	1.30	0.00	0.00	0.00
1994	AEF Big Five Car	0.52	0.00	0.00	0.00	0.52	0.00	0.00	0.00
1999	AEF Drilltech	0.18	0.00	0.15	0.00	0.18	0.00	0.15	0.00
1999	AEF Esquire	0.40	0.00	0.00	0.00	0.40	0.00	0.00	0.00
1997	AEF JY Estates	0.89	0.00	0.00	0.00	0.89	0.00	0.00	0.00
1995	AEF Kaila Lodge	0.10	0.00	0.00	0.00	0.10	0.00	0.00	0.00
1997	AEF Pentire	0.57	0.00	0.00	0.00	0.57	0.00	0.00	0.00
1972/73	Bata Shoe ZA	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
1997	Finance Bank	3.77	0.00	0.00	0.00	1.27	0.00	0.00	0.00
1997	IMDHZ	0.00	0.50	0.00	0.00	0.00	0.50	0.00	0.00
2022	KCM	0.00	5.63	24.38	0.00	0.00	5.63	3.28	0.00
1998	Nicozam	0.00	0.30	0.00	0.00	0.00	0.30	0.00	0.00
1999	Zamcell	4.50	0.60	0.00	0.00	4.50	0.60	0.00	0.00
	Total Portfolio:	12.23	7.03	24.53	0.00	9.73	7.03	3.43	0.00

Approvals Pending Commitment

		Loan	Equity	Quasi	Partic
1999	AEF Kembe Estate	1.30	0.00	0.00	0.00
1999	AEF Mpelembe	0.70	0.00	0.30	0.00
2000	AP	2.50	0.00	0.00	0.00
2000	Lusaka InterCon	4.60	0.00	0.00	0.00
1997	Safari Intl.	2.00	0.75	0.00	0.00
	Total Pending Commitment:	11.10	0.75	0.30	0.00

ZAMBIA: EVOLUTION OF POLICY REFORM AGREEMENTS

A. MACRO

ERC (3/91)	PIRC (6/92)	PIRC II (6/93)	ESAC (3/94)	ERIP (7/95)	ESAC II (8/96)	PSREP (1/99)	RESULTS ACHIEVED
General fiscal and monetary performance with specific limit on net banking credit	General fiscal and monetary performance	General fiscal and monetary performance	General fiscal and monetary performance	General fiscal and monetary performance	General fiscal and monetary performance	General fiscal and monetary performance	Primary fiscal balance changed from a deficit of 7 percent of GDP in 1991 to about 1 percent of surplus in 1999 Annual inflation reduced from over 170 percent in 1991-1992 to 25 percent in June 1998-99.
	Harmonize sales tax on imports and domestic products Reform business taxation and broaden tax bases		Time-bound action plan for VAT; Ensure parastatal dividends paid directly to Government	Introduce VAT			Zambia Revenue Authority has increased tax collection performance; VAT introduced July 1995
			Redirect budget to social sectors and within those to certain priority categories, e.g., drugs and primary education	Continue redirection of public spending from low-priority areas to social services	Redirect budget to social sectors and within those to certain priority categories, e.g., drugs and primary education	Maintain the share of core social sector expenditures in the health, education, safety nets, disaster relief, and water and sanitation	Social sector share of budget increased from 28 in 1993 to 36 percent in 1999
	Increase nominal interest rates						Interest rates completely decontrolled in 1993; Treasury Bill auction established in 1993
				Improve budget management procedures to avoid arrears and unplanned spending	Prepare guidelines for operation of the Cash Budget ; Adopt and distribute procedures and guidelines for Zambia National Tender Board; Establish time bound plan for public procurement, covering computerization, record keeping, training, administrative strengthening and external monitoring		System for monitoring arrears introduced
Phase out maize subsidies	Eliminate maize and fertilizer subsidies						Maize and fertilizer subsidies eliminated

B. TRADE

ERC (3/91)	PIRC (6/92)	PIRC II (6/93)	ESAC (3/94)	ERIP (7/95)	ESAC II (8/96)	PSREP (1/99)	RESULTS ACHIEVED
Achieve market clearing exchange rate in second-window forex market							Exchange rate determined by market forces
Expand OGL to all but a small negative list							All quantitative restrictions on imports removed other than those for health, safety and environmental resources
Remove export bans (except for ivory, oil, maize, and fertilizer)			Eliminate remaining export ban on maize				All export bans removed except for environmental reasons
Compress tariff rates	Reduce top tariff from 100% to 50%; adopt strategy for further tariff reduction	More tariff reduction and compression		Provide relief from transitional anomalies in the tariff structure Introduction of VAT will automatically lower protection by eliminating "up-lift" factor	Adopt a tariff structure with a maximum rate of 25%. Many raw materials would be free of tariffs, capital goods would be charged 5%, intermediate goods 15% and final goods 25% Eliminate most tariff exemptions, including for Government purchases, and no introduction of new exemptions; qualifying NGOs to be given refunds or vouchers for customs duties		Highest tariff rate reduced from 100 to 25 percent, and number of tariff bands reduced to 4 Mechanism for relief from tariff anomalies adopted in 1994 Most raw materials subject to zero tariffs Transparency and simplicity of tariff structure improved with the elimination of most exemptions in 1996
			Simplify and liberalize duty drawback system				Offsetting credit system introduced for duty drawback in 1994
						Revamp Duty Drawback (DD) and Manufactures-Under-Bond (MUB) Schemes; Eliminate the 5 percent Import Declaration Fee.	Revamped schemes fully operational; schemes have helped to promote exports; Eliminated the Import Declaration Fee as of July 1998.

C. PRIVATE SECTOR

ERC (3/91)	PIRC (6/92)	PIRC II (6/93)	ESAC (3/94)	ERIP (7/95)	ESAC II (8/96)	PSREP (1/99)	RESULTS ACHIEVED
	Reform Investment Law; prepare investment guidelines; streamline operations of Investment Center	Evaluate effectiveness of reformed Investment Act and Investment Center				Streamline investment approval process	Investment Act of 1991 replaced with new Act in 1993; Investment Center reorganized; Investment Guidelines issued in 1995; The 1993 Investment Act was further amended in the 1996 Investment (Amendment) Act of January 27 to simplify the approval process; however, full streamlining of the investment approval process is yet to be achieved.
Liberalize licensing for small-scale enterprise		Prepare action plan for SSE deregulation					Licensing requirements reviewed and simplified for new businesses
		Develop action plan for land market	Create legal basis for market in leasehold land and facilitate subdivision of land and property		Implement 1995 Land Act including the Land Tribunal and the Land Development Fund; The Ministry of Lands to establish a baseline performance assessment of its leaseholds grants; Informal urban settlements to be regularized		Market for leasehold land liberalized and regularized in 1995
			Increase budget allocation for road maintenance				Road Maintenance Fund established, funded by excise tax on fuel
					National Housing Policy		National Housing Policy issued in 1995
					Amend Employment, and Industrial and Labor Relations Acts		
Begin liberalization of maize marketing							Marketing of all crops liberalized in 1992; except temporary ban on maize 0.exports in 1995
Decontrol fertilizer prices							All prices for agricultural products and inputs decontrolled
Begin reducing consumer maize subsidy	Eliminate consumer maize subsidy						Consumer subsidies ended in 1993
					Adopt new mining sector policy to encourage private sector investment; Adopt new legal, fiscal and environmental frameworks; Strengthen capacity of Ministry of Mines to oversee new legal, fiscal and environmental frameworks		Mining policy statement approved by Cabinet in 1995 New legal, environmental, and fiscal frameworks for mining adopted in 1995 Training and reorganization plan prepared under mining sector technical assistance

D. FINANCIAL SECTOR

ERC (3/91)	PIRC (6/92)	PIRC II (6/93)	ESAC (3/94)	ERIP (7/95)	ESAC II (8/96)	PSREP (1/99)	RESULTS ACHIEVED
	Reform Securities Law Establish stock exchange and adopt capital market regulations	Amend Bank of Zambia Act to strengthen prudential regulations of banks					Foreign Exchange transactions liberalized, and exchange rate market determined; Eliminated all interventions in credit allocations and interest rates; BOZ introduced Treasury Bills weekly auctions; Reduced high reserve and liquidity requirements for commercial banks; Changed Banking and Financial Services Law to place all financial institutions under BOZ supervision; Issued BOZ regulations for banks; Developed a Stock Exchange and established a Securities Exchange commission to regulate it
End public monopoly on insurance industry	Reform business legislation	Adopt business legislation	Implement simplified procedures of 1993 Investment Act	Reform insurance industry policies and laws (including pension-fund management companies) and set up new regulatory and supervisory agency			Opened the insurance industry to private companies; new insurance law adopted
		Prepare action plans for DBZ, Eximbank and Lima Bank		Adopt policy framework and strategy for provision of term finance to private sector; Restructure DBZ as apex bank and create collection agency for DBZ loan portfolio; Privatize or close down Eximbank and Lima Bank; Reform rural credit and reorient Government-owned credit institutions			Adopted new policy and strategy for term finance in 1995 Development Bank has ceased new lending Apex established to on-lend external funds to private sector through commercial banks Stopped budget allocations to agricultural credit institutions in 1995 Eximbank and LIMA Bank in liquidation

E. CIVIL SERVICE REFORM

ERC (3/91)	PIRC (6/92)	PIRC II (6/93)	ESAC (3/94)	ERIP (7/95)	ESAC II	PSREP	RESULTS ACHIEVED
Eliminate "ghost workers" by physical survey Identify staffing needs in line ministries	Eliminate surplus civil service staff and "ghost workers" Retrench 10,000 workers and develop deeper restructuring program; include compensation measures		Improve retention incentives for high level staff Reduce up-front cash costs of severance benefits		Maintain adequate information system with reliable data on number and deployment of teachers		Approved use of in-kind benefits for severance payments in 1994 Nearly all workers now paid by check Launched a public sector reform program; restructuring plans for 14 ministries approved
						Reduce the size of the civil service by freezing recruitment, retrenching the CDEs, reducing pensionable staff through voluntary separation and enforcing the wage freeze.	A limited hiring freeze, instituted in August 1997, resulted in drop of the non-military public service from 137,000 in 1997 to 112,000 by end-1999.

