I. Introduction and Context

Country Context

1. Zambia’s recent economic performance has been encouraging with a decade of rapid economic expansion with growth rates averaging 6 percent per annum during the latter half of 2000s. GDP is estimated to have grown by 7.2 percent in 2012. Growth has been broad based, driven by strong performance in agriculture, manufacturing, and services even as mining output contracted in 2012 for a second year running - mining output is poised to rebound in 2013. The preliminary 2012 overall deficit is largely within the target at 4.8 percent of GDP; however, external financing was 0.7 percent of GDP which is higher than what was programmed for 2012. In 2011, tax revenues are estimated to have outperformed target, reaching about 19.3 percent of GDP against a programmed 18.4 percent with mining taxes, including payment of outstanding arrears, contributing a significant share to the increase.

2. Despite impressive economic growth, poverty levels have remained persistently high, particularly in the rural areas. Over the 1998-2006 periods, the poverty head count experienced only
a modest decline from 67 to 59 percent while rural poverty remained significantly higher, falling from 83 to only 77 percent (CSO). Broad based and higher growth rates are needed if Zambia is to reach its first Millennium Development Goal (MDG) which aims to reduce the proportion of Zambians living in extreme poverty by 50 percent. Zambia has immense, untapped mineral and agricultural resources. Less than half of Zambia’s 23 million hectares (ha) of potential arable land is used for agriculture and its substantial water resources are largely underutilized. The revised sixth national development plan (RSNDP) promises to depart from the past as emphasis is placed on enhancing inclusive growth and rural development.

3. The peaceful transfer of power following elections in September 2011 has strengthened Zambia’s democratic credentials. Zambia was a multi-party democracy for the first eight years of independence in 1964, but became a one-party state in 1973. The one-party government followed socialist principles of economic management, and many private firms were nationalized during its rule. In 1991, multi-party democratic governance was restored following the victory of reinstated opposition parties in the general elections. Since then, the country has conducted five elections that led to three changes in government, all of which were peaceful. The Patriotic Front (PF) government has identified growth that would reduce poverty and create jobs as its main priority. It recognizes that mining sector-led growth has failed to reach a large number of the poor and looks upon agriculture sector as an important source of pro-poor growth. Education development and health services are also priority areas for the PF government given their importance to poverty reduction and creating jobs.

4. The PF government has strongly signalled continued attention to macroeconomic stability, public service reforms, and business environment reforms as enablers of poverty-reducing and jobs-creating growth. This is also reflected in RSNDP that was revised to reflect the PF government’s policy direction. The IMF Article IV consultation in 2012 found that over the medium term, the aim was to sustainably raise growth and employment and reduce poverty, while maintaining macroeconomic stability. To achieve this, the IMF recommended reform efforts that included enhanced fiscal discipline and improved public financial management (PFM). The main downside risks were policy slippages that could arise from a failure to implement measures needed to meet their 2012 budget deficit target or substantially reduced world copper prices which have in fact fallen by around 10% since the date of the last IMF report. Large deficits in the government pension fund, energy pricing below cost recovery, and contingent liabilities also pose medium-term risks. Public financial management is an essential ingredient for efficient service delivery, strategic resource allocation, sound management of resources and fiscal discipline. It is also an imperative for curbing corruption in public service. The Public Financial Management Reform Program (PFMRP) will hopefully address some of the underlying technical weaknesses at national, sub-national and sectoral levels. PFMRP aims to improve fiscal management through improved Integrated Financial Management Information System (IFMIS) linking budgeting and accounting processes and by improving revenue and procurement management. It aims to improve PFM including control over contingent liabilities through reviewing the legislative framework and improving internal controls and governance through internal audit and Audit Committees.

**Sectoral and Institutional Context**

1. In the early 2000s Zambia embarked on a series of Public Financial Management (PFM) reforms supported by donors aimed at improving transparency, accountability and efficiency. The Public Expenditure Management and Financial Accountability (PEMFA) Program implemented a comprehensive PFM reform of about US$75 million. It has been under implementation from 2005
up to December, 2012. The initial phase of the PEMFA implemented between January 2005 and December 2010 had 13 components covering commitment control and financial management systems, IFMIS implementation, improved fiscal policy and economic planning, reformed budget preparation and budget execution, improved debt management, improved internal audit, better external finance and coordination, the legal and regulatory framework, strengthened external audit, enhanced parliamentary oversight, accountancy training and regulation, public procurement reform and a centralized Computer Services Department. PEMFA was extended for two years with a focus on IFMIS implementation, improved internal audit, revenue administration and public procurement reform. The PEMFA Programme has been a joint effort between the Government and a group of Cooperating Partners. This cooperation was guided by a Memorandum of Understanding (MOU), first signed in December 2004 and revised in July 2011. An independent evaluation of the Implementation of the PEMFA programme (July 2010) indicated that it was difficult to attribute the improvements in the PFM environment to PEMFA, as the program "had either failed to deliver what it set out to achieve or had delivered late." Lack of Government ownership, weak leadership, bad management design, and CPs' imposition of over ambitious plans in terms of both timescale and scope of reforms were all factors that contributed to this disappointing outcome. Lessons from PEMFA implementation and actions taken to address them are discussed in the later section of this document.

