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Summary of Zambia Investment Climate Assessment

The Zambian Investment Climate Assessment (ICA) was conducted to support the Zambian economy as it diversifies away from dependence on volatile copper extraction and enhances the competitiveness of its private sector. Current under-productivity in Zambia is fed by low quality inputs rooted in and exacerbated by a difficult investment climate, as shown by Zambia's low Institutional Investor rating (Table 1).

The main investment climate constraints in Zambia are macroeconomic instability, regulatory policy uncertainty and administration, inefficient labor and infrastructure markets, and corruption. An improved investment climate based on a stable macroeconomic environment of lower interest rates and inflation and amendment of current practices would encourage investment, create jobs, and fight poverty.

This note summarizes the ICA undertaken in Zambia in 2003. It is based on a survey of over 200 service and manufacturing firms of differing locations and sizes. It aims to highlight the conditions inhibiting productive investment and discusses policy options for private sector support.

Per capita gross domestic product (GDP) in Zambia declined for more than three decades, falling from $700 in 1970 to $390 in 1998. This trend appears to have been reversed recently as a result of the new approach to economic management put in place in the late 1990s, when the government began to focus on fiscal discipline, better governance, and the promotion of economic growth. The economy responded favorably to the new policies, producing four consecutive years of solid growth, with real GDP rising 3.7 percent per year between 1999 and 2002. Since independence, Zambia has relied almost exclusively on exporting copper to generate foreign exchange, and efforts to diversify production and exports began only in the 1990s. Nontraditional exports have since expanded, but their share remains less than one-third of the total. Private sector development can support these reforms and strengthen the economy as it attempts sustainable growth.

Table 1. Institutional Investor Ranking, 2002

Regional Rank	Country	Global Rank	Credit Rating	One-Year Change
1	*Botswana*	*39*	*59.0*	*2.3*
3	*South Africa*	*52*	*52.7*	*3.2*
14	*Uganda*	*111*	*20.0*	*–1.4*
23	***Zambia***	***128***	***15.8***	***–0.2***
29	*Zimbabwe*	*142*	*11.9*	*–1.1*
	Average	***114***	***21.6***	***1.2***

Note: Credit rating has values within the range of 0 to 100, with 100 being the highest.

Source: Institutional Investors (2003)

Productivity Concerns for the Private Sector

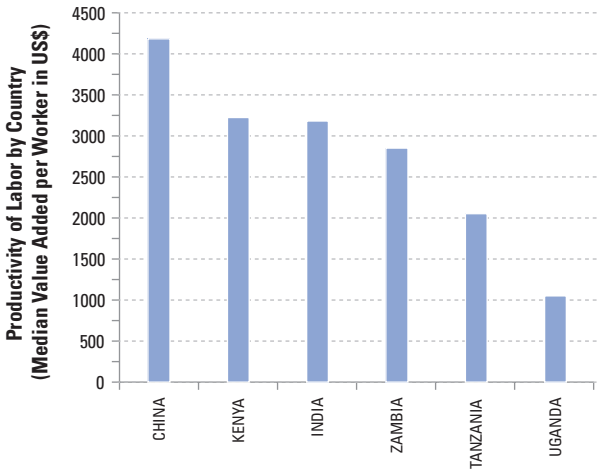
Empirical analysis of firm productivity underlines the importance of capital and labor inputs, which are of poor quality in Zambian firms. Two characteristics of firm productivity, in particular, constrain firms in Zambia:

Capital productivity is low, while capital intensity is high. Zambian firms use over $12,000 of capital per unit of labor, whereas their East African comparators average approximately $3,500. Likewise, value added per dollar of each unit of capital is only 23 cents in Zambia, compared with Uganda where returns are three times that amount. Diminishing returns are caused by low quality capital with an average age of 6-10 years.

Nominal wages are low, but the real cost of labor is high. Zambia's low wages offer no advantage to inves-

tors because they are offset by low productivity. The median value added per worker is low relative to comparator countries, as shown in Figure 1. The average ratio of labor to value added is 0.41 in Zambia compared with 0.32 in China. This poor performance is due in part to poor education and outdated labor laws, such as costly severance laws that impose huge burdens and suppress income, as well as inefficient hiring and firing practices. These distortions are exacerbated by cumbersome permit procedures and the HIV/AIDS epidemic, which forces firms to train multiple people for key positions, increasing recruitment costs and lowering productivity.