F. PRIVATIZATION

Announce privatization policy and develop modalities	Adopt overall privatization plan/strategy Enact Privatization Law	Update Privatization Program	Begin sale of state-owned farms				Adopted Privatization Act in 1992 Established Zambia Privatization Agency (ZPA) in 1992
Offer at least 6 parastatals for sale	Complete sale of at least 10 companies; and offer for sale companies accounting for 10 percent of total turnover of companies in program Offer for sale additional 10 parastatals	Offer for sale 60 companies; Reach point of sale for 20 companies; Complete sale or liquidate at least 15 companies; Offer for sale a total of 60 companies					Offered for sale 325 entities; Completed sale or liquidated 235 entities by end-1999.
		Recruit all key ZPA staff					ZPA operational since 1992
		Establish Privatization Trust Fund (PTF)					PTF set-up in 1993 PTF received shares in Chilanga Cement in 1995
		Study options to privatize ZCCM					Study completed; privatization under way
		Complete assessment of impact of privatization on specific target groups					Initial impact assessment completed
				Adopt and begin implementing plans to privatize and restructure ZCCM Adopt plans to develop Konkola Deep project on urgent basis in joint-venture with private sector in manner resulting in majority private-sector ownership and management			
						Implement agreed redundancy plan for ZCCM; Implement the reorganization plan for ZCCM; Complete transfer of ownership and control of remaining core ZCCM assets.	Sale of ZCCM completed March 30, 2000.

G. PARASTATALS MANAGEMENT

ERC (3/91)	PIRC (6/92)	PIRC II (6/93)	ESAC (3/94)	ERIP (7/95)	ESAC II (8/96)	PSREP (1/99)	RESULTS ACHIEVED
Complete studies of Zambia Airways, Post and Telecoms, and Zambia Railways			Adoption of acceptable financial plan for Zambia Airways				Zambia Airways liquidated in 1994 Telecoms separated from Post and commercialized in 1995
	Grant autonomy to all other parastatals						UBZ closed in 1995
	ZIMCO to be restructured and sub-holding companies abolished						ZIMCO closed in 1995. Directorate of State Enterprises set up under Ministry of Finance
	Establish autonomy of key parastatal utilities and establish transitional regulatory system, including price adjustment mechanisms	Study long-term regulatory arrangement for utilities				Complete transfer of ownership and control of remaining core ZCCM assets.	Utilities given authority to set their prices based on agreed mechanisms Sale of ZCCM completed March 30, 2000.

H. SOCIAL SECTORS

ERC (3/91)	PIRC (6/92)	PIRC II (6/93)	ESAC (3/94)	ERIP (7/95)	ESAC II	PSREP	RESULTS ACHIEVED
Implementation schedule for Social Action Program	Develop improved social action program and begin implementation						
Increase budget allocation for education			Meet minimum budget and spending targets for key social services in 1994	Meet minimum budget and spending targets for key social services in 1995	Maintain a social sector budget of at least 35 percent in 1996	Maintain social sector budget at 36 %	Overall budget allocations improved Social sector share of budget increased from 28 in 1993 to 34 percent in 1996; maintained at 36 % in 1998/99

			Expand role of NGOs in social services delivery Decentralize delivery of health and education services		Formulate a policy on collaboration with NGOs		Sector strategies adopted Decentralization of service delivery begun
			Adopt comprehensive water sector policy				Water sector policy adopted in 1994
					Prepare an Education Sector strategy Formulate a national drug procurement policy		

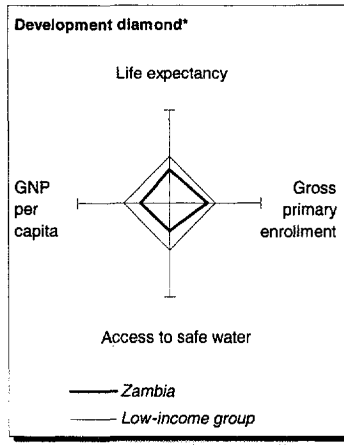
I. SOCIAL SECURITY

ERC (3/91)	PIRC (6/92)	PIRC II (6/93)	ESAC (3/94)	ERIP (7/95)	ESAC II	PSREP	RESULTS ACHIEVED
				Reform Social Security/Pension Fund System Adopt action plan to cover unfunded liabilities of existing statutory pension funds Repeal 22-years-of-service compulsory retirement law and modify benefit formulae and early retirement conditions Adopt action plan to improve administration and operations of Zambia National Provident Fund			New Social Security Act Passed by Parliament. Adopted reform strategy by NSSRISC based on joint Bank/ILO study in 1995 Draft legislation under preparation Approved Cabinet Memorandum on Social Security Reform in 1995

Zambia at a glance

6/1/00

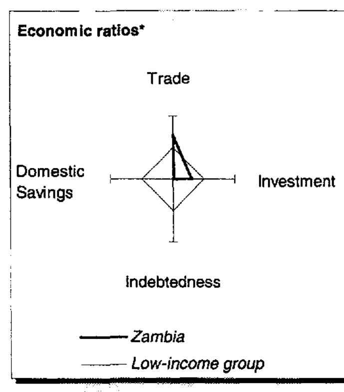
POVERTY and SOCIAL	Zambia	Sub-Saharan Africa	Low-income
1998			
Population, mid-year *(millions)*	9.7	627	3,536
GNP per capita *(Atlas method, US$)*	330	510	520
GNP *(Atlas method, US$ billions)*	3.2	323	1,842
Average annual growth, 1993-99			
Population *(%)*	2.5	2.6	1.7
Labor force *(%)*	2.8	2.6	1.9
Most recent estimate (latest year available, 1993-99)			
Poverty *(% of population below national poverty line)*	68	..	..
Urban population *(% of total population)*	44	33	30
Life expectancy at birth *(years)*	45	50	63
Infant mortality *(per 1,000 live births)*	..	92	68
Child malnutrition *(% of children under 5)*	29	33	36
Access to safe water *(% of population)*	43	43	73
Illiteracy *(% of population age 15+)*	22	40	31
Gross primary enrollment *(% of school-age population)*	89	78	107
Male	92	85	112
Female	86	71	102



KEY ECONOMIC RATIOS and LONG-TERM TRENDS

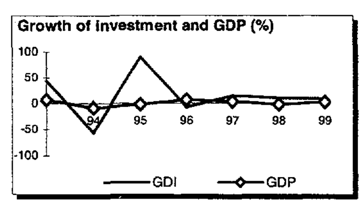
	1979	1989	1998	1999
GDP *(US$ billions)*	3.3	4.0	3.2	3.1
Gross domestic investment/GDP	14.2	10.8	16.3	17.5
Exports of goods and services/GDP	45.6	26.8	26.7	22.3
Gross domestic savings/GDP	23.2	3.8	3.9	-1.1
Gross national savings/GDP	15.0	-7.1	-3.6	-6.6
Current account balance/GDP	1.1	-5.6	-17.8	-15.8
Interest payments/GDP	2.8	1.9	2.8	5.2
Total debt/GDP	91.3	168.0	215.5	206.9
Total debt service/exports	22.1	13.6	25.8	38.1
Present value of debt/GDP	..	..	..	..
Present value of debt/exports	..	..	..	..

	1979-89	1989-99	1998	1999	1999-03
(average annual growth)					
GDP	1.1	0.2	-1.9	2.4	4.7
GNP per capita	-3.2	-1.9	-5.1	2.2	2.6
Exports of goods and services	-3.1	-6.1	5.0	4.9	11.8

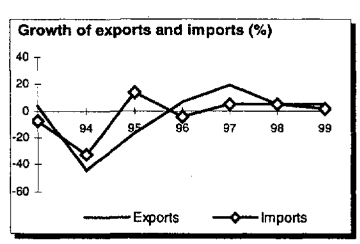


STRUCTURE of the ECONOMY

	1979	1989	1998	1999
(% of GDP)				
Agriculture	16.5	21.2	21.2	24.6
Industry	46.4	52.5	29.1	24.5
Manufacturing	20.2	34.4	13.0	12.0
Services	37.2	26.3	49.7	50.9
Private consumption	52.9	82.5	84.9	91.5
General government consumption	23.9	13.7	11.2	9.6
Imports of goods and services	36.6	33.8	39.2	40.9



	1979-89	1989-99	1998	1999
(average annual growth)				
Agriculture	3.6	3.4	1.8	13.7
Industry	-1.5	-5.2	-11.3	-4.9
Manufacturing	3.1	0.8	1.8	2.8
Services	3.8	3.1	4.4	5.2
Private consumption	3.4	0.8	-1.3	2.6
General government consumption	-3.8	-4.7	-14.8	-15.8
Gross domestic investment	-3.6	3.3	9.3	8.7
Imports of goods and services	-2.3	-5.6	4.6	1.6
Gross national product	-0.2	0.8	-2.9	4.4



Note: 1999 data are preliminary estimates.

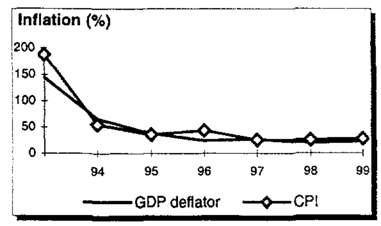
* The diamonds show four key indicators in the country (in bold) compared with its income-group average. If data are missing, the diamond will be incomplete.

Annex F
Page 2 of 2

Zambia

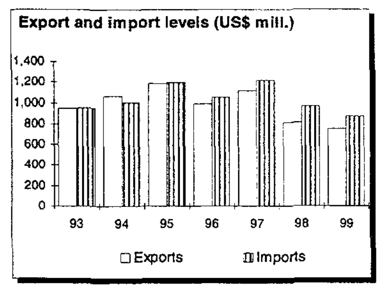
PRICES and GOVERNMENT FINANCE

	1979	1989	1998	1999
Domestic prices				
(% change)				
Consumer prices	9.7	127.7	24.4	26.8
Implicit GDP deflator	21.3	80.9	19.6	21.7
Government finance				
(% of GDP, includes current grants)				
Current revenue	..	18.6	18.7	17.6
Current budget balance	..	-4.4	1.4	2.6
Overall surplus/deficit	..	-6.6	-9.8	-10.0



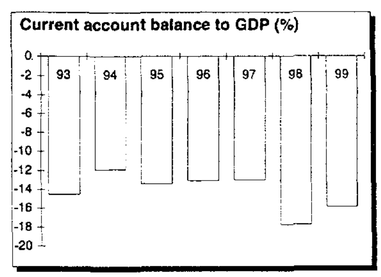
TRADE

	1979	1989	1998	1999
(US$ millions)				
Total exports (fob)	1,408	1,410	816	755
Copper	..	1,233	365	372
Zinc	..	84	155	95
Manufactures	..	36	194	188
Total imports (cif)	756	901	971	871
Food	..	14	108	0
Fuel and energy	..	103	42	115
Capital goods	..	372	539	523
Export price index *(1995=100)*	..	92	70	69
Import price index *(1995=100)*	55	79	87	88
Terms of trade *(1995=100)*	..	116	81	79



