

ZAMBIA:

Debt Strategies to Meet the Millennium Development Goals



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ZAMBIA: DEBT STRATEGIES TO MEET THE MILLENNIUM DEVELOPMENT GOALS



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Preface

Zambia's debt has been brought down to financially sustainable levels as a result of the Highly Indebted Poor Countries (HIPC) and Multilateral Debt Relief Initiatives. The country's growth and stability records are largely favourable and have been projected by the International Financial Institutions to remain fairly stable over the medium term. However, Zambia continues to face many challenges that will make its progress towards the MDGs more difficult. Economic growth in Zambia has been hampered by many domestic and external factors that have limited its size and quality, and ultimately it has not been 'pro-poor'.

Moreover, while no longer in a 'debt trap' because of extensive debt relief, Zambia may yet find herself in an 'MDG trap' because of insufficient access to predictable financing for the MDGs. Domestic resource mobilization and external grants have been limited and the Poverty Reduction Growth Facility conditionalities have continued to restrict both external and domestic borrowing. However, Zambia's return to creditworthiness – the objective of the HIPC initiative – means that Zambia will need to assess carefully how much it borrows in future and for what purpose. At the same time, more progress needs to be made on increasing Official Development Assistance (ODA) and improving its quality.

To meet these challenges and to ensure that Zambia continues to make progress towards the MDGs, a number of recommendations on debt and development financing have been proposed in the Report.

1. Closer liaison between the national authorities and the international community towards establishing consistency between macroeconomic and debt stability; and sectoral demands for MDGs spending. In its design, the macroeconomic framework should have more information about the sectoral spending requirements for meeting the MDGs as these are more reliable estimates of developmental requirements than macro estimates.
2. The need for international efforts to develop an MDG-consistent debt sustainability framework and provision of time-consistent predictable amounts of ODA.
3. More commitment from the local authorities to allocate resources in consonance with priority MDGs/Fifth National Development Plan areas.
4. Rationalization of domestic resource mobilization, including exploring more meaningful revenue generation options in mining.
5. The need for policy leadership on domestic and external debt management, systems development, capacity strengthening and fostering enabling environments.

The United Nations Development Programme believes that a combination of the foregoing steps will help move Zambia significantly towards meeting the MDGs. I hope that this Report will help to broaden an understanding of the debt sustainability issues and MDGS in Zambia and that the readers will find it useful.



Aeneas C Chuma
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List of Acronyms

ABB	Activity Based Budgeting
AfDB	African Development Bank
AGOA	African Growth and Opportunity Act
AIDS	Acquired Immune Deficiency Syndrome
ART	Antiretroviral therapy
ARVs	Antiretroviral (drugs)
BCC	Behaviour change from communication
BOP	Balance of payment
BOZ	Bank of Zambia
CFR	Case Fatality Rate
CET	Common external tariff
COMESA	Common Market for Eastern and Southern Africa
CPIA	Country Policy and Institutional Assessment
CSEA	Centre for Study of African Economies
CSO	Central Statistical Office
CSPR	Civil Society for Poverty Reduction
DFID	Department for International Development
DMS	Debt Management Strategy
DSA	Debt sustainability analysis
DSF	Debt Sustainability Framework
DTIS	Diagnostic Trade Integration Study
EPA	Economic Partnership Agreement
ESA	Eastern and Southern Africa
EU	European Union
FDI	Foreign direct investment
FNDP	Fifth National Development Plan
FRA	Food Reserve Agency
FTA	Free Trade Area
GDP	Gross domestic product
GPI	Gender parity index
GRZ	Government of the Republic of Zambia
GSP	Generalized System of Preference
HDI	Human development index
HIPC	Highly Indebted Poor Countries
HIV	Human Immunodeficiency Virus
HMIS	Health Management Information Systems
IDA	International Development Association
IEC	Information, education and communication
IF	Integrated Framework
IFIs	International Financial Institutions
IMF	International Monetary Fund
IRAI	IDA Resource Allocation Index
IRS	Indoor residual spraying
ITN	Insecticide treated nets

IVM	Integrated Vector Management
JCTR	Jesuit Centre for Theological Reflection
LDCs	Least developed countries
LICs	Low income countries
LCMS	Living Conditions and Monitoring Survey
MAC	Ministry of Agriculture and Cooperatives
MAMP	Multi-country AIDS Program
MCTI	Minister of Commerce, Trade and Industry
MDRI	Multilateral Debt Relief Initiative
MGDS	Millennium Development Goals
MOE	Ministry of Education
MOH	Ministry of Health
MONFP	Ministry of Finance and National Planning
MTEF	Medium Term Expenditure Framework
NAC	National HIV/AIDS/STD/TB Council
NDP	National Development Plan
NEPAD	New Partnership for Africa's Development
NPV	Net present value
NTEs	Non-traditional exports
ODA	Official Development Assistance
P.AY.E	Pay-as-you-earn (tax)
PEPFAR	(US) President's Emergency Plan for AIDS Relief
PPPs	Public-Private Partnerships
PRGF	Poverty Reduction and Growth Facility
PRPs	Poverty Reducing Programs
PRSP	Poverty Reduction Strategy Paper
PS	Priority Survey
PSD	Private Sector Development
SADC	Southern African Development Community
SAPs	Structural Adjustment Programs
SOEs	State-owned enterprises
SSA	Sub-Saharan African
SWAps	Sector-wide approaches
TBs	Treasury bills
TNDP	Transitional National Development Plan
TOTs	Terms of trade
UNDP	United Nations Development Programme
VAT	Value-added tax
ZASF	Zambia HIV and AIDS Strategic Framework
ZAMTEL	Zambia Telecommunications
ZBF	Zambia Business Forum
ZDHS	Zambia Demographic and Health Survey
ZESCO	Zambia Electricity Supply Company
ZRA	Zambia Revenue Authority

1 Introduction

Text Box 1.1: Millennium Development Goals

GOAL 1

Eradicate poverty and hunger

GOAL 2

Achieve universal primary education

GOAL 3

Promote gender equality and empower women

GOAL 4

Reduce child mortality

GOAL 5

Improve maternal health

GOAL 6

Combat HIV/AIDS, Malaria and other diseases

GOAL 7

Ensure Environmental sustainability

GOAL 8

Develop a global partnership for development

(See also, Annex 1, with MDG Targets)

In September 2000, the Millennium Summit declared poverty as one of the main human development challenges of the 21st Century which required the spirited response of all the peoples of the World. This declaration conferred clear obligations on all the countries that ratified the Millennium Development Goals (MDGs) to address and eventually overcome their key human development challenges. During the Millennium Summit, a promise was made – and reaffirmed on successive occasions – that no country would go without the additional resources required to achieve the MDGs.

Goal number 8 of the MDGs includes the target to “deal comprehensively with the debt problems of developing countries through national and international measures in order to make debt sustainable in the long term.” This target on

debt – alongside the targets on more and better aid and fairer international trade – is intended to support domestic and external investment for achieving the MDGs.

To aid such resource mobilization, far reaching international efforts to tackle external debt problems in least developed countries were implemented in terms of the Highly Indebted Poor Countries (HIPC) initiative, in its initial and enhanced versions, and more recently the Multilateral Debt Relief Initiative (MDRI). Zambia has already benefited substantially from debt relief under the enhanced HIPC initiative and is poised to continue getting debt relief under the MDRI though gains under the MDRI are likely to be smaller¹.

¹ Partly this is because finance for relief on monies owed to the World Bank is subtracted from Zambia's

Despite many landmark efforts, there is a growing debate about the sufficiency of the various debt strategies to foster the achievement of the MDGs. For instance, though the cancellation of significant proportions of Zambia's external debt has allowed the country to divert additional resources to priority Poverty Reducing Programs (PRPs)², the resources needed to achieve the MDGs are likely to far exceed those freed up under the combined debt relief initiatives. And while the Zambian government will most likely continue to make efforts to increase its domestic resource mobilization, fiscal scope for reallocating expenditures within the budget may be considerably constrained³. Hence, in the short- to medium-term Zambia will need to supplement the limited domestic resources with those provided by donors. A key issue will therefore be on what terms Zambia receives these external resources – whether as grants or loans (concessional or market rate) that may build up to be an unsustainable future liability. If the preference is for grant financing to invest in the MDGs, what should Zambia do in the event that grant financing is insufficient or unpredictable? If additional loans are entered into, what would constitute a 'sustainable' level of debt in respect of the human development imperative and how could appropriate contraction of loans and the use of loan funds be guaranteed?