Figure 1. Median Value Added Per Worker (U.S. dollars)



Contraints to Investment Climate

Low productivity cannot be accounted for solely by the quality of inputs. It is also a product of a poor investment climate, which exacerbates poor quality inputs. To promote and sustain growth, governments must enable a competitive business environment. However, as the recent rating "D" by the Economist Intelligence Unit Country Risk assessment indicates, the Zambian private sector is perceived as difficult and the government's policies are perceived as constraining. The firm survey outlined in Table 2 emphasizes the major concerns of investors regarding firm operation and growth in Zambia. This report focuses on the top five constraints from the view of the firms surveyed and then identifies opportunities for improvement.

1. Unstable macroeconomic conditions and inaccessible capital depress incentives for investment, especially for smaller firms with no access to microfinance. The cost

Table 2. Respondents' Evaluation of General Constraints to Business Operations
(% of firms evaluating constraint as "major" or "very severe")

		Zambia	Small	Large	Non-Exporter	Exporter	Foreign-Owned	Domestic
1	*Cost of financing*	82.1	85.7	80.3	82.2	81.8	75.4	84.9
2	*Macroeconomic nstability*	73.9	81.8	65.2	79.0	60.0	70.5	75.3
3	*Tax rates*	57.5	59.7	56.1	59.2	52.7	54.1	58.9
4	*Regulatory uncertainty*	57.0	58.4	60.6	59.2	50.9	59.0	56.2
5	*Access to finance*	54.1	66.2	42.4	56.6	47.3	47.5	56.9
6	*Crime, theft, fraud and disorder*	48.8	49.4	53	50.66	43.64	47.54	49.3
7	*Corruption*	46.4	54.6	39.4	47.4	43.6	50.8	44.5
8	*Electricity*	39.6	32.5	50.0	34.2	54.6	41.0	39.0
9	*Anti-competitive behavior*	38.7	42.9	28.8	40.1	34.6	34.4	40.4
10	*Skills & education of workers*	35.8	36.4	37.9	36.8	32.7	31.2	37.7
11	*Telecommunications*	32.9	32.5	37.9	26.3	50.9	29.5	34.3
12	*Customs and trade regulation*	32.4	24.7	34.9	32.2	32.7	34.4	31.5
13	*Transportation*	30.4	28.6	30.3	27.6	38.2	29.5	30.8
14	*Tax administration*	27.5	32.5	27.3	27.0	29.1	34.4	24.7
15	*Access to land/security of tenure*	17.4	22.1	16.7	20.4	9.1	23.0	15.1
16	*Labor regulations*	16.9	11.7	21.2	15.1	21.8	16.4	17.1
17	*Business licensing & permits*	10.1	7.8	9.1	11.2	7.3	13.1	8.9

of capital in Zambia is too high. The average surveyed firm with a loan paid an annual interest rate of over 28 percent. The collateral required for a loan averages three times the loan size. This high cost of capital is driven by government bond market borrowing, which crowds out investment, and is spurred by high budget deficits of over 13 percent of GDP.

Fiscal imbalances increase inflation and interest rates, which in turn increase risk to investors. Nearly 74 percent of firms surveyed rated macroeconomic instability as a severe constraint, compared with half the firms in comparator countries. Bond market borrowing by the government depresses the exchange rate and makes already high inflation volatile, raising the risk premium on loans. This situation is exacerbated by huge deficits that restrict monetary control and cause the government to rely on the Bank of Zambia to service external debt.

2. Despite reform, taxation and tax administration continue to inhibit profitability, and inconsistent regulations encumber investment. The tax burden in Zambia is high relative to comparator countries. World Development Indicators show real tax burdens in Zambia, where the highest marginal tax rate is higher than the rate of its neighbors by five percentage points, as is the tax-to-GDP ratio.