2. Government has in place the Sixth National Development Plan (SNDP) covering the period 2011 – 2015 and a revised draft SNDP for 2013-16. The macroeconomic focus of the revised SNDP is to improve the livelihood of the Zambian people through promoting growth in sectors that employ a lot of people, and stability in the prices of essential and other commodities. In order to raise and broaden economic growth and employment, the growth and investment strategy will be accompanied by continued implementation of reforms. The Government does recognize the need to continue with PFM reforms in order to achieve its medium and long term objectives of the SNDP. It is the view of the Government that the continued implementation of the PFM reforms should lead to the attainment of economic development, poverty reduction and improved public service delivery. The Government has since developed a three-year (2013–2015) PFM Reform Strategy (PFMRS) focusing on improving efficiency, effectiveness, accountability and transparency in the use of public resources. The strategy has ten reform areas which are (i) Integrated Planning and Budgeting; (ii) Debt Management; (iii) Government Investments; (iv) Domestic Revenues; (v) Fiscal Decentralization; (vi) Integrated Financial Management Systems and Cash Management; (vii) Public Procurement; (viii) Enhanced Internal Audit and Control; (ix) Monitoring & Evaluation; and (x) Restructuring of Ministry of Finance.

3. Public Expenditure and Financial Accountability (PEFA) evaluations have been undertaken in 2005, 2008 and 2012. The 2005 evaluation provided a baseline and the 2008 assessment generally highlighted improvements in transparency, comprehensiveness and accountability of fiscal management. It showed stronger commitment to clearance of arrears and enforcement of commitment controls. A revision to the Chart of Accounts allowed for more detail on public spending, allowing direct linkage of the Activity-Based Budget (ABB) and the accounting system. External audit of public financial management improved, with the Auditor General's Office decentralized to five provinces. For Parliamentary oversight, there was more access by the public to Committee deliberations through the construction of Committee Rooms. Between 2008 and 2012, the overall picture is mixed, with improvements in financial reporting, tax administration and internal audit, but significant slippages in budget credibility and accessibility to fiscal information. Following is a chart depicting aggregate comparison of PEFA scores for 2008 and 2012. A detailed
comparison of the ratings between the 2008 and 2012 assessments, and the reasons for any performance changes, is provided in Annex 6 of the program document.

4. The PEFA study in 2012 together with the IMF review of the Government’s PFM Reform Strategy and Article IV consultations found that there was room for improvement in all the areas contained in the PFMRS. On the PFM reform strategy, the IMF report cautioned that the breadth of the reform strategy should not exceed the absorptive capacity and resources of GRZ and that the strategy should focus on core ongoing reforms (macro fiscal forecasting, budget formulation, cash management, TSA, fiscal reporting and IFMIS) which create a platform for future more advanced PFM reform. It also stresses the need for the strategy to facilitate more active engagement of MoF senior management in planning, decision-making, progress monitoring and problem resolution.

5. Based on selectivity, absorptive capacity, resource availability and the need to focus on ongoing core reform areas, the PFMRP will support four main components (integrated planning and budgeting, IFMIS and cash management, public procurement and internal audit and internal control) of the PFM Strategy in the first phase of the proposed reform program. The remaining areas may be taken up in the next phase when more resources become available. Some other components are in the meantime covered through bilateral support. Following are some of the issues highlighted by the latest PEFA assessment and other reviews in the areas of intervention in the first phase.

Integrated planning and budgeting:
• Credibility of the budget is not strong as evidenced by the low ratings for PI-2 (variance of the composition of the budget), PI-4 (stock of expenditure arrears) and PI-16 (in-year predictability of resources for funding budget execution). Ministries, Provinces and Spending Agencies (MPSAs) are not confident that they will receive the financial resources provided for in their approved budgets and in general are transferred with considerable delay.
• The current budget preparation process and the way the budget classification system is configured do not assure the optimum strategic allocation of resources. The linkage between policy objectives and budgets is not as strong as it could be. Strengthening procedures for monitoring the macro forecasts and improved estimation of the recurrent cost of capital investment are needed.