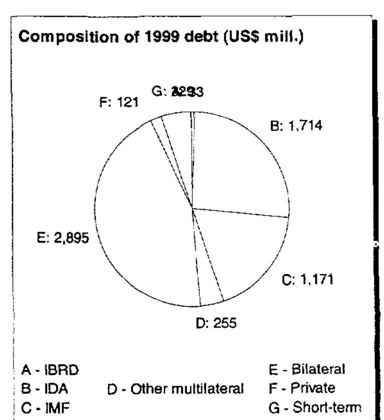
BALANCE of PAYMENTS

	1979	1989	1998	1999
(US$ millions)				
Exports of goods and services	1,523	1,493	919	842
Imports of goods and services	1,212	1,281	1,253	1,169
Resource balance	311	212	-334	-327
Net income	-169	-406	-215	-156
Net current transfers	-105	-28	-27	-16
Current account balance	37	-222	-576	-499
Financing items (net)	-146	487	365	518
Changes in net reserves	109	-265	211	-19
Memo:				
Reserves including gold *(US$ millions)*	191	123	69	50
Conversion rate *(DEC, local/US$)*	0.8	13.8	1,862.0	2,388.0



EXTERNAL DEBT and RESOURCE FLOWS

	1979	1989	1998	1999
(US$ millions)				
Total debt outstanding and disbursed	3,047	6,709	6,982	6,518
IBRD	336	501	42	33
IDA	1	253	1,562	1,714
Total debt service	340	206	247	331
IBRD	41	0	25	12
IDA	0	0	16	16
Composition of net resource flows				
Official grants	..	72	221	214
Official creditors	305	90	-54	66
Private creditors	1	11	-11	-20
Foreign direct investment	..	0	198	163
Portfolio equity	..	..	..	..
World Bank program				
Commitments	11	0	75	213
Disbursements	28	4	43	156
Principal repayments	13	0	25	13
Net flows	16	4	18	143
Interest payments	29	0	16	15
Net transfers	-13	4	2	128



Pension Reforms

Existing Pension Schemes in Zambia: Coverage, Weaknesses and Reform Areas

1.1 There are approximately six pension systems in Zambia. They include: the Public Service Pensions Fund (PSPF), Zambia National Provident Fund (ZNPF), Workmen's Compensation Fund (WCF), the Local Authorities Superannuation Fund (LASF), the Zambia State Insurance Corporation Pension Scheme, and Mukuba Pension Scheme (see Table 1). In addition to these, some larger banks have their own pension arrangements (e.g. Bank of Zambia and Barclays Bank), and some private companies have established pension funds which are managed for them by specialists such as the Life Division of insurance companies.

1.2 Table 1 summarizes the basic features of pension schemes in Zambia. Clearly, almost all of the pension schemes in Zambia have been undermined by very low coverage, fundamental flaws in benefit-design and revenue-collecting mechanisms, excessive administrative costs and an inherent inability to prevent political interference and manipulation by the government. Almost all of them have also been facing negative real rates of return on their investments, and suffer from liquidity problems. The harsh economic climate, increasing uncertainty about the future, increasing unemployment levels, and, a shortage of information and technological capacity have all contributed to make these schemes financially insolvent and unsustainable. Adding to the financial insolvency of the schemes—particularly the public schemes—has also been an uncontrolled government borrowing of funds at subsidized interest rates. As a result of their financial fragility, these schemes have increasingly failed to fulfil their obligations toward pensioners.

1.3 To its credit, the Government of Zambia has been trying to establish a unified social security system for some time now. In fact, as early as the 1980's the Kabwe Commission looked into aspects of social security. However, progress at the time was slow because of other pressing macroeconomic priorities. More recently, based on the World Bank /ILO technical assistance (1994), the Government drafted the National Pension Scheme Act of 1996 (NAPSA 1996). The National Pension Scheme Act of 1996 promises a solidarity based partially funded defined benefit (DB) pension system, and is certainly a move in the right direction for Zambia. However, there are areas where the design and details would need substantial improvement if the goal of a national pension system is to materialize effectively. In addition to NAPSA 1996, three other acts were drafted and passed during the same year: the Pension Scheme Regulation Act of 1996 (PSRA 1996), the Public Sector Pensions Act of 1996 (PSPA 1996), and the Local Superannuation Amendment Act of 1996 (LASA 1996). PSRA 1996 establishes a regulatory framework for all pension schemes in Zambia except the new National Pension Scheme. This Act contains provisions for the establishment of a registrar and a supervisory authority to register and de-register pension funds. The PSPA 1996 extends coverage to all public servants by including teachers and the armed forces in its scope of coverage. Further, it eliminates the early retirement option after 20 years of service. The LASA 1996 eliminates the requirement to retire after 22 years of service. These legislative acts have certainly been steps in the right direction toward creating a comprehensive pension system in Zambia as well as in improving the financial viability of some of the existing schemes.

1.4 Clearly, however, there is a great deal more that needs to be achieved by means of policy reform, especially in making these schemes financially viable. Within the broader goal of establishing a credible and coherent pensions system, the road ahead should involve one of continuing the reform process already underway. The last column of Table 1 defines a set of measures and activities that would constitute the wider pension reform agenda in the country. Table 2 summarizes proposed short, medium and long-term policy measures.

Table 1: Zambia—Pension Schemes, Coverage, Weaknesses and Reform Areas

Scheme Type	Design	Coverage/ Sector/ Membership	Weaknesses	Interventions to Date	Reform Gaps / Tasks Ahead
I. Statutory					
2.2 Zambian National Provident Fund (ZNPF)	Funded DC	Private sector 180,000 Non-CSPF Civil Servants 30,000 Non-LASF Local Govt. 5,000 Parastatal Employees 140,000 Total 355,000	• Evasion and non compliance by employers and employees • No scope for redistribution within this system, i.e. benefits not related to needs • Deficiencies in fund management: contribution ceiling not regularly adjusted for inflation; political interference in fund management • Data problems: lack of good computerized data management system; difficulty in benefit processing • High administrative costs (ratio of administrative cost to investment income is about 250%)	• NAPSA 1996 enacted on the basis of ILO/ World Bank recommendations .NAPSA provides for the conversion of the ZNPF into National Pension Scheme (NPS).	• Reduce administrative costs: Help retrenchment of workers at the ZNPF since staff-related costs constitute the bulk of administrative costs. • Establish transparent governance structure and investment policy for NPS. • Address deficiencies in the design of NPS including: (a) the huge implicit and explicit pension liabilities that it implies; (b) its equity and redistribution implications; (c) Implications of AIDS for stream of contributions and benefits; (d) survivor benefits; and (d) the feasibility of the proposed wage indexation mechanisms • Improve upon the design of the NPS in light of such studies. • Develop mechanisms for dealing with the data management problems that the ZNPF is currently facing before it is converted into the NPS. • Complement staff retrenchment with training and upgrading of skills for the staff members staying with NPS • Decentralize the NPS, and ensure provincial access to pension services
1.2. Public Service Pension Fund (PSPF)	Funded DB	Civil Servants N/A Armed Forces N/A Teachers N/A Total 100,000	• Under-funded since it is a PAYG system • Benefits are too high in relation to contributions and/or are distorted • Huge outstanding govt. liabilities (on the order of K67 billion only over 1991-99) • Other administrative and logistical problems such as computing facilities • Lacks portability, i.e. transferability of the benefits when one changes jobs	• Actuarial evaluation completed by Hymans and Robertson and Co., a South Africa based actuarial firm	• Develop proposals for the government to clear its outstanding liabilities • Separate out employment related liabilities from pension liabilities • Institute, if possible, measures to counteract Article 124 of the Constitution • Institute parametric reforms • Set up an autonomous MIS for the pension fund. • Decentralize the pension disbursement services to provincial and district levels.

1.3. Local Authorities Superannuation Fund (LASF)	PAYG DB	Local Govt. Employees 22,000 NHA, ZESCO N/A	• Non-compliance by Government (more than K 2.1 billion contribution in arrears) • Low investment income • Seriously under-funded due to low contributions and rising expenditures	• None	• Contribution rates, retirement rules, and commutation factor and amounts to be revised • Proposals for the government to clear its outstanding liabilities to be worked out • Mechanisms for improving management and reducing administrative costs yet to be proposed and implemented (e.g. contracting out of management to the private sector)
1.4. Workers' Compensation Fund (WCF)	Employers' contribution based on Industry accident	Factory/ manufacturing workers N/A	• Political interference with regard to fund management • Negative real returns on investment • High administrative expenditure (about 60% of contribution income)	• None	• Ways to reduce political interference in fund management yet to be ensured • Exact modalities for merger between the WCF and PCF yet to be worked out
1.5. Pneumoconiosis Compensation Fund (PCF)	Levy on Mines	Miners 1,150 **Total, Statutory 478,150**	• Very low entitlement (based on wage of K 200). • High administrative costs, and postal commission (of 10%) on the already low benefits	• None	• Maximum wage (which would allow for higher benefits) yet to be revised • Exact modalities for merger between the WCF and PCF yet to be worked out
II. Occupational					
2.1 Zambia State Insurance Corporation (ZSIC)	DB and DC	Parastatal Employees 120,000 Private 60,000	• Prescribed investment decisions by the government • Low levels of real pension payments both due to lack of compliance and inflation • lack of regulation and supervision of these schemes by the government • lack of qualified management personnel.	• None	• Autonomy in fund management yet to be achieved • Improved compliance and inflation adjusted benefits yet to be achieved • Service standards and regulations for occupational pension schemes yet to be developed and legislated by the govt. • Mechanisms for improving management and administrative efficiency yet to be proposed and implemented
2.2 MUKUBA		ZCCM 18,000	• Administrative expenses of ZCCM high by *international* standards (27% of contribution income); otherwise a well-run and actuarially sound pension scheme	• None	• It is not clear what will happen to this scheme if privatization of ZCCM goes ahead as planned.
		Occup., Total	**78,000**		
		Grand, Total	**565,000**		

Sources: (1) ILO/World Bank Mission Report, 1994; (2) " Reforming Pensions in Zambia" , World Bank Staff Working Paper # 1716, January 1997.