A second area of concern is Zambia's traditionally high level of domestic debt. Although the servicing cost of domestic debt has started to decline recently due to lower interest rates, the volume of government securities issued is still rising⁴. Zambia remains vulnerable to interest rates rises which would significantly increase the cost of servicing its internal debt, notwithstanding the growth and poverty reduction benefits that can be realised from the targeted use of government borrowing. This could further squeeze out priority investment areas as identified in Zambia's Fifth National Development Plan (FNDP) 2006-2010.

This study explores the above issues with the following question in mind: In respect of both external and domestic debt, how can the concept of debt sustainability place development and poverty reduction aims at its center, in addition to financial viability? Overall, the study therefore seeks to understand the level and quality of financing and particularly, indebtedness that Zambia would be able to sustain and use productively without compromising its ability to finance the MDGs and without building up an

initial IDA-14 allocation. It is estimated that additional net resources from the International Development Association (IDA) will amount to US\$6m during the period of IDA-14; while debt service savings to the International Monetary Fund (IMF) will amount to US\$86m over 2005-07.

2 Most of these additional expenditures have been in the areas of infrastructure, support for small-scale farmers and food security, and increased expenditures in the social sectors – especially education (MOFNP, 2004a).

3 Weeks and McKinley (2006) have provided various insights into the nature and extent of fiscal space restrictions post HIPC debt relief.

4 Internal debt servicing costs represented over 11% of total government expenditure in 2004 (MOFNP, 2004b).

excessive risk of future debt distress. Specifically, the study seeks to achieve the following:

- Explore the issues of external and internal indebtedness against the context of the efforts of Zambia and the international community to achieve the MDGs;
- Suggest macroeconomic or other policy measures that would support the contribution of debt relief to pro-poor growth and achievement of the MDGs; and;
- Contribute these insights and recommendations to UNDP's global project that is aiming for a renewed overall understanding of MDG consistent debt sustainability.

The rest of the paper is structured as follows: the rest of Section 1 considers the various dimensions of poverty and human development in Zambia as well as some of the strategies for addressing the challenges; Section 2 looks at the cost estimates of required financing of the FNDP poverty goals and for achieving the MDGs; in Section 3, Zambia's macroeconomic situation is explained, in retrospect and prospect; in Section 4, Zambia's public debt record and future outlook are considered in terms of both external and domestic debt; Section 5 discusses the prospects for future development financing and debt sustainability in Zambia; and Section 6 concludes and offers some recommendations.

1.1 Poverty and Human Development in Zambia

Having committed to the MDGs in 2000, Zambia has pursued various strategies and plans for addressing poverty and other salient developmental issues since 2002. From the implementation of a Poverty Reduction Strategy Paper (PRSP) during 2002 to 2004, which was extended into a Transitional National Development Plan (TNDP) in 2005, the country is moving ahead to implement the FNDP, which was finalized in December 2006. It is envisaged that the FNDP will be implemented from 2007 as the mechanism for continuing to guide the country towards spurring economic and sustained human development. Many are optimistic that the FNDP will assist the country to effectively address and ultimately triumph over its Millennium human development challenges.

To date however, Zambia's progress towards achieving the MDGs has been relatively slow. In its progress report for 2005⁵, the UNDP categorized Zambia's prospects for achieving the MDGs as 'likely' for four goals, 'potential' for three, and 'unlikely' for two. Although this represents a considerable improvement from the prospects reflected in the 2003 status report – wherein three of the goals were seen as 'likely' to be achieved, two had 'potential', and two were 'unlikely' – it nevertheless implies that there is a possibility of not achieving half of the MDGs (see Annex 2 for detailed categorization

5 UNDP (2005)

of the MDGs in 2003 and 2005).

1 Arguably, the most challenging MDG would be the poverty reduction goal (goal number 1) because it would require robust and pro-poor growth well above historical rates. In spite of implementing the PRSP and TNDP, which contributed to the positive economic growth trends⁶, the country is yet to register notable declines in income poverty. The Living Conditions and Monitoring Survey (LCMS) IV of 2004 (CSO, 2005) shows that about 68 percent of the population fell below the national overall poverty line of K111,747 per month (approximately US\$25), implying that this proportion of the population were unable to meet the cost of acquiring the minimum level of consumption on food, shelter, health, education and so on. This further meant failure and incapacity of a significant proportion (68%) of the population to attain US\$0.83 (less than a dollar) a day. On the other hand, extreme poverty⁷, which was set at an income expenditure of K78,233 (or US\$18) per month or US\$0.58 a day, covered about 53 percent of the population. The depth of poverty (defined as the average gap between the expenditure of the poor and from the poverty line) and severity of poverty (the square of the poverty gap of each poor individual from the poverty line, reflecting core-poverty) were also high in 2004; at the national level these stood at 36 and 23 percent, respectively in the year in reference.

1.2 Income Poverty Trends Since 1990

Since the time that far reaching economic reforms were ushered in during 1991/92, Zambia's overall income poverty situation has remained virtually the same with only marginal improvements (see Fig 1.1 below). While the depth of poverty (P1) and severity of poverty (P2) have declined steadily over time, extreme poverty – mimicking the overall poverty trend – has only marginally declined below the 58 percent level of 1991 to 52 percent in 2004. This means that over 13 years, extreme poverty has only declined by six percent.

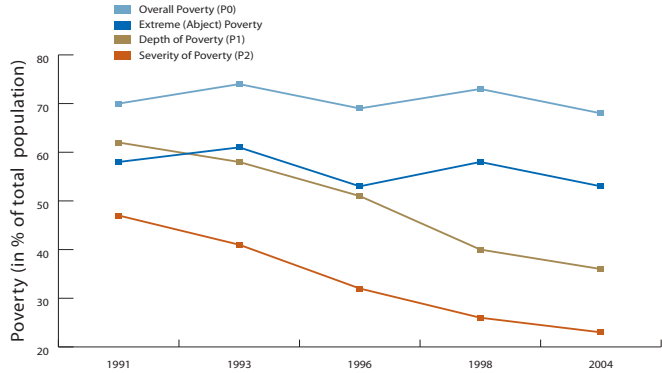
In relation to goal number 1 (halving extreme poverty by 2015) two UNDP progress reports (2003 and 2005) make very different observations. In 2003, it was determined that the goal was 'unlikely' to be achieved, but later (in 2005) the goal was reflected as 'likely' to be achieved. The debate on the likelihood of achieving goal number 1 of the MDGs is still on-going. Overall however, with such high historic poverty levels, it is not surprising that Zambia is ranked number 165 out of 177 countries according to the UNDP human development index (HDI) and that some observers remain fairly sceptical about the country's resource capacity to adequately redress its poverty challenge.

6 Zambia has experienced a positive growth trend since 1999, but the PRSP was only implemented in 2002; thus, though no direct, quantifiable contribution is being attributed to the PRSP here, it is reasonable to presume that the PRSP had at least some positive growth benefits.

7 Measured by taking a lower poverty line that reflects the minimum requirements of food spending only (excluding the other items included in the overall poverty line)

Figure 1.1
Poverty Dynamics
(1994 - 2004)

Source: CSO (1997) and CSO (2005)^{8,9}



Observers have argued that one reason why poverty has not significantly reduced in spite of the improved economic performance since 1999 is the weak growth-poverty relationship associated with the recent growth. The positive growth outturns have been concentrated in the mining, wholesale and retail trade and construction sectors which are all mainly capital intensive urban-based economic activities. This type of growth fails to generate sufficient employment due to weak linkages with the rest of the economy. Since the growth path does not include utilization of the main economic asset of the poor – their labour – it does not foster enough poverty alleviation, particularly in the rural areas where about 70 percent of the poor reside.