The Foreign Investment Advisory Service highlights the onerous policies of tax administration by the Zambia Revenue Authority. Frequent and unpredictable changes in procedures and badly trained officials with wide discretionary powers invite corruption and arbitrary practices.

Regulatory policy is also cited as an important constraint. Only 28 percent of Ugandan firms cite regulatory policy as an important problem compared with 57 percent of firms in Zambia, where foreign direct investment (FDI) has declined over the last five years. Inconsistent policies—such as the recent change in immigration laws requiring all non-Zambians to renew unexpired permits at high costs—increase firms' perceived risk in investment.

3. Perceptions of weak law enforcement and fierce corruption hinder investment. Although 77 percent of Zambian firms claimed losses due to theft or other crime in the previous year, only half of these cases were reported and only a quarter of those were solved, which suggests that the low confidence in the police system is justified. Corruption ranks among the top five constraints for firms with FDI. Firms spend an average of 1.7 percent of their total revenue on bribes to facilitate operations, and a government contract requires an average bribe of 3.7 percent of the contractual value. The judicial system also suffers from poor training that leads to a substantial case backlog.

4. Firms are concerned about the poor quality and limited availability of infrastructure services. Unreliable electricity lowers productivity because of work stoppages, time needed to reset machines, ruined production, and damage to equipment. Electricity provision in Zambia is quite ineffective, with an average of 37.2 power outages in 2004 alone. Firms in China lose an average of 1.8 percent of productivity due to outages but firms in Zambia lose more than double that amount (4.5 percent).

5. Lack of labor flexibility reduces productivity and dissuades investment. The majority of Zambian labor laws have not been amended in 20 years. Severance pay in Zambia constrains firm productivity, because it is far higher there than in other countries in Africa. Zambia requires firms to pay termination benefits of 2–3 months base salary for every year of service, so a person employed for 20 years in Zambia would receive 20-30 months of salary. By contrast, the same person in Kenya or Tanzania would only receive 10-12 months of pay.

Policy Options

The various business impediments outlined above impose high financial and opportunity costs on firms in Zambia, depressing potential investment and productivity (see figure 2). Comparisons with other countries inside the region show that the constraints are more severe and widespread in Zambia than in most of its neighbors. To help create a better investment climate and support sustainable growth,

Figure 2. Inflows of Foreign Direct Investment

priority should be given to the following policies in five main areas of concern:

- Macroeconomics and finance:
  1. Manage better the budget process, stabilize the foreign exchange market, and decrease the fiscal deficit.
- Public-Private Interaction:
  2. Review current collection procedures and create new uniform procedures for the Zambia Revenue Authority.
  3. Improve public policy dialogue to increase understanding between the government and the companies driving private investments and to identify and accelerate measures to address impediments to reform.
- Infrastructure:
  4. Assess current practices of infrastructure services to identify areas for improvement.
  5. Privatize utilities within an appropriate regulatory framework to improve services and promote competition.
- Labor Market Issues:
  6. Amend the labor law to reduce the cost of redundancy.
  7. Require ministries to take responsibility for needed reforms within their areas; for example, the Ministry for Labor must investigate red tape and the Ministry for Health must increase prevention and treatment efforts for HIV/AIDS.
- Crime and Corruption:
  8. Improve judicial autonomy through budget allocation and greater political commitment.
  9. Establish small claims court to reduce backlog of cases.

The future of private sector–led growth does not lie in selected industry promotion by the Zambian government but rather in creating policies and institutions that encourage investors to productively and creatively employ their resources and people. Addressing the constraints identified in the survey will advance the government's capacity to strengthen the Zambian economy and support its strategy for poverty reduction.

This note is part of a series of summaries of analytical work of the Africa Private Sector Unit. This note is authored by Shireen El-Wahab based on a report entitled ***Zambia Investment Climate Assessment*** (June 2005). The report was written by a team led by Constantine Chikosi, and including Vijaya Ramachandran, Linda Cotton, Chad Leechor, and James Habyarimana. For more information, contact Melanie S. Mbuyi via email at mmbuyi@worldbank.org or via telephone on 202 473 9574. A copy of the report is also available from www.worldbank.org/afr/aftps