Table 2: Zambia—A Summary of Proposed Pension Reform Measures under FSC and Beyond

Scheme Type	Short-term Measures(to be completed under FSC)	Possible Medium-term Measures (to be completed in the next 2-3 years)
I. Statutory		
1.1. Zambian National Provident Fund (ZNPF)	• Propose to move to a multi-pillar NPS; hold consultations with different constituents on the need for such a change; submit the improved NAPSA 1996 to the parliament for amendment. • Help reduce administrative costs (i.e. help the staff retrenchment process) under ZNPF • Put in place transparent governance structure and investment policy for NPS. • Strengthen the data and information management capacity of the ZNPF before it is converted into the NPS (to be done through PSCAP)	• Implement the amended NAPSA/ revised NPS. • Complement staff retrenchment at the ZNPF with training and upgrading of skills for the remaining staff • Decentralize the NPS, and ensure provincial access to pension services
1.2. Public Service Pension Fund (PSPF)	• Complete the actuarial study on PSPF (done) • Help work out proposals for the government to clear its outstanding liabilities • Separate out employment related liabilities from pension liabilities • Propose and implement short-term measures (recommended by the actuarial study) that would help improve the financial viability of the fund	• Decentralize the pension services to provincial and district levels. • Help set up an autonomous MIS for the Fund
1.3. Local Authorities Superannuation Fund (LASF)	• None	• Work out proposals for the government to clear its outstanding liabilities • Propose and implement mechanisms for improving management and investment policy, as well as reducing administrative costs
1.4. Workers' Compensation Fund (WCF)	• None	• Institute a mechanism to reduce political interference in fund management • Determine exact modalities for merger between the WCF and PCF
1.5. Pneumoconiosis Compensation Fund (PCF)	• None	• Provide for a mechanism to regularly revise maximum monthly wage (which would allow for higher benefits) • Determine exact modalities for merger between the WCF and PCF
II. Occupational 2.1 Zambia State Insurance Corporation (ZSIC)	• None	• Help set up an autonomous fund management committee • Develop and legislate service standards and regulations for occupational pension schemes. • Propose and help implement mechanisms for improving management and administrative efficiency
2.2 MUKUBA	• None	

Sources: World Bank staff analysis

Zambia: Matrix of Policy Agreements under Fiscal Sustainability Credit (FSC)

AREAS AND OBJECTIVES	PROGRESS TO DATE	PROPOSED REFORM MEASURES UNDER FSC
A. QUASI-FISCAL DEFICIT		
A.1 DEFICITS OF PARASTATALS Reduce the deficits of state-owned enterprises that have adverse impact on the Government budget by: i) unbundling and privatizing ZESCO; ii) offering for sale a majority controlling interest in the package of the Indeni refinery, TAZAMA pipeline and Ndola terminal to a strategic partner or group of partners that will be required to operate these assets in accordance with market principles; iii) liberalizing imports and retail prices of petroleum products; iv) limiting the role of ZNOC to manage and control strategic reserves of petroleum products (leaving all commercial operations to oil marketing companies); and v) private concessioning of Zambia Railways.	• Privatization of ZCCM completed (March 2000)	**ZCCM** • Agreement by all parties involved on the amount of ZCCM debt and cross-debt to be settled, including an action plan to speedily clear arrears; • Initial implementation of the above action plan.
	• Electricity tariffs increased by 25% in April 2000. • GRZ committed to unbundling and privatization of ZESCO; Cabinet directed the Zambia Privatization Agency (ZPA) to prepare a plan for ZESCO's privatization (October 1999). • Agreement reached among MOFED, ZESCO, CEC on the amount of debt and cross-debt to be settled, including an action plan to speedily clear the arrears; and • Agreement between ZESCO and ERB reached on specific modalities of the Automatic Tariff Adjustment Formula.	**ZESCO** • Increase retail tariffs according to revenue requirement agreed with IDA and the approved Automatic Tariff Adjustment Formula; • Implement further measures to reduce ZESCO's operating costs such as restrictions on salary increase, divestiture of non-core activities, and restructuring of the current short-term borrowings into medium-term loans; • Improve billing and revenue collection; • Conduct studies to investigate options for privatization and to review the legislative and regulatory framework to establish an enabling environment for private sector participation. Adopt a suitable option and have it approved by the Cabinet for implementation.
	• Clearance of ZNOC arrears to TAZAMA.	**ZNOC** • Offer for sale a majority controlling interest in the refinery, pipeline and terminal, as a package, to a strategic partner or group

	• Cabinet approved concessioning of Zambia Railways • Agree with IDA to increase Private Sector Participation in ZR through private concessioning of infrastructure and selling/leasing of locomotives and rolling stock; • Staff rationalization program at ZR.	of partners. Meanwhile, any work on rebuilding the refinery and/or other facilities will be deferred until the new owner takes possession of the assets; • Establish a robust payment mechanism for TAZAMA, to ensure that it is remunerated in full and in a timely manner for its services. The mechanism could also include a procedure whereby TAZAMA would be remunerated with products which it could dispose of for its own account; • Fully liberalize imports (so that all oil marketing companies could import petroleum products directly) and retail prices of petroleum products; and • Limit the role of ZNOC to manage and control strategic reserves of petroleum products equal to thirty days of average national use. **Zambia Railways** • Establish an autonomous regulatory body to enforce safety and environment-related regulations; • Map out strategies for restructuring/winding up of the (residual) ZR after concessioning has become operational.
A.2 BANK OF ZAMBIA DEFICIT: Reduce the risk of new contingent or actual liabilities developing on the books of the Bank of Zambia, and lower the government's cost of domestic debt finance.	• Submission to the Cabinet's Legislation Committee the amendments to the Banking and Financial Services Act (1994) to enhance the BOZ's power to sanction, take control of, and de-licence banks, and to ensure the Government will make provision in all future budgets to indemnify	**Reduce Risk of Contingent Liabilities** • Submit to Parliament proposed amendments to the Banking and Financial Services Act (1994) to enhance the BOZ's powers to sanction, take control of and de-licence banks. • Make provision in all future budgets to indemnify the Bank of Zambia for any probable loss on new guarantees that will be called upon.

	the Bank of Zambia for any probable loss on new guarantees that will be called upon. • Submission of a plan by BOZ and MOFED to alter cash management practices in relation to ministerial accounts held at commercial banks so as to minimize the arbitrage opportunity that presently exists.	**Lower Government's Cost of Domestic Debt Finance** • Adopt a cash management method, agreed upon by BOZ and MOFED, to minimize the arbitrage opportunity presently created by ministries' accounts at commercial banks; • Create, within MOFED, a unified and integrated database for recording and monitoring external and domestic debt, including timely debt service; and • Improve the management of liquidity by BOZ to reduce both the levels and the volatility of interest rates on Government debt.
A.3 PENSION REFORMS: Help set up a financially viable, efficient National Pension Scheme (NPS), and improve the financial position of the Public Service Pensions Fund	• Actuarial evaluation completed for Public Service Pensions Fund by Hymans and Robertson and Co., a South Africa based actuarial firm (November 1999). • Allocation of K26 billion in the 2000 budget to stem further financial losses to the PSPF; • Creation of a mandatory National Pension Scheme (NPS) in 1996 that would harmonize all the existing plans. The NPS Act 1996 has been made effective February 1, 2000, and the National Pension Scheme Authority (NAPSA) has been put in charge of running the day-to-day operations of the scheme;	**Public Service Pensions Fund (PSPF)** • Clear the arrears to the PSPF; • Phase down the PSPF over the long-term, while consolidating and improving NPS (below), which has become effective as of February 1, 2000, to make it fair and cost-effective and to allow portability (i.e. compatibility) with the private sector. **National Pension Scheme (NPS)** • Agree with IDA on the number of NAPSA staff to be retrenched and the cost thereof, based on the established criteria; • Issue NAPSA statutory instruments in the official Gazette to reflect parameters as contained in proposed regulations with respect to benefit formulas, minimum pension guarantee, required length of service, and accrual rate; • Submit to IDA evidence on staff retrenchment, including an audit satisfactory to the Association and carried out by an independent agency acceptable to the Association, showing that NAPSA had implemented its Redundancy Plan;

	• Agreed with IDA on staff retrenchment plans at NAPSA, including clear and transparent retrenchment criteria prepared by the management of NAPSA; • Issued NAPSA statutory instruments to reflect parameters (as agreed with IDA) as contained in the proposed regulations with respect to contribution rates, including contribution ceiling and floor; and • Submitted to IDA draft NAPSA statutory instruments concerning benefit formulas, minimum pension guarantee, required length of service, and accrual rate, as submitted by the Ministry of Labor and Social Security to the Ministry of Legal Affairs.	• Establish transparent governance structure and prudential investment guidelines for NAPSA; publish in the official Gazette prudential investment guidelines for NAPSA; • Complete an actuarial evaluation of NPS to determine (i) the viability of a second-pillar component and (ii) the relative size of contributions that constitute individual accounts; • Commence a study on insurance markets and annuities in Zambia and other selected countries.; • Strengthen the voluntary/ occupational pension schemes through improving governance, transparency and autonomy in fund management; and • Move the NPS towards a multi-pillar system and rely on three pillars to produce an adequate income and provide about 60-70% replacement rates of pre-retirement salaries for a full career worker.
B. FISCAL MANAGEMENT		
Improve budget implementation policies and mechanisms to improve the predictability, accountability, and transparency of public spending. Also to reduce the government's costs of purchasing goods and services, improve the efficiency of government operations, and channel more resources into economically and		**Improve Predictability of Public Spending** • Extend the time-period covered by each cash release from the present one month to three months by preparing a quarterly cash allocation pan; • This cash allocation plan, which will amount to 80 percent of the Yellow Book allocation for the corresponding three months, will be subdivided into three monthly cash releases. MOFED will inform every spending agency of their projected cash allocation so

socially important sectors and ministries.	• The Finance Act has been revised to include appropriate sanctions and penalties for controlling officers who fail to fulfill their responsibilities.	to allow spending agencies to start planning their activities; • MOFED will issue a set of rules, as part of the quarterly cash allocation plan above, indicating how, if necessary, reductions in cash allocations are to be implemented. In addition, budget allocations to the social sector ministries will be protected at at least 36 percent, and domestically-financed capital expenditures of the economic sector ministries at least 12 percent, of the discretionary budget; • Implement a mid-year budget review. **Improve Accountability** • MOFED to send the revised Finance Act (which strengthens sanctions and penalties to failing controlling officers) to Cabinet for approval, and subsequently to Parliament; • MOFED to cut back quarterly cash allocations to over-committed ministries and redistribute saved funds to ministries operating within their commitment ceilings. MOFED to impose strict controls on expenditure commitments, and by strictly enforcing the existing rule by which total outstanding expenditure commitments are limited to 10 percent of the annual warrant; • Controlling officers of line ministries to submit regular monthly reports on total outstanding commitments (both new and ongoing) and that these reports be accurate, comprehensive, and submitted on a timely basis (within 15 days after the end of each month). Non-compliance with this rule will result in MOFED withholding of monthly cash releases; • The Commitment Monitoring Unit (CMU) to monitor over-commitments carefully and to prepare monthly reports summarizing the situation of commitments, cash outlays, and

		payment arrears and provide these to MOFED managers. For every quarter, these reports will be distributed more widely, including to ministries. For ministries that exceed commitment limits or accumulate new expenditure arrears, quarterly reports will attach the obligatory written explanations by controlling officers of ministries for the reasons; and • Controlling officers to be held personally accountable to enforce the new financial regulations, which will specify clearly the sanctions and penalties to these officers and delegated officials who fail to fulfill their responsibilities. **Improve Budget Transparency and Governance** • MoFED to publish quarterly reports, which would include a comparison between actual cash releases by ministry (budget head) and major expenditure category (budget subhead) with the quarterly cash allocation plan and with original budget allocations; • Government financial statistics to be strengthened as an instrument for fiscal analysis. Information about the major state-owned enterprises, including their income statements, would be published in the annual *Economic Report* issued by MOFED. In addition, the budget (Yellow Book) would include two summary fiscal tables. The monthly *Macroeconomic Indicators* report will include tables showing projected level and composition of central government debt; • The office of the auditor-general (AG) to be equipped with adequate financial resources to carry out audits of government accounts within a year of the end of the year. The AG will be called upon to investigate and report to parliament on spending agencies that continue to make over-commitments.