The FNDP (MOFNP, 2006b) estimates that if the country continues with this growth path, overall (head count) poverty will only marginally decline to 62.3 percent by 2010 (from 68 percent) in 2004. This will clearly be insufficient for making progress towards halving the 1990 poverty of 70 percent¹⁰ level by 2015. Similarly, as evidenced later on, Zambia's projected growth path will not result in the reduction of the extreme poverty level of 58 percent in 1990 to 29 percent by 2015. Income poverty therefore remains a significant concern for Zambia.

8 Op. cit

9 Data from the LCMS III (of 2002/03) were not included due to incomparability with the other datasets reflected in Fig 1.1 (i.e., PS I & II and LCMS I, II & IV). This arose from significant differences in sampling and data collection methods and definitions used in LCMS III compared with the approaches in the other datasets.

10 The 1991 figure given in the Priority Survey I is the closest estimate

1.3 Additional Dimension of Poverty and Inequalities

In terms of other (non-income) social dimensions of human development of importance to household welfare, limited progress has been made in redressing some of the social dimensions of poverty; but much more can be done still. The country has seen improvements in some education and health indicators (see Table 1.1 and 1.2):

Table 1.1 Selected Education Indicators, 2001-2004

Indicator:	2001-2002	2004	% Change
Gross enrolment ratio (%)	92.3	105.3	14
Repetition rates, avg. grades 1-7 (% of total pupils)	5.2	7.0	35
Drop out rates, avg. grades 1-7 (% of all pupils)	4.4	2.9	-34

Source: CSO (2003b) & MOE (2004)

A significant concern in education is with the increase in the repetition rate because this has negative implications on prospects for achieving the third MDG Goal of ensuring that by 2015, children everywhere, boys and girls alike, will complete a full course of primary schooling. The obvious fact is that completion of primary school by everyone requires not only ensuring high enrolment into the primary schooling system, but also reducing repetition and drop out rates (these later aspects ensure efficient progression through the system). Another concern is that the gender parity index (GPI) – which measures sex-related differences in school attendance rates as the gross attendance ratio for females divided by the gross attendance ratio for males – is still fairly low at 0.87. There will be slower progress in achieving universal primary education for girl children.

The role of civil society and donors in fostering positive social outcomes is clearly demonstrated in the education sector, where significant time, effort and money have been invested to sensitize stakeholders and lobby more resources. Indeed, the recent positive outturn of indicators in the sector attests to this (see Annex 3: Table A3).

In health, a mixed picture is painted by the indicators selected in Table 1.2. Given the improvements in infant and child mortality indicators, it is not surprising that the 2005 MDGs progress report observes that there is potential for meeting goal number 5.

Table 1.2 Selected Health Indicators, 1996-2002

Indicator:	1996	2001-2002	% Change
Infant Mortality Rate (per 1,000 live-births)	98	81	-17
Child Mortality Rate (per 1,000 live-births)	109	95	-13
Maternal Mortality Rate (per 1,000 women-years of exposure)	1.34	1.44	7
Maternal Mortality Ratio (per 100,000 live-births)	649	729	12

Source: CSO (2003a)

On the other hand, deteriorations are observed in both indicators on maternal mortality. This is also consistent with the views of the MDGs progress report, where the likelihood of reducing maternal mortality by three-quarters by 2015 is reflected as ‘unlikely’.

Moreover, the burden of disease is very high, with the Central Statistical Office (CSO) reporting that about 13 percent of persons in Zambia reported an illness in the two weeks period prior to the LCMS III survey. This implies a total of approximately 1.4 million persons reporting an illness nationwide in the two weeks period of the survey. The disease burden is dominated by malaria (36.9 percent) and respiratory infections non-pneumonia (21.1 percent), which jointly makes up about 58 percent of all cases of illness seen at public health facilities in Zambia. The two diseases are also the leading causes of death.

Another significant socio-economic and health stress factor is the country’s continued vulnerability to HIV/AIDS, with the country currently experiencing the health, economic and social impacts of a mature epidemic. In this regard, since the mid 1980s, Zambia’s growth and poverty problems have been severely compounded by one of the world’s most devastating HIV/AIDS epidemics. The national HIV prevalence rate is estimated at about 15.6 percent. The statistics below^{11,12} emphasize the significance and some of the inequalities of the HIV/AIDS burden in Zambia:

- Out of a population of about 10.9 million, 1.1 million people (over 10% of the total population) were living with HIV in 2005;
- Adult HIV/AIDS prevalence remains twice as high in urban areas as in rural areas;
- Women are 40% more likely to be infected than men;
- About 7.7% of young people aged 15-24 years were HIV positive in 2003;
- Almost 40% of infants born to HIV positive parents are infected;
- More than 89,000 people died of AIDS in 2003;

11 op. cit CSO 2003a

12 MOH and CBOH (2006)

- With the impact of HIV/AIDS mortality, life expectancy at birth in 2004 was about 14% lower than it would have been without AIDS deaths¹³;
- Out of about 1.1 million orphans under 18 years of age, over 630,000 children (57% of the total) are AIDS orphans;
- About 200,000 of the 1.1 million HIV positive people required ARVs in 2004;
- As of end-2005, only 51,764 persons (or 26%) of those in immediate need of antiretroviral therapy (ART) were on ARVs.

Zambia's national response to HIV/AIDS was formalized through the creation of the National HIV/AIDS/STD/TB Council (NAC) in March 2000; although the NAC did not become operational until December 2002 when Parliament passed a national AIDS bill that made the NAC a legally-established body able to apply for funding. At the passing of this bill, the NAC became the single, high-level institution responsible for coordinating the actions of all segments of government and society in the fight against HIV/AIDS.

In October 2000, the NAC published a National Strategic Intervention Plan (2002-2005) and in May 2006, finalized a successor Zambia HIV and AIDS Strategic Framework (ZASF) 2006-2010. These documents: provided a comprehensive overview of the HIV epidemic in Zambia and outlined guiding principles for the national response in terms of prevention programs, universal access to treatment, socio-economic impact management and mitigation, and policy and institutional responses. A landmark decision was made in August 2005 in the area of HIV/AIDS treatment when the government took the policy decision to provide ARVs and a wide range of related ART services free of charge to Zambian citizens. To a limited extent, this decision was perhaps possible to take because of the sizable debt relief that the country benefited from. To a larger extent, however, it was the establishment of HIV/AIDS specific funds such as the Global Fund, the United States' President's Emergency Plan for AIDS Relief (PEPFAR) and the World Bank Multi-country AIDS Program (MAP) and the resulting partnerships between these funds and the Zambian government that encouraged the government to take the bold decision on free ART.

As would be expected, the funding resources required for an effective response to the HIV/AIDS epidemic are substantial and somewhat overwhelming. The ZASF 2006-2010 broadly estimates the resources required to mount an effective response as US\$1.22 billion (approximately K4.88 trillion) during 2006-2010. Clearly, for a poor, resource-constrained country like Zambia, prospects for achieving goal number 6 of the MDGs are (and will continue to be) heavily dependant on external donor financing to sustain the current and future HIV/AIDS effort. The ZASF notes that although the resources

13 Other source estimate there is a 38-66% difference between current life expectancy (with AIDS deaths) and the life expectancy that would have been observed without AIDS.

required to implement the HIV/AIDS intervention seem daunting, it is clear that there are many partners prepared to provide significant support to Zambia to ensure success in meeting the goals and objectives of the strategic framework. It is perhaps partly from this point of view that the 2005 MDGs progress report determined that halting by 2015 and beginning to reverse the spread of HIV/AIDS is 'likely' to be achieved. The view of the MDGs report is also probably partly due to observations of the natural trajectory of the disease in Zambia, though not enough empirical attention has been paid to this aspect to provide insights that would enable this paper to make a stronger assertion about the natural trajectory of HIV/AIDS.