Cash Management and IFMIS:
• Cash management has improved but the full Treasury Single Account (TSA) is yet to be adopted. The 2011 Financial Report for the Republic of Zambia shows an end of year cash balance of 5.02 trillion ZMK which is around 21% of the 2011 expenditures. At the same time the Closing Domestic Debt Stock was 13.83 trillion ZMK with interest payments on Treasury Bills and Government Bonds for 2011 of 1.02 trillion ZMK. Improved management of cash balances could be used to reduce borrowings and interest charges. The IMF report of April 2012 advocated more progress towards implementation of a Treasury Single Account and further consolidation through the use of electronic transfer of funds to reduce the float of government cash balances held in commercial bank accounts.
• Expenditure commitment controls [PI-20, dimension (i)] have strengthened through the introduction into IFMIS in 2013 of commitment management, which blocks any proposed commitment not supported by the approved budget and the quarterly allocation ceilings. This needs to be supported by audit trails of any interventions to over-ride the commitment controls. The IFMIS is not yet fully implemented. There are concerns over inadequate MoF engagement, unresolved functionality issues, insufficient operational support for MPSA users, and inadequate
training. The IMF report recommends establishment of a Financial Systems Unit (FSU) within a restructured Accountant General’s Department (AGD) and the creation of stronger oversight arrangements to guide and monitor implementation.

Public Procurement:
- Records of procurements are not collated systematically and the Zambia Public Procurement Authority (ZPPA) appears not to have firm assurance that competitive tendering procedures are always followed.
- Procurement Audits from various Ministries, as well as OAG reports, show lack of compliance of procurement rules and procedures.
- Inadequate institutional capacity of ZIPS to regulate the procurement profession and deliver training.

Internal audit and control:
- Deficiencies in internal control systems raise the possibility of wastage and leakage of funds. Non-compliance is reflected in the high number of ‘Disclaimer of Opinions’ issued by the Office of the Auditor General (OAG) in connection with its review of MPSA financial statements. Non-compliance implies the risk of leakage of funds, wasteful spending and perhaps also fraud.
- The annual reports of the Auditor General show that internal control systems are not being sufficiently complied with.
- The main issue with internal audit is that MPSAs are not sufficiently implementing the recommendations of the internal audit reports. There is a similar situation for external audit reports responses.

Revenue Administration
- The frequent amendments (sometimes even twice a year) to the Income Tax Act, the VAT Act and the Property Transfer Act and the accompanying frequent issues of Practice Notes and Statutory Instruments, though clear in themselves and necessary in some cases for the purposes of clarification, appear to detract from transparency in other cases (e.g. changing list of VAT exemptions and zero ratings every year).
- The frequent issuance of Practice Notes and Statutory Instruments for some tax types is likely to reduce the user-friendliness of the information, and accessibility is potentially affected by the relatively limited geographical reach of some activities, and the relatively limited access to the internet outside of Lusaka.
- The effectiveness of the functioning of Revenue Appeals Tribunal (RAT) is constrained by its not operating at full strength in terms of its members, and its location only in Lusaka, thus potentially limiting access to those based a significant distance away from Lusaka.

6. The World Bank assessed fiduciary risks in using country financial management (FM) systems in full or in part for implementing Bank-financed investment projects in Zambia and to identify risk mitigation measures required for such use. The study found that Zambia has made progress in strengthening its country public financial management systems in particular using PEMFA but significant challenges remain. Areas that needed focused attention were: strengthening internal audit, managing arrears, improving discipline in budget management, reinforcing tax administration, and strengthening payroll controls.

Relationship to CAS
1. The proposed operation is an integral part of the World Bank's partnership program with Zambia. The Country Partnership Strategy (CPS) is fully aligned with the government’s development objectives identified in the Sixth National Development Plan (SNPD) which was launched in February, 2011 and covers the period 2011-15. Improving governance and strengthening economic management is a foundation objective that runs across the CPS and it gives special emphasis two areas: strengthened systems and processes for public sector performance and increased access to information for citizens. The proposed operation will support policy reforms that seek to contribute towards strengthening controls in the management of public finances and reducing key fiduciary risks in the PFM system in line with the new World Bank Africa Region Strategy's foundation of building governance and public sector capacity through the public expenditure management systems.

2. These policy reforms for Zambia are laid down in the Government’s PFM Reform Strategy for 2013-15 approved by the Cabinet. The Finance Minister notes in his Foreword to the strategy document that the design of a good PFM should lead to attainment of economic development, poverty reduction and improved service delivery; that reforms of this nature have far reaching implications; and that Government is committed to the strategy and its key programs, and will give all the necessary political support and leadership to ensure that the overall objectives of the reforms are realized by 2015.

II. Proposed Development Objective(s)

Proposed Development Objective(s) (From PCN)

The project development objective (PDO) is to improve fiscal discipline and public accountability of the Recipient’s finances. Achievement of this objective will be assessed through impact on public financial management processes in relevant PEFA performance indicators.