Zambia: Fiscal Sustainability Credit

Performance Indicators

A. DEFICITS OF STATE-OWNED ENTERPRISES

A.1. ZESCO
- Clearance of arrears.
- Completion of cost reduction measures. Tariff increases according to criteria set out.

A.2. ZNOC
- Clearance of arrears to TAZAMA and other public entities.
- Offering for sale a majority controlling interest in the package of the Indeni refinery, TAZAMA pipeline and Ndola terminal to a strategic partner or group of partners.
- Retail prices of petroleum products significantly lowered.
- Role of ZNOC limited to manage and control strategic reserves of petroleum products (leaving all commercial operations to oil marketing companies).

A.3. Zambia Railways
- Improved short-term cost recovery (or reduced financial losses).
- Improved capital maintenance and provision of better services.

B. BANK OF ZAMBIA
- Reduction in BOZ deficit in relation to GDP. Reduction in the scale of intra-month volatility in the overnight rate.
- Improvement in the cash management method to minimize the arbitrage opportunity presently created by ministries' accounts at commercial banks.

C. PENSION REFORMS

C.1 National Pension Scheme (NPS)
- First pillar of NPS set up and operational;
- Prudential investment guidelines issued and implemented for NAPSA; and
- Staff retrenchment at NAPSA carried out satisfactorily, and audit completed.

D. FISCAL MANAGEMENT
- Satisfactory replacement of the current ad-hoc budget management system by rule-based decisions. The quarterly cash allocation system will replace the current ad-hoc monthly cash releases;
- Introduction of a formal mid-year review;
- Over-commitments of expenditures will be closely monitored and penalized;
- The shares of social and economic ministries in the budget will be protected during the course of budget implementation; and
- Budget implementation will be made transparent by publication of timely and more accurate information on public spending.

31st May, 2000

Mr. Callisto Madavo
Vice President, Africa Region
The World Bank
Washington, DC
USA

Dear Mr. Madavo,

RE: LETTER OF DEVELOPMENT POLICY
FISCAL SUSTAINABILITY CREDIT (FSC)

I. INTRODUCTION

1. I am writing to request, on behalf of the Government of Zambia, a Credit of $140 million equivalent from the International Development Association (IDA) in support of our structural adjustment programme. This Credit, the Fiscal Sustainability Credit (FSC) aims at helping Zambia sustain its fiscal progress achieved in recent years by: (i) expanding fiscal adjustment beyond the central government to other public sector entities, including state-owned enterprises, pension funds, and the Bank of Zambia; and (ii) reestablishing fiscal discipline through improvement in the predictability, accountability, and transparency of public spending.

2. **Past Achievements**: The Zambian Government that took office in 1991 launched a programme of economic stabilisation and liberalisation designed to reverse the country's economic decline and put it on the path of sustainable growth. Prices were decontrolled and subsidies eliminated, inflation was brought down significantly, market forces have been allowed to determine the exchange and interest rates, quantitative restrictions on imports were eliminated; and the tariff structure was compressed and simplified. Parastatal monopolies have ended, crop marketing was liberalized, and a far-reaching privatisation programme has made good progress. The central government budget deficit (after grants and debt rescheduling, cash basis) declined from 7 percent of GDP in 1991 to 2.3 percent in 1997, although it rose again to about 4 percent in 1998-1999. The privatisation of non-mining public enterprises has continued at a rapid pace, with over 80 percent of companies/units privatized by December 1999 out of a total portfolio of 282.

3. While the government has been quite successful in implementing this programme, the economy has responded slowly, with average annual growth of less than 1 percent in 1994-1998 compared to 3 percent growth of the population. Furthermore, macroeconomic stability has not been fully achieved. While inflation has declined from close to 200 percent in 1992-1993 to about 20 percent by 1997, it has remained between 20 and 30 percent since then. The decline in GDP in 1998 after growth had resumed in 1996 and 1997 shows that Zambia has not yet attained sustained economic growth.

4. Following the successful privatisation of ZCCM in March 2000, the Government is redoubling its efforts, with support from the World Bank and the IMF, to attain a sustainable growth path and fight widespread poverty. In May 2000, the Government of Zambia completed the discussions on the first review of the Poverty Reduction and Growth Facility (PRGF) with the International Monetary Fund (IMF), including progress in the implementation of the outstanding prior actions. At the same time, it also discussed with World Bank and IMF staff its interim Poverty Reduction Strategy Paper (PRSP) and the debt sustainability analysis that will be included in a preliminary Highly Indebted Poor Countries (HIPC) Initiative document. As part of the interim PRSP, a matrix of policy reforms covering the 2000-2002 period has been formulated in collaboration with the staffs of the World Bank and the IMF and will be considered for adoption by the Cabinet.

5. The main macroeconomic objectives for the period 2000-2002 are to lay the basis for sustained economic growth of 4-5 percent per year, further reduction in inflation and a strengthening of the external payments position. The ultimate objective of these policies is to reduce the incidence of poverty in Zambia from the current estimate of 70 percent to 50 percent by the year 2004. During this period, the Government will continue with its stabilisation efforts through prudent fiscal and monetary policies, including efforts to achieve a marked reduction in the overall public sector deficit (quasi-fiscal deficit). These policies will be complemented by structural and institutional reforms, particularly in the areas of state-owned enterprises, pension, fiscal management, public service, and the banking sector. Other reform measures will include improving the framework for provision of growth-enabling infrastructure, rural development, and expanding targeted poverty alleviation programs.

II. RECENT ECONOMIC AND FINANCIAL DEVELOPMENTS

6. Following two successive years of economic growth in 1996 and 1997, the economy slowed down in 1998 due to a combination of internal and external shocks. A 25 percent drop in the copper price, combined with operational and financial problems at the copper parastatal, Zambia Consolidated Copper Mines (ZCCM) —until March 31, 2000, the largest public sector company in Zambia—as well as delays in ZCCM's privatisation substantially reduced copper production and export revenues. Adverse weather conditions also contributed to a reduction in agricultural output, especially maize production. As a result, in 1998 GDP declined by 2 percent in real terms. The fall in foreign exchange earnings was further exacerbated by a reduction in balance of payments support, resulting in a depreciation of the Kwacha by over 60 percent during the year. The current account deficit (after transfers) widened to about 11 percent of GDP, while official foreign exchange reserves fell from two months of imports at end-1997 to less than two weeks of imports by end-1998. Inflation rose to about 30 percent by year end, reflecting in part the pass-through effects of the Kwacha depreciation. Although the government exercised fiscal restraint on recurrent expenditures, capital expenditures increased at a time when balance of payments support declined. The central government budget deficit (on a cash basis, after grants) increased from 2.0 percent of GDP in 1997 to 4.4 percent of GDP in 1998.

7. The economy recovered in 1999, aided by good weather and a relatively stable exchange rate. Nevertheless, GDP grew by only 2.4 percent because of the continuing adverse effects of the delays in ZCCM privatisation. Increased production of maize, rice, mixed beans, and cash crops (seed cotton and soybeans) contributed to a 13.7% percent growth in the agricultural output. Overall economic growth would have been higher if not for the decline in mining output (25 percent) and modest growth in the manufacturing sector (3 percent), where the sources of growth were mainly in food, beverages and tobacco. Despite a fall in foreign exchange earnings due to copper exports and to lower than expected balance of payments support, the Government managed to pursue stringent fiscal and monetary policies. This policy framework, combined with a relatively stable exchange rate (compared to 1998), contributed to a decline in the end-of-period inflation, from 31 percent in 1998 to about 21 percent in 1999.

8. Despite a decline in the central government revenues caused mainly by factors related to the delay in ZCCM privatisation, the Government pursued a tight fiscal policy. In 1999, the central government budget deficit (on a cash basis, after grants) declined slightly to 4.0 percent of GDP. At the same time, total tax revenue fell from 18.1 percent of GDP in 1998 to about 17.1 percent of GDP, due in large part to the financial difficulties that ZCCM and its suppliers experienced in meeting their tax obligations. The shortfall in revenues was balanced by sharp cuts in expenditures: current expenditures fell from 17.3 percent of GDP in 1998 to 15.0 percent of GDP in 1999. This tight fiscal policy was accompanied by a stringent monetary policy, as money and quasi-money grew at the same pace as nominal GDP. On the external side, tightened imports compensated for the drop in export earnings. As a result, the current account deficit (after transfers) declined from 11 percent of GDP in 1998 to about 9 percent in 1999. . Exports continued to decline in 1999, but the rate of decline slowed down – from 12.9 percent in 1998 to only 4.6 percent in 1999.

9. Despite these considerable economic hardships, progress continued on a number of policy fronts. In March 1999, the Government agreed on a new Policy Framework Paper with the Bank and the IMF, and the IMF approved a new three-year Enhanced Structural Adjustment Facility (ESAF) (now Poverty Reduction and Growth Facility (PRGF)) program. In April, the Government concluded a debt rescheduling agreement with the Paris Club. Following a successful Consultative Group Meeting in late May 1999, and subject to continuing progress on economic and governance issues, several bilateral donors either resumed balance of payment support or indicated a willingness to do so. Progress on the Public Service Reform Program (PSRP) continued, and the Bank released the second tranche of the PSREP in early April 2000. Nonetheless, in the last half of 1999, the delay in the privatisation of ZCCM and consequent delays in related balance of payments support increased the vulnerability of the economic reform program and adversely affected the Government's ability to meet some of the PRGF's targets, particularly on the external side. As mentioned earlier, in May 2000, the Government reached a preliminary agreement with the Fund on a new annual program under the PRGF.