Reducing the incidence of malaria is also understood as an important health target of the MDGs, like HIV/AIDS and others. Malaria remains a major public health problem in Zambia, accounting for almost half (46-47 percent) of the country's total disease burden (defined here as total visitations to public health facilities; see Table 1.3 below)¹⁴. The Health Management Information Systems (HMIS) shows that in 2005/2006 an annual average of about 3.5 million cases of malaria, both confirmed and unconfirmed, were notified (MOH, 2006).

Table 1.3 Malaria among the Ten Major Causes of Visitation to Public Health Facilities, 2004-2005

Disease Name	Incidences per 1,000 population					
	2004	2005	2004	2005	2004	2005
	Under 5 years old		5 years and over		Total	
Malaria	1130.7	1108	203.2	197	1333.9	1305
Respiratory Infections non-Pneumonia	436.2	469	84.9	87	521.1	556
Diarrhoea: non-bloody	257.6	258	30.7	31	288.3	289
Trauma	66.4	57	41.6	43	108	100
Respiratory Infections Pneumonia	137.4	132	21.3	21	158.7	153
Skin Infections	111.6	111	25.1	26	136.7	137
Eye Infections	144.2	145	14.6	14	158.8	159
ENT Infections	55.1	57	15.3	16	70.4	73
Digestive system (not Infections)	22.4	23	17.9	18	40.3	41

¹⁴ Visitations account for only a small proportion of the total incidence of disease in general. However, the proportions of specific diseases within the overall morbidity profile are consistent between data in the HMIS and survey data such as from the Zambia Demographic and Health Survey (ZDHS) or the LCMS. Thus, we do not augment the HMIS data present above with any data from the surveys.

Muscular Skeletal	4.2	5	20.8	21	25	26
Total visitations (all diseases)	2365.8	2365	475.4	474	2841.2	2839
Malaria (% of total morbidity)	48%	47%	43%	42%	47%	46%

Source: MOH (2006)

1

Despite malaria accounting for significantly the largest proportion of morbidity, there have been some successes in combating the disease. During the 2005/2006 malaria transmission season there were marginal improvements in malaria-based mortality and morbidity, as evidenced in the reported reduction in mortality and morbidity indicators public health facilities (MOH, 2006). For instance, the national incidence of malaria dropped by 2 percent from 383 cases per 1,000 population in 2004 to 373 cases per 1,000 population in 2005.

Partly, the marginal gains in addressing malaria are the result of the scaling up of case management and preventive interventions. Recent interventions in Zambia include prevention through indoor residual spraying (IRS), insecticide treated nets (ITNs), and to a lesser extent prophylactic drug prescriptions as well as treatment through the use of drugs and case management for those infected. The overall malaria program also supports an Integrated Vector Management (IVM) component, information, education and communication (IEC), behaviour change from communication (BCC), monitoring, surveillance and operations research and so on.

Among the many challenges to the malaria program, some are general problems facing the health sector. For instance, human resource shortages due to attrition (health worker deaths and departures for better prospects abroad and in the private sector) have adverse effects on malaria control. Furthermore, limited capacities at all levels for procurement, supply logistics management of malaria commodities and late disbursement of funds negatively affect speedy implementation of anti-malaria programs.

On the other hand, as specific challenges to the malaria program, the high costs of malaria commodities are a barrier to expanding services to the home management of fever. This is particularly problematic in view of the high level of poverty in the country, resulting in low community participation in malaria programs.

As with HIV/AIDS, many global partners such as the World Bank (Malaria Booster Program), the United Nations (through the Global Fund) and more recently, the US Government (through PEPFAR) recognize malaria as a significant health stress. Through various models and mechanisms, the global partners have therefore pledged sizable support to malaria efforts in Zambia. While these pledges and extra resources have been generally welcome, some observers worry that at the same time that they address the problems associated with specific diseases, they distort the health system. This is partly through drawing attention, human resources and financial resources away

from other priority health problems and focusing them on these specific conditions and associated problems. The recommendation has therefore been for global and national partners to support an integrated health response under an integrated health system. There is still a lot of work ahead before consensus can be found and steps taken in developing integrated and effective responses.

1.4 Other Socio-Economic Aspects of Human Development

The situation in water and sanitation and in environmental sustainability is less encouraging than the indicative situations in health and education.

The situation in environmental sustainability is disconcerting with environmental degradation having now reached alarming proportions. The country's forests are under tremendous pressure to provide an expanding population with wood fuel and timber for construction. Land clearance for agriculture and human settlement are encroaching on natural habitats and adversely affecting the country's rich wild life and bio-diversity. In the last decade, environmental degradation (particularly through deforestation and wildlife and fish depletion) has become particularly severe and threatens sustainable economic growth and the survival of the poorest in the population. It is therefore no surprise that the MDGs progress report established that the environmental sustainability goal (target #9 of goal number 7) is 'unlikely' to be met by Zambia.

In water and sanitation, we look at the water sub-sector only as this is simply for illustrative purposes. Although some progress is being made in the provisioning of safe drinking water, a high proportion of the Zambian population, estimated at 47 percent, has no access to safe water. Significant inequalities are seen between the rural and urban areas (see Table 1.3). The majority of the rural population access their water from lakes/ rivers and unprotected wells.

Table 1.3 Percentage Population with Access to Safe Water Supply

Access to Safe Water	1993	1995	2000	2002	2003
Urban Areas (% of population)	76	66	69	89	87
Rural Areas (% of population)	43	37	48	37	37
Total (% of population)	59	53	58	63	53

Source: CSO 2003a

Most observers would probably agree that compared to most other sub-Saharan African (SSA) countries, Zambia is rather well endowed with water resources, accounting for two-fifths of ground water resources in Southern Africa. The Zambian population can draw on these resources for consumptive purposes (particularly in agriculture). Zambia

has a diversity of freshwater sources. There is a relatively good amount of rain in a normal rainy season and the country is also endowed with an extensive ground water system, including five major rivers, and several large lakes and many more small ones. Nevertheless, several deaths each year are caused by unsafe water, poor sanitation and hygiene. For instance, Sinkala et al (2005) report that cholera has remained endemic in Zambia for some time. They show that Zambia experienced widespread cholera epidemics in 1991 (13,154 cases), 1992 (11,659) and 1993 (11,327). Although the Government and its cooperating partners initiated a number of effective anti-cholera programs and strategies from 1998, reducing cholera experiences to the extent that no outbreaks were reported during 2000-2002, epidemic cholera returned to the country at the end of 2003. By early 2004, an estimated 2,529 cholera cases and 128 cholera deaths occurred in Lusaka alone (the case-fatality rate [CFR] implied by the estimations was 5.1%). Sinkala et al (2005) demonstrate cholera as a food-borne transmission and also show the protective role for hand washing with soap. They underscore the importance of hygiene, clean water and sanitary food handling for cholera prevention. Despite the availability of this information and Zambia's vast water resources, the country has simply been unable to exploit these aspects to foster better hygiene, water and sanitation outcomes, although the potential exists to do so and achieve the related MDG.

Finally, much in agreement with the MDGs progress report of 2005, in the current circumstances Zambia might or might not achieve half of the human development goals outlined in the MDGs; there is some potential, but achievement of the goals cannot be described as likely. Looking ahead, understanding the costs of Zambia's human development challenges and the resource requirement to address these challenges is therefore essential for informing the formulation of all future strategies and plans.

1.5 Strategies to Reduce Poverty: the Past and the Present

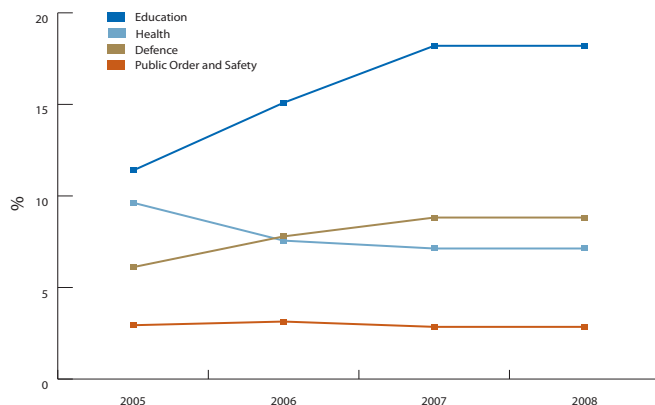
As earlier noted, since Zambia ratified the MDGs as its international human development mission until 2015, it has formulated and implemented three main national poverty strategies. A PRSP was implemented from 2002 to 2004, which overlapped with the TNDP in 2005. In 2006, the country finalized the FNDP, which it launched for implementation in 2007. The achievements, pitfalls, opportunities and risks of the three strategies are briefly considered below.