Key Results (From PCN)

Key results expected are: (i) improved fiscal discipline; (ii) increased transparency in public finances; (iii) increased effectiveness in revenue administration; (iv) strengthened procurement; and (v) enhanced internal controls and internal audit. This will be achieved through better implementation of the rules and regulations and fuller utilization of IFMIS functionalities. The achievement of the program development objectives will be measured at the next PEFA 2015 using the following key high level outcome indicators. The yearly outcomes per component are outlined in the results framework annex 1. The results framework will be monitored on a quarterly and annual basis to keep track of strategic objectives of each component.

- Improved fiscal discipline through changes in PEFA indicator PI-2 (budget credibility)
- Increased transparency using PEFA indicator PI-24 (quality and timeliness of in year budget reports)
- Strengthened procurement controls through PEFA indicators PI-19 (competition, value for money and controls in procurement)
- Enhanced internal controls and internal audit through PEFA indicator PI-20 (effectiveness of internal controls)
- Increased effectiveness in revenue administration through PEFA PI-15 (effectiveness in collection of taxes).

III. Preliminary Description
Concept Description
Government PFM Strategy

1. The Government of Zambia has developed a Public Financial Management Reform Strategy for 2013-15 which has been approved by the Cabinet. The strategy builds on the lessons learned so far including the successes and challenges encountered by the government in earlier reforms. The strategy has ten reform areas which have been identified by the PFM Reform Technical Committee chaired by the Ministry of Finance (MOF). This Committee has been set up to oversee and guide the development of the PFM reform strategy. The Strategy covers the following reform areas:
   i. Integrated Planning and Budgeting
   ii. Debt Management
   iii. Government Investments
   iv. Domestic Revenues
   v. Fiscal Decentralization
   vi. Integrated Financial Management Systems and Cash Management
   vii. Public Procurement
   viii. Enhanced Internal Audit and Control
   ix. Monitoring & Evaluation
   x. Restructuring of Ministry of Finance

PFMRP Program Selection and Implementation

2. The PFM Strategy describes the implementation period as 2013 to 15. Considering the pace of the previous reforms and delays in decision making at various levels, the implementation period for this program is expected to be from late 2013 to end 2017.
   The components for this program have been selected based on the following criteria:
   • Prioritization to get the PFM basics right (commitment controls, fiscal reporting, effective public procurement)
   • Need for selectivity
   • Bi-lateral donor support- some components are already being supported through bi-lateral financing arrangements; this program will provide supplementary support as required
   • Unfinished agenda and natural continuation of ongoing reforms Immediate funding needs and handholding support requirements
   • Available donor funds
   • Component readiness and implementation capacity.

3. Based on the above principles, this program will take up the following components in its first phase of implementation. A separate component is provided to support program management and coordination. As the PFM system is an interlinked system with independent agencies such as the Auditor General and the Legislature playing important roles, an additional component is included to respond to any necessary just in time needs. The following are the components in the first phase of implementation.
   i. Integrated Planning and Budgeting to ensure that budgeting and expenditure management through IFMIS are linked.
   ii. Integrated Financial Management Systems and Cash Management as part of continuing the ongoing roll out to remaining sites and refinement of functionalities.
   iii. Public Procurement to support the new role of ZPPA and to strengthen the procurement capacity in MPSAs.
iv. Enhance Internal Audit and Control to strengthen the system controls and improve the
effectiveness of audit committees.
v. Revenue administration to improve its effectiveness and establish mining sector monitoring
mechanism.
vi. Tax policy to improve policy analysis and enhance access to information to aid tax policy
formulation.
vii. Program Management to support implementation and monitoring of the overall reform
program.
viii. Other PFM Functions to respond to just in time needs likely to come up during the life of
the program.

4. Policies with regard to fiscal decentralization and MoF restructuring components are not yet
clear and the activities and cost details can be firmed up when the way forward is clear. There is
also ongoing support to fiscal decentralization initiatives from GIZ. Re-organization of Debt
Management Department could be carried out as part of re-organization of MOF. All legal review
relating PFM, including development of legal framework for management of States Owned
Enterprises (SOEs) could be carried out through a coherent exercise as part of budgeting and
planning component. On government investments component, the legal framework is more logically
aligned to overall review of legal arrangements for various dimensions of PFM under component 1-
budgeting and planning.

5. There will be two main parts to the proposed pooled funding arrangement – one is the
recipient (GRZ) executed portion approximating about US$30 million for the components
mentioned above and the other is the World Bank executed component estimated at US$2.17
million.

IV. Safeguard Policies that might apply

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V. Financing (in USD Million)

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