III. POLICY OBJECTIVES FOR 2000-2002

10. The Government medium term programme aims at achieving high and sustained growth and poverty reduction by maintaining macroeconomic stability and completing the unfinished agenda of structural reforms. These objectives are consistent with the Government's long term vision of the Zambian economy as one with a rapidly growing private sector operating in a competitive and stable economic environment, with the public sector focusing on the provision of social and economic infrastructure and support services as well as on enforcement of laws and regulations. To this end, the Government plans to take measures in three areas: (1) stabilisation measures aimed at establishing and maintaining internal and external balance; (2) structural adjustment measures to strengthen the basis for a more diversified, market based, and outward oriented economy; and (3) social sector policies aimed at poverty reduction and human resource development.

11. The policy targets for the 2000-2002 period are to achieve economic growth of 4-5% per year while reducing the rate of inflation from the annual average of 26.8 percent in 1999 to about 22% in 2000 and further down to about 8 % by 2002[1]. . Among others, this will require a marked reduction in the public sector's quasi-fiscal deficit, including the deficit of public enterprises, pension funds, and the Bank of Zambia as mentioned below. A key fiscal target for 2000-2002 is to generate Central Government domestic budget surpluses of some 1.3 percent of GDP by 2002. This would create the necessary room for the expansion of private sector activity and will also allow Zambia to reduce over the medium-term its dependence on external assistance as a source of budget financing. The principal key to achieving fiscal objectives will lie in the strengthening of tax administration and stricter controls over public expenditures, in particular commitments and domestic arrears.

12. To bolster our ability to respond to external shocks, gross official reserves will increase to 1.5 months import cover in 2000 and rise further to 2.2 months import cover by 2001 (2.7 months by 2002). The external current account deficit after grants is expected to improve from 9 percent of GDP in 1999 to below 7 percent of GDP in 2000-2002, as increases in imports of capital goods will be offset by growth in metal exports by the privatized copper industry. . Government's role will be centered on the provision of infrastructure, the maintenance of a favourable policy environment for achieving high growth rates in mining, agriculture, tourism and manufacturing, and the more effective delivery of social and other support services.

13. The growth projections over the 2000-2002 period are based on an annual increase in copper production of 6 percent, spillover effects of this to other sectors, mainly trade and manufacturing (both 4-5 percent), supported by further privatisation in manufacturing, and continued, but slower, agricultural output growth of some 6-7 percent. These growth prospects are underpinned by an expected increase in gross investment, from around 15 percent of GDP in 1998 to some 23 percent in 2002. The increase is to come mainly from private investment in the mining sector now that the main assets of ZCCM have been privatized, but also in exports of agricultural commodities, manufacturing and tourism.

---

[1] The slow programmed reduction in inflation in 2000 is due to the effects of increased oil and electricity prices

Following the privatisation, private investment is expected to rise from 6.7 percent of GDP in 1998 to 14.1 percent of GDP by 2002. Most of the increase in investment is expected to be financed by the inflow of foreign private capital and rising private domestic savings.

14. The Government is committed to maintaining the liberal trade and exchange regime, and to continuing trade liberalisation including in the context of the Cross-Border Initiative (CBI). Over the medium term, it aims to reduce the average import tax to 10 percent. To this effect, the maximum rate will be reduced from 25 to 20 percent in 2001. In addition, the Government plans a further streamlining of the investment promotion process, including improved access to infrastructure services.

15. Zambia's heavy external public debt burden will require continued reliance on debt relief and concessional balance of payments assistance. We seek to reach the decision point for assistance under the Heavily Indebted Poor Countries (HIPC) Initiative as soon as possible, because even with the full use of all traditional debt relief mechanisms, the country would still face an unsustainable level of external debt over the medium term. The Government recognizes that continued assistance from Paris Club creditors and the provision of assistance under the HIPC Initiative will depend on a strong track record under IMF and World Bank-supported programmes in the coming years.

IV. REDUCING THE QUASI-FISCAL DEFICIT

16. The Government is fully aware that the high overall public sector deficit (quasi-fiscal deficit) has been one of the main reasons why the Zambian economy has failed to achieve economic growth and macro stability, despite a marked reduction in the Central Government budget deficit. In 1997, over two-thirds of this deficit was caused by non-central government entities such as public enterprises, pension funds and BOZ. To achieve a lasting effect on the overall public sector deficit, the Government will implement a number of measures designed to improve the financial situation of these entities. At the same time, it will seek to reestablish fiscal discipline through measures to improve the predictability, accountability, and transparency of public spending. This section describes our intentions to reduce the overall public sector deficit.

Publicly-Owned Enterprises

17. Privatisation is fundamental to Zambia's Adjustment Programme. With the successful completion of the ZCCM privatisation on March 31, 2000, the Government's privatisation program has achieved one of its major objectives. Nevertheless, the Government will continue and even accelerate implementation of the privatisation program by divesting most of the remaining state owned enterprises. An immediate major focus will be a number of key utilities, such as the Electricity Supply Company (ZESCO) and the Zambian Railways. In addition, we intend to restructure the petroleum sector in order to enhance efficiency and Government revenues, increase potential exports, and reduce the cost to the consumers. To

prepare for their successful privatisation by making these enterprises more attractive to private investors, the Government will implement a series of detailed measures, including settlement of debts, increases/liberalisation of tariffs and prices charged by these enterprises, staff rationalisation, and changes in the regulatory frameworks where necessary.

18. Concerning the ZCCM's liabilities, the Government has reached an agreement with all parties on the amount of ZCCM debt and cross-debt to be settled and has begun to implement an action plan to speedily clear these arrears.

19. For ZESCO, an agreement has been reached among Ministry of Finance and Economic Development (MOFED), ZESCO, CEC on the amount of debt and cross-debt to be settled, including an action plan to clear the arrears in an orderly manner. In order to improve the financial viability of ZESCO, we have increased electricity tariffs by 25% effective April 2000. In the future, we plan to adjust retail tariffs according to a revenue requirement agreed with IDA and the approved Automatic Tariff Adjustment Formula. An agreement has been reached between ZESCO and the Electricity Regulatory Board (ERB) on the specific modalities of the operation of this formula. In addition, we intend to implement the following measures:

- Take further measures to reduce ZESCO's operating costs. ZESCO's cost reduction measures have so far mainly focused on: (i) outsourcing of non-core activities, (ii) tighter control of telephone and transport and fuel expenditures, and (iii) effective freezing of new recruitment. New measures over the next twelve months will include: (a) restrictions on salary increase, (b) divestiture of residential properties, and (c) restructuring of the current short-term borrowings into medium-term loans;

- Improve billing and revenue collection;

- The Government is committed to a reduction of a majority of its shareholding in ZESCO. To that end, we will conduct studies to investigate options for privatisation and to review the legislative and regulatory framework to establish an enabling environment for private sector participation. We will, in consultation with IDA, adopt a suitable privatisation option for implementation.

20. For the petroleum sector, we confirm that Zambia National Oil Company (ZNOC) has no outstanding debt or cross-debt to be settled with the Government or with TAZAMA. Furthermore, to improve efficiency of the petroleum sector, the Government will offer for sale a majority controlling interest in the refinery, pipeline and terminal, as a package, to a strategic partner or group of partners. The winning partner, on taking possession of the controlling interest, will determine whether the pipeline will be operated in crude mode or in product mode. Meanwhile, any work on rebuilding the refinery and/or other facilities will be deferred until the new owner takes possession of the assets. To ensure operational efficiency, bidders will be required to agree to operate the assets on a basis that is compatible with market principles (e.g. refined products will be available, from the refinery or from the

pipeline as the case may be, on an open and equal basis to any bill-paying public or private entity). We will implement the following measures to restructure the petroleum sector:

- Issue bidding documents for the transfer of a majority controlling interest in the package to a strategic partner or group of partners that will be required to operate the assets in accordance with market principles;

- Establish a robust payment mechanism for TAZAMA, to ensure that it is remunerated in full and in a timely manner for its services. The mechanism could also include a procedure whereby TAZAMA would be remunerated with product which it could dispose of for its own account;

- Fully liberalize imports (so that all oil marketing companies could import petroleum products directly) and retail prices of petroleum products; and

- Limit the role of ZNOC to manage and control strategic reserves of petroleum products (leaving all commercial operations to oil marketing companies) equal to thirty days of average national use.

21. In order to implement the above measures a detailed program will be prepared, in consultation with IDA, by July 15, 2000 and communicated to IDA for its review. Thereafter, arrangements will be made for selection of consultants/contractors to: a) prepare asset evaluation and bidding documents for the sale of a majority controlling interest in the refinery, pipeline and Ndola product terminal, as a package, to a strategic partner or group of partners; b) propose specific steps on restructuring ZNOC so that its role will be limited to manage and control strategic reserves of petroleum products equal to thirty days of average national use; c) make necessary arrangements for liberalisation of petroleum imports and retail prices; and d) establish adequate mechanisms for payment of pipeline and terminal tariffs. Arrangements for liberalisation of petroleum imports and retail prices would involve announcement in the local press to inform the public, written communication to the oil companies with a requirement that they display the prices at the retail outlets, and written communication to the Energy Regulatory Board that it can only exercise ex-post review of prices.

22. For Zambia Railways (ZR), we have implemented the following measures:

- Approved (at the Cabinet level) the concessioning of Zambia Railways as recommended by ZPA. We have therefore taken an important decision to increase private sector participation in ZR through private concessioning of infrastructure and selling/leasing of locomotives and rolling stock in order to: (i) help overcome problems associated with public ownership and management, viz., inefficiency, over investment, waste, excess employment, financial losses, and (ii) provide the much needed capital that would enable to address problems of deferred maintenance and upgrading of the track.

- Agreed with IDA on the Zambia Railways staff rationalisation plan in order to aggressively reduce administrative cost by cutting staff from almost 5,900 to about 3,300 by retrenchment.

We plan to implement the following measures:

- Reforming the Regulatory Framework. The safety and environment-related regulation for the railways, currently exercised by ZR itself, is inadequate and unsatisfactory. There is a need to establish an autonomous regulatory body to enforce technical and economic regulations more effectively. This body would be expected to deal with, among other things, fair competition, and fair trade practices;

- ZR Restructuring/winding up. Since ZR Limited will no longer have a role once the freight and passenger services are concessioned, Zambia Railways Limited (ZRL) should be either restructured to operate as an asset holding company or wound up within a short period after the concession becomes operational.