According to the second PRSP Implementation Progress Report (MOFNP, 2004a), the implementation period of the PRSP saw improvements in funding outlays to priority Poverty Reducing Programs (PRPs) from K140 billion (US\$35 million) during January 2002 to June 2003 to K430 million (US\$107.5 billion) in the period from July 2003 to June 2004. Major strides were reportedly made in public finance management, particularly budgetary disbursement performance, mainly due to the introduction in 2004 of a Medium Term Expenditure Framework (MTEF) and Activity Based Budgeting (ABB).

Despite these positive outturns and the continued economic growth, a number of sectors continued to experience PRSP implementation problems as a result of stretching limited resources across too many projects and sectors. And even though funding to PRPs improved during the implementation period, late disbursements of funds were nonetheless experienced especially in 2003; this adversely affected the execution of some anti-poverty programs. Without appropriate prioritization and political will to allocate resources according to priorities, there is the danger that this situation might continue as Zambia implements the FNDP. For instance, looking at the MTEF for 2006-2008 (published in November 2005), it was clear that while some social sectors such as education had been considerably favoured with increased budgetary allocation others such as health were significantly disadvantaged (see, Figure 1.2).

Figure 1.2
MTEF Percentage
Allocation to Selected
Sectors

Source: Constructed using MTEF
(2006-2008) data

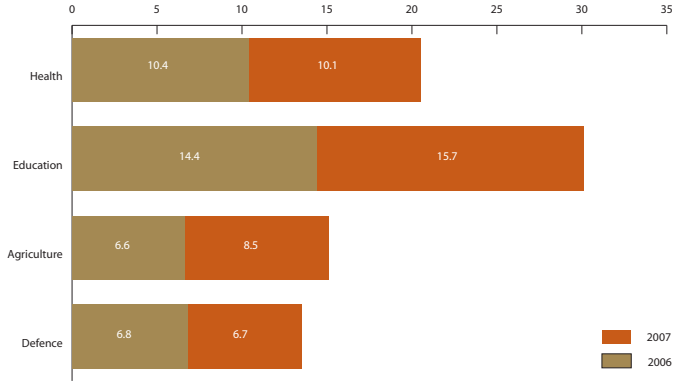


The MTEF data showed anti-health allocation biases with shifts of allocations to defence – a lesser priority – to the extent of overtaking the health allocations. This was obviously worrisome given the huge problems in the health sectors, including critical human resource shortages and occasional drug stock-outs. Thus, through extensive lobbying by Zambian civil society (through CSPP) and concerns expressed by donors over increased defence sector allocations, as well as a more open and competitive discussion of budget priorities in the Cabinet (DFID, 2006), social sector allocations in 2006 and 2007 actually increased and defence allocation decreased from the indicative figures published in the MTEF for 2006 (see also Figure 1.3).

1

Figure 1.3
Budget Allocation to Selected Sectors

Source: constructed from GZR (2007)



The PRSP came to an end in December 2004 and was succeeded by the TNDP (2002-2005). Even though the TNDP was prepared and published in October 2002 and only came into full effect as the national development document in 2005, it reportedly encompassed all the areas in the PRSP and included other aspects such as the Judiciary, law, order, defence and security. Hence there was no implementation conflict when compared with the preceding poverty strategic paper. Indeed, many commentators describe the TNDP as simply an extension of the PRSP. It was originally envisaged that the successor to the TNDP (i.e., the FNDP) would be prepared within the course of 2005, but the process was delayed and the FNDP was finalized a year later in 2006.

It was noted earlier that the improved growth performance of the country since 1999 has had a weak link with poverty, which, it has been said, may ultimately result in insufficient progress towards meeting goal number 1 of the MDGs. Based on this and other observations, the FNDP attempts to focus “on pro-poor growth oriented sectors that will create employment opportunities for the poor” and “emphasizes the creation of strong linkages between the capital intensive sectors and the rest of the economy”. The latter emphasis stems from the recognition that the mining, construction, energy and trade sectors are expected to continue contributing strongly to overall economic growth.

2 Costing of Poverty Goals in the FNDP and Costs of MDGs

This section looks at the resource requirements and the funding prospects for meeting Zambia's various poverty related goals and specifically, the MDGs. We therefore begin by looking at the financing estimates in the FNDP and then turn to consider the financing estimates for the human development challenges in the context of the MDGs.

2.1 Financing Estimates on Key Poverty Goals in the FNDP

Zambia's national spending intentions for addressing its economic and human develop-

Text Box 2.1: FNDP Expenditure Priorities: Overview

Towards strengthening and broadening the growth process and fostering human development, the FNDP identifies two broad areas where public spending shall focus: (a) strengthening the relevant economic and social infrastructure, especially roads, bridges, dams, etc; and (ii) enhancing agriculture and rural development. It envisages that these will be complemented by the implementation of specific structural reforms across various sectors in order to improve the business and investment climate.

To foster human development, the public spending priorities shall focus on enhancing the quality of education provision and skills development; better health service delivery; addressing the problem of frontline personnel in the two critical sectors of education and health, including the lack of requisite working implements; and expanding the proportion of the Zambian population with access to safe drinking water, especially in the rural areas. The Plan also seeks to significantly improve the working and operating conditions in the public order and safety sector, in particular, those related to housing for law enforcement officers. Attention will also be given to the sustainable management of natural resources and the environment.

In many respects, these priorities also match the Millennium Development Goals.

Source: MOFNP (2006a)

ment challenges are elaborated in the FNDP. These intentions have been formulated in line with a broad-based, pro-poor growth focus. In that regard, the expenditure focus of the FNDP is expected to be on infrastructure (particularly roads development), agricultural development, education, health, water and sanitation and public order and safety (see Text Box 2.1).

The Zambian authorities anticipate that the priority areas of the FNDP will largely be financed through three sources, namely, domestic revenues; external grants; and, to a limited extent, borrowing (both internally and externally).

Domestic revenues: These are financial resources that the Government mobilizes locally and include tax and non-tax revenues. Taxes are collected by the Zambia Revenue Authority (ZRA), while most non-tax revenues are collected

at both the central and local government level.

External Grants: This refers to development assistance (aid) that shall be provided to Zambia by Cooperating Partners/donors through direct budget support; sector-wide approaches (SWAps); project support; and debt relief. In the past, external assistance came through project support. However, in line with Zambia's Aid Policy and Strategy, the country has formally moved to direct budget support. The rationale for direct budget support is that this will enhance efficiency and reduce transaction costs for donors and the government alike.

The government's official view on direct budget support in that this will also strengthen local ownership of the development programs and allow for easier integration of external support into the country's own development programs as expressed in the FNDP. For funding partners that are not yet ready to channel their support directly to the budget, the government hopes that SWAp will be utilized as the second preferred mode of external support. The government assumes that more external resources will be forthcoming to support the FNDP following international commitments made by the G8 Nations at the Gleneagles Summit in 2005¹⁵ as well as similar commitments by both bilateral and multilateral donors.

The extent of "national ownership" of the budget under direct budget support and other funding modalities is still at the heart of considerable debate. In part, this is because of the conditionalities that are often tied to poverty reduction budget support, which have the potential to limit fiscal space, even as low income countries are granted debt relief and higher amounts of general budget support or ODA (see, Weeks and McKinley, 2006).