23. The Government will continue to divest itself from publicly-owned financial institutions in accordance with the provisions of the Zambia Privatisation Act. Publicly -owned financial institutions will be divested in accordance with the provisions of the Privatisation Act, including the Zambia National Commercial Bank and Zambia State Insurance Company, and privatisation of the National Savings and Credit Bank.

Bank of Zambia (BOZ)

24. The Bank of Zambia (BOZ) has undertaken substantial quasi-fiscal activities in recent years. These activities have largely been in response to generalized financial distress in the domestic economy caused by poor performance in the fiscal and external sectors, which have created the need to support distressed financial institutions to cover losses and guaranteed public sector liabilities denominated in foreign currency and provide overdrafts to commercial banks.

25. The Government is planning to address the BOZ deficit in a comprehensive way. First, it recognizes that the root causes of this deficit lie in the real sector, i.e., the state owned enterprises and poor fiscal performance. To that end, a number of measures will be taken to address these two issues as discussed in this Letter. Second, additional policies will be implemented to reduce the risk of new contingent or actual liabilities developing on the books of the Bank of Zambia. The Government plans to limit BOZ exposure to potential future losses, especially overdrafts to weak banks and guarantees to state owned enterprises. Third, the operations of BOZ and MOFED will be enhanced to minimize the fiscal cost of Government debt finance.

26. The BOZ has submitted to the Cabinet's Legislation Committee, for approval, the amendments to the Banking and Financial Services Act (1994) to enhance the BOZ's power to sanction, take control of, and de-licence banks. The Government will make provision in all

future budgets to indemnify the Bank of Zambia for any probable loss on new guarantees that will be called upon. This will avoid any future losses by BOZ caused by support of distressed financial institutions, provision of overdrafts to commercial banks, and guaranteed public sector liabilities denominated in foreign currency. Furthermore, a plan has been submitted by BOZ and MOFED to alter cash management practices in relation to ministerial accounts held at commercial banks so as to minimize the arbitrage opportunity that presently exists.

27. In addition, to further reduce the cost of Government debt finance, the Government intends to take the following measures:

- Submit to Parliament proposed amendments to the Banking and Financial Services Act (1994) to enhance the BOZ's powers to sanction, take control of and de-licence banks.

- Make provision in all future budgets to indemnify the Bank of Zambia for any probable loss on new guarantees that will be called upon.

- Adopt a cash management method, agreed upon by BOZ and MOFED, to minimize the arbitrage opportunity presently created by ministries' accounts at commercial banks.

- Create, within MOFED, a unified and integrated database for recording and monitoring external and domestic debt, including timely debt service.

- Reduce the uncertainty premium in domestic interest rates. Specifically, the BOZ will reduce volatility in the overnight interest rate from current levels and to increase participation in treasury bill auctions by making an appropriate mix of modifications to the following operating parameters (i) liquidity management operations (to create a smoother daily path of excess reserves), (ii) accommodation policy (to reduce the extreme nature of the penalty for failure to meet liquidity requirements), and (iii) the reserve maintenance period (to reduce the sensitivity of banks to daily fluctuations in reserve money).

28. The exchange rate of the Kwacha will continue to be market determined, and the BOZ intends to maintain its policy of refraining from interventions in the foreign exchange market that go against the underlying market trend. BOZ will closely monitor conditions in the exchange market, including price and exchange rate developments in major trading partner countries.

Pension Reforms

29. The Government is well aware of the vital importance of a well-functioning pension system given its vital importance as a social safety net as well as a major contributor to the high quasi-fiscal deficit. A number of measures have been planned to be implemented rapidly, focusing on urgent, short-term measures to restore the financial solvency of the Public Service Pensions Fund (PSPF) and on vital longer-term measures to improve the newly

created National Pensions Scheme (NPS). The National Pension Scheme Authority (NAPSA) is the administrative agency responsible for implementing and operating the new NPS.

30. To stem further financial losses to the PSPF, Government has already allocated K26 billion in the 2000 budget to partially clear arrears to the Fund. In addition, it is considering to implement some of the principal recommendations of the 1999 Actuarial Report. The Government is fully aware that, while revisions to the benefit and contribution formulas could include: (a) reducing the benefit rate; (b) raising the length of service before retirement; (c) raising the retirement age; (d) raising the contribution rate; and/ or (e) reducing the commutation factor, changing the first three parameters would not effect those civil servants who have begun their careers prior to 1996 because their pension benefits are protected by Zambia's Constitution. Reforms in these areas would, therefore, require amendments to the pension provisions in the Constitution which would require two-thirds majority vote in Parliament and a popular referendum.

31. The Government therefore intends to phase down the PSPF over the long-term, while consolidating and improving NPS, which has become effective as of February 1, 2000, to make it fair and cost-effective and to allow portability (i.e. compatibility) with the private sector. In order to provide fully satisfactory results, however, the new pension scheme needs improvements. In the short term Government plans to take three measures:

- Adopt financially sound contribution and benefit parameters;
- Establish transparent governance structure and prudential investment guidelines consistent with Annex 1 of this letter; and
- Reduce administrative costs, principally through implementing a redundancy plan prepared for NPS based on recent optimal human resources evaluation.

32. The above measures build on specific actions already taken by the Government. In this regard, we have:

To complement these actions, the Government intends to:

- Agree with IDA on the number of NAPSA staff to be retrenched and the cost thereof, based on the established criteria;
- Issue NAPSA statutory instruments in the official Gazette to reflect parameters as contained in proposed regulations with respect to benefit formulas, minimum pension guarantee, required length of service, and accrual rate;
- Submit to IDA evidence on staff retrenchment, including an audit satisfactory to the Association and carried out by an independent agency acceptable to the Association, showing that NAPSA had implemented its Redundancy Plan;

- Publish in the official Gazette prudential investment guidelines for NAPSA; such guidelines involve a statement of principles, policies and objectives, rather than a specific statement of asset categories and so forth, to be reviewed and agreed by IDA; and

- Complete an actuarial evaluation of NPS to determine (i) the viability of a second-pillar component and (ii) the relative size of contributions that constitute individual accounts.

- Commence a study on insurance markets and annuities in Zambia and other selected countries.

33. In order to ensure transparency in the retrenchment process, NAPSA's Board of Trustees will approve the criteria and guidelines specified in the document entitled "National Pension Scheme Authority, Retrenchment Criteria" dated May 13, 2000. The Government will provide NAPSA with resources up to USD 5 million needed to finance the cost of retrenchment and will consult with IDA on the terms and conditions of the subsidiary loan agreement we shall enter into with NAPSA. This subsidiary loan agreement will be approved by the NAPSA's Board of Trustees. We will:

- Upon completion of the retrenchment exercise, carry out an audit to ensure that it is conducted in conformity with the agreed criteria and guidelines. A copy of the report will be furnished to IDA for its review.

34. These short-term measures will be further complemented by a number of medium to long-term actions that are critical for the success of the National Pension Scheme and that are presently being studied by Government:

- Training and human resource up-grade for core staff, strengthening the information and database system, and decentralizing the NPS in order to ensure provincial access to pension services;

- Strengthen the occupational pension schemes. The effort in respect of creating a unified, financially viable national pension system should be complemented, to the extent possible, by measures to strengthen the functioning of current occupational schemes that would complement the statutory schemes.

- Move the NPS towards a multi-pillar system and rely on three pillars[2] to produce an adequate income and provide about 60-70% replacement rates of pre-retirement salaries

[2] The first pillar will be a defined benefit plan based on a pay-as-you-go (PAYG) basis. The second pillar will be run on a defined contribution (DC) basis with decentralized fund management. Based on salaries in the range of 2 to 4 gross average wages, this pillar would provide a vehicle for long term savings mobilization in Zambia. Individual (pension) accounts will be privately managed and held in segregated trust accounts under appropriate

for a full career worker. This system would have several advantages over the currently proposed national pension plan: it supplements the existing system; integrates both poverty reduction goals and income replacement goals; and, allows for better risk diversification, labor market mobility, improved compliance and improved financial markets, all of which would enhance efficiency and broader macroeconomic goals such as increased national savings and investment.

V. FISCAL MANAGEMENT

35. The Government recognizes that without fundamental reforms of the budget management system, public expenditures will continue to have little impact on poverty reduction and economic growth. The current cash rationing system as implemented in Zambia has been fraught with problems: *ad hoc* budget decisions throughout the year that bear no relation to the original budget; inefficiencies in government operations as the Government has to pay for its purchases of materials and supplies at higher prices; and sub-optimal allocation of scarce budgetary resources. Furthermore, the breakdown of fiscal discipline has resulted in the budget losing its central role as an instrument in the allocation of resources according to the country's priorities. In the medium term, Zambia needs to move toward a more conventional budget system, based on a strategic policy and medium-term expenditure framework where line ministries are provided with greater responsibility for decisions related to resource allocation and use. In the short term, however, the Government plans to implement a series of major improvements to the present cash budget system. Specifically, it intends to improve predictability, accountability and transparency of public spending in the present budget implementation system.

36. To improve predictability for line ministries and other spending agencies, the cash release system will be modified by introducing the concept of a quarterly cash allocation plan:

- On the basis of projected revenues and other inflows into the government account at BOZ, the Government will prepare within the last 10 working days of the current quarter a cash allocation plan for the next quarter, to be issued in the Treasury Circulars. This cash allocation plan, which will amount to 80 percent of the Yellow Book allocation for the corresponding three months, will be subdivided into three monthly cash releases. MOFED will inform every spending agency of their projected cash allocation (broken down by Personal Emolument (PE), RDC, grants, and Capital Expenditures). This would allow spending agencies to start planning their activities for the entire quarter. Nonetheless, actual cash releases will continue to be made on a monthly basis. Preparation of the quarterly cash allocation plans and of the monthly cash releases will be done by the existing cash release committee in MOFED enlarged by a representative of MOFED's Macroeconomics and Policy Analysis Directorate.

---

custodianship. It is expected that this scheme will be regulated and supervised by an agency to be determined by the GRZ. The third-pillar would allow for voluntary risk sharing activities between employees and employers.

- A set of rules would be issued, as part of the quarterly cash allocation plan above, indicating how reductions in cash allocations are to be implemented if such reductions are deemed necessary. Among other things, this would aim at protecting the social sector ministries from *ad hoc* transfers of their budget allocations to other ministries from July 2000 (estimated date of Credit effectiveness) and at protecting the economic sector ministries[3] from *ad hoc* transfers of their domestically-financed budget allocations for project capital expenditures from January 1, 2001, forward. In addition, budget allocations to the social sector ministries will total at least 36 percent, and domestically-financed project capital expenditures of the economic sector ministries at least 12 percent, of the discretionary budget. Compliance with this measure would be monitored by specific targets for cash releases to the priority ministries, thereby strengthening and expanding the Bank's efforts to redirect public spending to social services, begun successfully with the 1994 ESAC.