Borrowing: This refers to resources generated through domestic and external loans. The FNDP asserts that in the case of external loans, the medium to long-term focus is to avoid a return to the high indebtedness of the past. Hence, any new borrowings over the period 2006-2010 will be procured in a manner that does not affect the debt sustainability ratios negatively with the country also continuing to rely on highly concessional loans. It is estimated that during the FNDP period, new borrowing in the region of US\$50-60 million annually will be allowed and will mostly be from the World Bank and African Development Bank.

Additionally, the authorities hope to encourage Public-Private Partnerships (PPP) for infrastructure programs. Other likely sources of financing highlighted in the FNDP are regional and international financing initiatives such as the NEPAD Investment Climate Facility and the proposed Africa Enterprise Challenge Fund. Internationally, it is planned that such initiatives as the Infrastructure Consortium under the G8 and the Millennium Challenge Corporation will also be considered, particularly for large

15 At the Gleneagles G8 Summit in 2005, the G8 countries pledged that Official Development Assistance (ODA) will be \$50 billion higher by 2010 than is currently the case, with half of the increase being earmarked for Africa.

investments, which cannot be easily accommodated within the resource envelope. All these financing sources are expected to support the core costs of the FNDP. In terms of the coverage of the core FNDP costs (Table 2.1), these essentially follow the expenditure focus of the FNDP as elaborated in Text Box 2.1.

About 90 percent of the core FNDP costs are focused on infrastructure, agriculture, education, health, water and sanitation, and public order and safety. The core FNDP cost estimates exclude very large capital programs, which are reportedly to be financed through private capital flows, including major projects in the energy sector such as the development of the Kafue Gorge Lower power station at an estimated cost of US\$600 million and the Kariba North Bank at a cost of US\$300 million. Other projects include rail infrastructure projects in the transportation sector. All these are expected to be financed through private public partnerships or wholly private capital.

It is estimated that core FNDP expenditures will, in absolute terms, increase from a baseline scenario of K59.6 trillion (or US\$14.5 billion) to K62.6 trillion (or US\$15.2 billion) in the FNDP. Further, the FNDP report shows that the requirement to implement the FNDP programs will result in an expansion in total public expenditure to an annual average of 25.0 percent of GDP from 23.8 percent of GDP in the baseline.

In terms of financing and the resource gap, additional resources – over and above the baseline projections – that are needed to undertake the projected public expenditure during the FNDP period amounts to about 1.2 percent of GDP or K2.98 trillion (or US\$0.73 billion). Without giving any specific qualitative or quantitative detail, the final FNDP report highlights that a significant part of this resource gap will have to be met from external grants and loans.

2.2 Sectoral Financing Estimates: Other Observers

Given the consideration of the financing requirements entailed in the Zambia national poverty reduction plan, the FNDP, a natural extension of the discussion is to compare these requirements with the financing requirements implied by the country's commitment to the international agenda on human development. We therefore look at various sectoral MDG financing estimates as encapsulated by various observers.

Beginning with extreme poverty, it must be noted that the cost of halving the 1990 level by 2015 is defined and gauged in terms of the amount of GDP growth required to deliver the required outcome. Mphuka (2005) shows that halving poverty in accordance with the MDGs target (i.e., bring extreme poverty down from the 58.1 percent level in 1991 to 29.1 percent by 2015) would require a sustained GDP growth rate of 9 percent per year. As Mphuka rightly observes this sort of growth would be unprecedented in Zambia. Although the Zambian authorities do not envisage achieving this growth rate, they are nevertheless optimistic about the country's growth prospects, expecting that GDP growth will average 7 percent per annum during 2006-2011. More detailed consideration of the financing requirements for reducing the 1991 level of poverty by

half is made in Section 2.4 below.

On the sectoral financing requirement of the other MDGs, the costs have been variously estimated as presented in Table 2.1. The costs were obtained largely from Mphuka (2005), with additional cost estimates on HIV/AIDS from NAC (2006) and MOFNP (2006b), as explained in Table 2.1.

The costs in Table 2.1 imply that the overall average investment required in capital and operating expenditure to meet the MDGs is US\$1.5 billion per year (over 2005-2015) or US\$110 per capita per year. Assuming, as Mphuka does, that the MDGs would be largely domestically financed through government contributions of 10 percent of GDP and household contributions of 2 percent of GDP, the total domestic contribution would potentially be 12 percent of GDP. This implies a financing gap of about 13 percent of GDP (or a total of US\$803 million annually i.e., avg. of US\$56.7 per year per capita).

Table 2.1 Range Estimates of MDG Costing

Goal/Target:	Total period cost (\$' million)	Avg. annual cost (\$' million)	Per capita annual cost (\$)
Hunger	1,656.8	150.6	11
Universal Primary Education	1,759.7	160	12
Gender Equality & Women Empowerment	291.7	26.5	2
Health (inc. child; exc. Malaria, HIV/AIDS & maternal)*	2,512.9	228.4	16.6
Child Mortality (minimum costs)**	127.7	11.6	n.a
Maternal Mortality	167.4	15.2	1.3
HIV/AIDS	1,092.6	99.4	7.4
HIV costs in ZASF (2006-10)***	2,684.0	244	18.5
HIV costs in FNDP(2006-10)***	45.8	9.2	7.8
Malaria & other Major Diseases (adjusted to include malaria only)	630.7	57.3	4.8
Environmental Sustainability	Not available	Not available	Not available
Water and Sanitation	1,612.5	146.6	7.5

Notes:

*The MDGs do not present any specific goal or target with the label "health"; thus the health costs are presented indicatively for insight, not as core MDG cost per se

** Mphuka (2005) does not present child mortality costs separately as they represent bear minimum costs of immunization. Here they are drawn out separately simply to illustrate the minimum indicative costs of child mortality as a goal falling squarely into the category of MDGs per se

*** These data represent alternative cost estimates as worked out by the NAC (2006) and MOFNP (2006b), respectively. The figures have been re-worked to fit the cost definitions in the table.

Source: Constructed using inputs for Mphuka (2005), NAC (2006) and MOFNP (2006b), with modifications

A summary comparison of the core FNDP costs and costs of the MDGs as presented in Mphuka (2005) is provided in Table 2.2 below.

Table 2.2 FNDP vs. MDG Costs

	Total costs (US\$ million)*	Total costs, adjusted (US\$ million)	annual avg costs (US\$ million)	per capita costs (US\$)**	% of FNDP GDP
Cost estimates in Mphuka (2005)	15,993.1	7,601.0	1,520.2	131.1	2.5%
FNDP (2006-2010) core costs***	9,490.0	9,490.0	1,898.0	163.6	3.1%
Gap/Excess		1,889.0	377.8	32.6	0.6%
Notes:					
*Total costs in Mphuka (2005) are over 11years (2005-2015) while total FNDP costs are over 5 years (2006-2010); hence annual avg costs in Mphuka were projected over five years					
**Assuming 11.6 million people per year on average during 2006-2010					
***Converted from original Kwacha terms to US\$ using FNDP assumed exchange rate (of K4,070 per US\$)					

Source: Author's construction using data from FNDP and Mphuka (2005) with modifications

As a very crude comparison, the main thing to note in Table 2.2 is that the MDG cost estimates as captured by Mphuka (2005) are less than the FNDP cores cost estimates, implying that financing the FNDP core costs would result in a surplus (or excess) of resources over and above the resource requirements for meeting the MDGs. Based on these two separate estimates, the implied resource surplus would be approximately 0.6 percent of FNDP projects of GDP.

However, considerable caution must be exercised in comparing the alternative cost estimates in Table 2.2. This cannot be overemphasized because the estimates have very limited statistical comparability. A number of points validate this assertion: firstly, in Mphuka (2005), the cost estimates do not account for key MDGs cost items such as Goals 7 and 8 on ensuring environmental sustainability and developing a global partnership for development, respectively (see Table 2.1, which misses these). In addition, the costs of other MDGs are underestimated, as demonstrated by the higher alternative costs on HIV/AIDS in Table 2.1 (a detailed assessment is offered in the latter part of Section 2.3 below). It is also noteworthy that costs of technical cooperation for capacity building and other purposes, emergency assistance or other ODA that does not

directly finance the capital or operational costs of MDG interventions are not included in Mphuka's (2005).

Secondly, in relation to the FDNP, various aspects point to cost underestimations. To begin with, the core FDNP cost estimates do not include the costs of the earlier-mentioned large capital program in the energy, transport and communications sub-sectors; these are envisaged to be financed through private-public partnerships. This costing approach most likely causes the FNDP estimates to underestimate the true costs. To some extent consistent with Mphuka, the FNDP costing essentially excludes the general administration, running expenses and personnel related expenditures of all implementing sectors except health and education. Perhaps more importantly, the coverage of core FNDP costs is by definition much broader than the cost coverage of the MDGs, particularly as captured by Mphuka. The FNDP costs cover macroeconomic and financial management, central administration, mining, manufacturing, public order and safety, defence, etc. These elements jointly account for a sizable amount (10.3 percent) of core FNDP costs. Including these costs has the bias of overstating the costs compared to the costs of the MDGs.

The foregoing simply highlights the difficulties in getting consistent and comparable cost estimates. To further demonstrate that the financial requirements (or cost) estimates considered above are underestimates of the true MDG costs, Section 2.3 below offers a detailed assessment of the various estimates, also paying attention (where data allow) to the underlying assumptions in each estimation procedure.

2.3 Assessment of the Various Estimates

Our assessment of the key issues seen in the financing requirement estimates and their assumptions looks at both the FNDP and MDG cost estimates that this study was able to find. The ensuing discussion is simply meant to draw out a few illustrations that emphasize the magnitude of problems related to financing the development and poverty reduction programs. The assessment focuses on highlighting and commenting on some of the variations in the requirement estimates derived by the observers.

Assessment of FNDP Cost Estimates

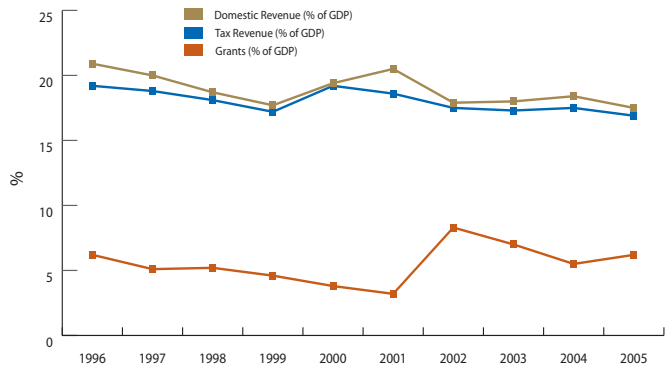
To begin with, although the FNDP is somewhat modest about the country's prospects for increasing domestic revenues, the proposed strategies for generating revenue, particularly tax revenue raise questions about feasibility and equity. For instance, looking into the recent history of domestic revenue performance (Figure 2.1) shows that between 1996 and 2005, annual domestic revenue was 18.9 percent of GDP on average. Over the last four years this average outturn has taken a slightly downward trend, averaging 17.3 percent of GDP per year during 2002-2005. FNDP estimates are consistent with this observation showing that domestic revenues currently remains steady at around 18.3 percent of GDP compared, for instance, to the PRSP target of 20 percent by 2004. Tax collections for the period of the PRSP (2002-2005) averaged 17.5 percent and generally

stagnated at this level.

According to the FNDP, this revenue performance outturn mainly reflected the difficulty of bringing more segments of the economy into the tax net especially the agricultural sector and the informal sector. It is intended that more pragmatic steps will be taken towards making these sectors taxable. It is expected that ultimately over the FNDP period domestic revenue will increase from 18.0 percent in 2008 to 18.6 percent of GDP by 2010. Achieving this and ensuring the reversal of the marginally downward trend of actual domestic revenue generation exhibited in Figure 2.1 will require significantly better domestic revenue outturns than what the recent trends show.

Figure 2.1
Fiscal Revenue
Dynamics

Source: Authors' own construction using CSO data



However, how exactly this could be achieved is unclear. The main proposed strategy for increasing domestic revenue is to include more of the agricultural sector and the informal sector under the tax bracket. This strategy has two key problems: firstly, it might be difficult to execute the strategy given the inherent evasiveness of accurately identifying and being able to actually tax the targeted economic agents in both sectors. The revenue authorities usually have little capacity for tracking the activities of small-scale farmers and subsistence farmers¹⁶ and informal sector actors. And even when the capacity for tracking exists, the transactions costs of chasing up tax obligations against meager and uncertain incomes usually outweigh the revenue benefits of tax collection.

Secondly and perhaps more importantly, the appropriateness of a strategy that brings the informal sector and more of the agricultural sector under the tax brackets is questionable. The strategy may have serious poverty and inequality implications, as the average Zambian income tax burden is already disproportionately carried by the poor.

¹⁶ Note that in agriculture, it is mainly small-scale and subsistence farmers that cannot be captured in the tax bracket as they are able to easily avoid or evade taxes.

Moreover, the effective tax burden decreases with total income; hence, income taxation is regressive (Gortner, 2004).

Taxes on agriculture and the informal sector would mainly take away from the incomes of the poor as these sectors are precisely where the poor participate, the urban poor dedicating their labour in the informal sector and the rural poor participating in subsistence agriculture.

The two illustrative issues brought out above raise questions about the attainability of the domestic revenue projections in the FNDP. This underscores the fact that though the authorities already anticipate financing to be difficult, it is likely the financing will be even harder than the current understanding suggests.

Given these observations, it will be important for the authorities to consider alternative tax policies for increasing domestic revenue. For instance, closer attention should be paid to increasing taxation of the mining sector, particularly now that sufficient time has passed for mining firms to recover some portions of their capital investment. In this regard, there is still considerable debate over the rate of royalty taxes that the government should apply. Many stakeholders, with civil society at the forefront, have expressed that royalties are a viable and sustainable source of national financing, but the government has been slow to respond in terms of formulating an appropriate royalty tax policy. Reducing the widespread application tax holidays, tax rebates and other tax concessions has the potential to improve domestic revenue generation since mining is such a significant economic activity. Imposing one-off, windfall taxes on mining is another option that could provide the occasional one-off boost to domestic revenue.

Another option might be to pay closer attention to understanding and possibly expanding the list of luxury goods that could attract specific excise taxes. This effort could be complemented with strategies of increasing the taxes on excise duties. However, it should be emphasized that empirical understanding of the costs and benefits of both expanding the list of taxable luxury goods and increasing excise duty rates should first be fostered.

Ultimately, it is up to the finance ministry working with the revenue authorities to identify feasible (i.e., cost effective), progressive, equitable and sustainable tax points within the Zambian economy, which will improve domestic revenue and minimize adverse effects on human development.

Assessment of MDG Cost Estimates

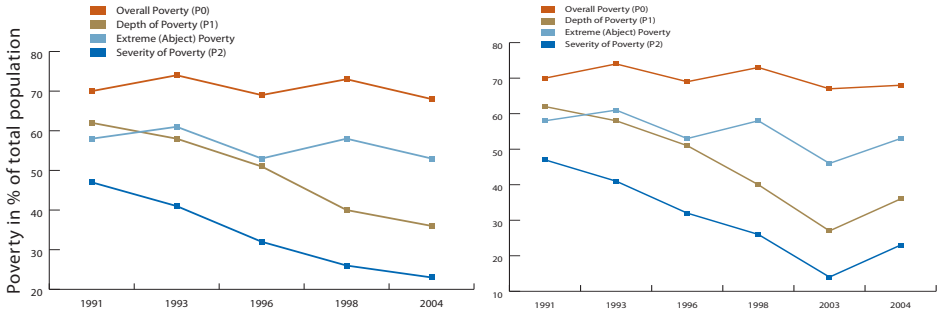
In relation to the MDGs cost estimates, the observations made in Mphuka (2005) on the required extent of GDP growth (9 percent per annum) were based on McCulloch et al (2000). McCulloch et al use CSO official poverty data for 1991, 1996 and 1998 to estimate elasticities of extreme poverty to GDP growth and to inequality. Based on the estimated elasticity of poverty to growth, they projected the growth rate and growth path that would be required to reduce poverty from 46 percent in 2003 – the base year

in McCulloch et al – to 29 percent in 2015. They determined that this growth path would require sustained growth of 9 percent per year. Two key observations about this finding are noteworthy: firstly, this type of high and sustained growth is unprecedented in Zambia, and is significantly higher than the best-case growth scenario of the FNDP, which estimates that growth under the accelerated FNDP would average 7 percent per annum during the period between 2006 and 2011. The FNDP growth target would itself be unprecedented for Zambia and yet with the weak historic links between growth and poverty, such growth (of 7 percent) would still be insufficient to realize goal number 1 of the MDGs.