- A mid-year budget review will be undertaken by MOFED following present procedures for the preparation and submission of supplementary estimates.

37. To improve <u>accountability</u>, the following measures will be implemented to strengthen commitment control and sanctions:

- MOFED will cut back quarterly cash allocations to over-committed ministries and to redistribute saved funds to ministries operating within their commitment ceilings. In addition, for over-committing ministries, MOFED will impose strict controls on expenditure commitments (e.g., by imposing a freeze on the signing of new project contracts by the delinquent ministry until expenditure commitments are reduced to allowable levels), and by strictly enforcing the existing rule by which total outstanding expenditure commitments are limited to 10 percent of the annual warrant.

- Controlling officers of line ministries will submit regular monthly reports on total outstanding commitments (both new and ongoing) and that these reports be accurate, comprehensive, and submitted on a timely basis (within 15 days after the end of each month). Non-compliance with this rule will result in MOFED withholding of monthly cash releases. As an additional security against spending overruns, any unused quarterly contingency will continue to be used to pay arrears in capital expenditures. Otherwise,

---

[3] Including the following budget heads: Ministry of Energy and Water Development (except for water and sanitation, which is protected in the social ministries),.Ministry of Mines and Minerals Development, Ministry of Environment and Natural Resources Development (except for water and sanitation, which is protected in the social ministries), Loans and Investments – Ministry of Local Government and Housing, Loans and Investments – Ministry of Finance and Economic Development, Ministry of Local Government and Housing, Ministry of Commerce, Trade and Industry, Ministry of Communications and Transport, Ministry of Works and Supply, Ministry of Tourism, Ministry of Lands, Ministry of Agriculture, Food and Fisheries.

they will be carried forward to the following quarter. At the end of the year, any unused contingency will be used to retire Government debt.

- The Commitment Monitoring Unit (CMU) will monitor over-commitments carefully and use the information on expenditure commitments in the quarterly cash planning exercises. The CMU will be required to prepare monthly reports summarizing the situation of commitments, cash outlays, and payment arrears and provide these to MOFED managers. For every quarter, these reports will be distributed more widely, including copies to ministries. For all ministries that exceed commitment limits or accumulate new expenditure arrears, the quarterly reports will attach the obligatory written explanations by controlling officers of ministries as to the reasons why these adverse developments have taken place.

- Controlling officers will be held personally accountable to enforce the new financial regulations, which will specify clearly the sanctions and penalties to these officers and delegated officials who fail to fulfill their responsibilities. To this end, the Finance Act is being revised to include appropriate sanctions and penalties for controlling officers who fail to fulfil their responsibilities. The revisions have been completed and are under consideration within MOFED. They will subsequently be sent to Cabinet for approval, and after Cabinet approval, a draft will be sent to the Ministry of Legal Affairs (MOLA) for legal drafting and subsequent presentation to Parliament.

38. To improve budget transparency and to facilitate monitoring, the Government intends to implement the following measures:

- Within a month after the end of each quarter, MOFED will publish a quarterly report on Government expenditures in the monthly *Macroeconomic Indicators* report, which would include a comparison between actual cash releases by spending agency (budget head) and major expenditure category (budget subhead) with the quarterly cash allocation plan and with original budget allocations along the format specified in Annex 4, Table 3 of the Minutes of Negotiations dated May 31, 2000. Among other things, these reports would show from which ministries funds have been taken away to finance new expenditure requests from other ministries not originally funded in the budget.

- Furthermore, government financial statistics should be strengthened as an instrument for fiscal analysis by providing expanded information on extra-budgetary funds, contingency claims, quasi-fiscal activities, and financing plans, including projected level and composition of central government debt. As a next step, information about the major state-owned enterprises, including their income statements, would be published in the annual *Economic Report* issued by MOFED. In addition, the Yellow Book would include two summary tables along the format specified in Annex 3 to the Minutes of Negotiations dated May 31, 2000. The first one ("Government Domestic Operations") will show aggregate revenues and expenditures by broad category[4] and the second ("Annual Government Expenditure Summary") will show expenditures by budget head and broad category, including preceding year actuals and present year allocations. Finally, the monthly *Macroeconomic Indicators* report will include tables showing the level and composition of external and domestic government debt.

- The office of the auditor-general (AG) will be equipped with adequate financial resources to carry out audits of government accounts within a year of the end of the year. The AG will be called upon to investigate and report to parliament on spending agencies that continue to make over-commitments.

39. In the longer term, the Government will replace the current cash budget by a conventional budget system. To that end, the Government will actively pursue preparation of a Medium-Term Expenditure Framework (MTEF) -based budget system and introduction of an Integrated Financial Management Information System(IFMIS). These efforts to be undertaken as part of the Public Sector Capacity Building Program (PSCAP).

The Public Sector Reform Programme (PSRP)

40. To stem the decline in the cost-effectiveness of the public service, and to make it more responsive to the country's needs, the Government adopted a public sector reform program (PSRP) in 1993 aimed at, inter alia, reducing nonmilitary public employment, decompressing public sector salaries, and improving performance management systems. Substantial progress has been made but the effort needs to continue. Through a combination of a voluntary separation programme and a limited hiring freeze the size of the nonmilitary public service was reduced from 137,000 in 1997 to 112,000 by end-1999. Within this significant downsizing, efforts have been made to maintain adequate service delivery by protecting front line service providers (e.g. nurses, teachers, police) from retrenchment. Reforms have also included measures to improve political and economic governance. The Government presented a comprehensive Governance program to donors at the May 1999 Consultative Group Meeting which was officially launched by the President of Zambia recently, affirming Zambia's commitment to the good governance program. This builds on past actions (e.g. the establishment of the Anti-Corruption Commission, training of justices, auditing and public tender reforms) and is closely tied to PSRP measures aimed at raising the morale and performance standards of civil service.

---

[4] On the revenue side, income tax, VAT, import tax, non tax revenue, and grants . On the expenditure side, wages, interest on domestic and external debt, RDC, grants, and capital expenditures.

VI. SOCIAL POLICIES AND POVERTY REDUCTION

41. The Government is deeply concerned about the widespread poverty in Zambia. It will pursue its fight against poverty within the framework of the National Poverty Reduction Action Plan (NPRAP) first prepared in November 1998 and refined at a consultative meeting held in January of this year. A final draft of the NPRAP is expected to be submitted to Cabinet for approval and adoption soon. It will contribute to Zambia's long term prospects for growth and enhance the quality of life for its citizens. Among others, it revamps the Public Welfare Assistance Scheme, both in terms of its eligibility criteria and operational guidelines and makes it more community based.

42. The NPRAP aims at reducing the overall incidence of poverty from 70 to 50 percent of the population by the year 2004. The strategies proposed recognize the fact that poverty can only be tackled successfully by sustained growth in per capita income. Hence, the importance given in the Plan to efficient management of the economy and sustainable economic growth with particular emphasis on agriculture and rural development. Urban development to be stimulated through increasing productivity of urban micro enterprises and informal sector. Human resource development will focus on the provision of more adequate and reliable educational and health services and improvements in the social safety net. To strengthen the delivery of social services Government intends to improve the policy and institutional framework and the effectiveness of the social safety net as well as to maintain public expenditures to specific social sector categories at least at 36 percent of domestic budget expenditures (excluding debt service) during 2000-2001 as was the case in 1998-1999.

43. The Poverty Reduction Plan will be further elucidated in an Interim Poverty Reduction Strategy Paper (PRSP) prepared by the Government in collaboration with the World Bank and the IMF. PRSP preparation will utilize Zambia's rich source of poverty and household data compiled through four national household surveys conducted in the 1990s. A Poverty and Public Expenditure Review has also been initiated with Bank collaboration and will serve as an underpinning to the full-PRSP by analyzing the level and nature of expenditures and public services that reach the poor.

VII. PROGRAM IMPLEMENTATION AND MONITORING

44. The program of measures proposed in the context of the Fiscal Sustainability Credit requires effective coordination among many agencies and ministries. For these reasons, management of the program has been entrusted to a Technical Committee of Permanent Secretaries to be chaired by the Secretary to the Treasury.

VIII. CONCLUDING REMARKS

45. The Fiscal Sustainability Credit will help meet Zambia's external financing needs for the year 2000 and 2001, support major reforms to reduce the overall public sector deficit and to improve fiscal management in Zambia. At an aggregate level, the Credit directly contributes to the maintenance of a stable macroeconomic framework conducive to economic growth by ensuring that fiscal progress achieved in the last few years will be long lasting. At a sector level, the Credit has specific and direct impacts on poverty alleviation. Reducing the overall public sector deficit will help ensure adequate funding to help the poor and other vulnerable groups, in addition to mobilizing domestic savings to finance higher investment and growth. Reforming budget management will ensure that Government's budget priorities on social development and poverty alleviation will be faithfully reflected in actual cash releases. The proposed Credit therefore will have direct, positive impact on our country's poverty reduction strategy.

Yours sincerely,

(SIGNED)

DR. KATELE KALUMBA, MP

MINISTER OF FINANCE AND ECONOMIC DEVELOPMENT

Annex 1

NAPSA PRUDENTIAL INVESTMENT GUIDELINES

The guidelines should contain first and foremost a set of guiding principles and objectives. Those should embody policy choices that balance the best interests of members and contributing employers on the one hand and with the development objectives of Zambia on the other hand. Members' and contributors' interests may be defined as obtaining an expected rate of return that is as high as possible consistent with volatility, and country risks that have been explicitly chosen by policy makers. This suggests guidelines that emphasize investment in a broadly diversified portfolio of investment-grade foreign securities. Development objectives, on the other hand, would emphasize investment in Zambia, optimally in a manner that would encourage the development of a local financial infrastructure of well-regulated but competitive actors seeking the most efficient allocation of capital. These various objectives may have different balances overtime as Zambia's capital markets develop and may be constrained by current account considerations. Prudence, however , requires that primary attention must be given to members' and contributors' interests within known risk/reward parameters chosen by policy-makers.

Some countries in their pension schemes maintain only "prudent man" principles with a specific emphasis on procedural and conflict-of-interest rules. Other countries buttress procedural and conflict rules with ones concerning asset categories and investment grading. The task for Zambia is to analyze different foreign experiences and have a clear debate about the competing objectives discussed above.