Secondly, the required growth rate estimated as 9 percent per annum in McCulloch et al was based on the assumption that the level of extreme poverty at the beginning of the analysis reference period was 46 percent (taking 2003 as the base year). Unfortunately however, the LCMS IV shows that extreme poverty was 53 percent a year later in 2004. This disparity mainly results from differences in the sampling and data collection methodology of the two surveys, the LCMS III of 2003 and the LCMS IV of 2004. In this regard, the CSO has cautioned that in its design the LCMS III was not meant to be and is not comparable with other surveys such as the Priority Surveys (PS I (1991) and PS II (1993)), the earlier LCMSs (LCMS I (1996) and II (1998)) and the more recent LCMS IV. The LCMS III was specifically intended to capture and illustrate intra-year seasonal aspects about the variables and indicators it considers, including poverty. Perhaps due to the lower level of extreme poverty observed in the survey, many observers gravitated towards anchoring their poverty analyses around the LCMS III. This caused a downward bias in the level of poverty compared with the actual historic levels that are revealed in the other survey datasets. The downward bias is illustrated in Figure 2.2, which compares (in two panels) the poverty trends without and with the inclusion of LCMS III data in 2003.

To adjust for the above flaw, we re-estimate the extreme poverty reduction entailed by the annual average GDP growth rate scenarios of 9 and 10 percent. We also use the same elasticity and population growth rate assumptions. The difference with McCulloch et al is in the baseline poverty levels as in this case we assume that extreme poverty in the base year (2004 in this case) was 53 percent, in accordance with LCMS IV.

Figure 2.2



Poverty Dynamics (1994 - 2004)

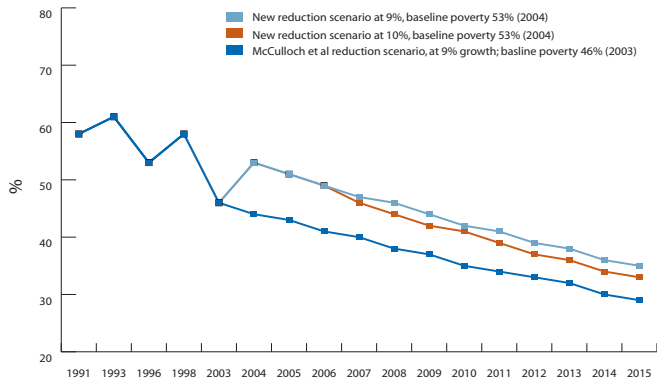
Poverty Dynamics (1994 - 2004) with LCMS III

Source: Author's own construction using CSO data

The adjustments in our re-estimates are consistent with the CSO's expert opinion that LCMS IV is comparable with PS II and LCMS I and II, whereas LCMS III is not. The new results on extreme poverty reduction are illustrated in Figure 2.3.

Figure 2.3
Potential Reduction
of Extreme Poverty

Source: Authors' own construction using data from Mphuka (2005) and CSO



The main thing to note is that with the more plausible baseline of extreme poverty level of 53%, growth rates of 9 percent and even 10 percent would not reduce extreme poverty to 29.1 percent by 2015. Of course, a significant determinant of this outcome is the average elasticity of extreme poverty to GDP growth, estimated at -0.62 in McCulloch et al. A higher responsiveness of poverty to growth would yield greater poverty reduction at 9 and 10 percent GDP growth rates or even below these levels.

The foregoing is simply to illustrate that the key to reducing poverty in Zambia lies in increasing the responsiveness (elasticity) of poverty reduction to growth by focusing developmental efforts on pro-poor economic activity. That is, by ensuring that growth takes place in sectors and areas such as in agriculture and in the informal sector where the poor are able to participate, using their labour to earn higher incomes. A higher average elasticity of extreme poverty to GDP growth would definitely paint a less gloomy picture about Zambia's prospects for meeting goal number 1 of the MDGs¹⁷.

As a second illustration we draw on assessing various HIV/AIDS cost estimates. The MDGs cost estimate of US\$99.4 million per annum in Mphuka (2005) – though significantly higher than that entailed in the FNDP financing requirement estimates of US\$ 45.8 million in total or US\$9.2 million per year on average over the FNDP period – is actually an underestimate of the anticipated cost of mounting an effective, MDGs consistent HIV/AIDS response as worked out by the national authority (NAC) in the National HIV/AIDS Strategic Framework (ZASF, 2006-2010).

These few illustrations simply re-enforce earlier arguments that the widely held understanding on the indicative financing requirements for developmental and poverty programs in the FNDP as well as many of the cost estimates of the MDGs are probably significantly less than the true resource requirements for development and poverty reduction in Zambia. The resources actually needed to achieve the MDGs are likely to far exceed those suggested in national and international operational plans. Unfortunately, it is not possible to estimate by what amount the FNDP amounts fall short of MDG requirements. This is because, as highlighted above, the true costs of meeting the MDGs in Zambia have not been fully established. Mphuka (2005) presents somewhat modest costs, which most likely underestimate the true costs of MDG requirements.

However, it must be recognized that although the FNDP does not appear to be fully consistent with the MDGs in terms of ambition, it nevertheless sets out most of its core spending priorities as MDG-consistent investment intentions that will support progress against poverty reduction in Zambia if the assumptions of the FNDP hold.

17 Clearly more work in the area of understanding the poverty-growth linkages needs to be done

3 Zambia's Recent Macroeconomic Context

The macroeconomic context of poverty alleviation and development programs gives useful insight into the feasibility of attaining the goals and target of the various efforts. It speaks to the economic environment in which growth, poverty reduction and development is expected to take place. This section therefore describes the macroeconomic context of Zambia's past and forward-looking development strategies and plans.

3.1 Size, Growth and Growth Prospects

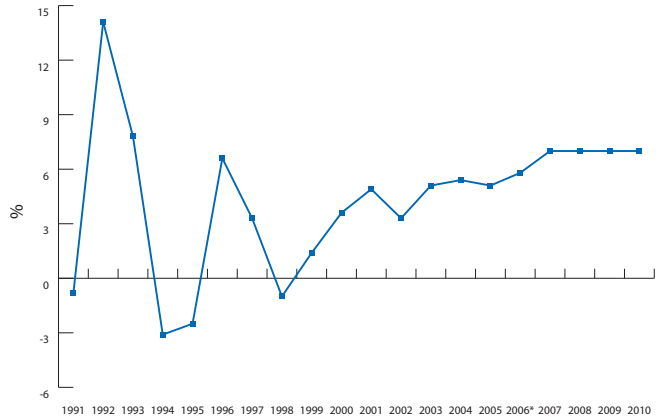
Zambia has a vast geographical spread, covering an expanse of 753,000 square kilometres. It has a total population of about 10.8 million people, and an abundance of natural and environmental resources, including an estimated 40 percent of the southern African ground water resources, substantial copper reserves and large tracts of arable land. In spite of its vast potential, Zambia can be described as a least developed, small, open economy. In value terms, its GDP – at constant 1994 prices – was estimated at K3,337 billion (US\$821.2 million) in 2006 compared to K3,156 billion (US\$789.0 million) in 2005. In current prices, 2006 GDP was estimated at K38,586 billion or US\$9496.2 million compared to K 32,456 billion or US\$ 8114.0 million in 2005. Preliminary observations suggest that the Zambian economy continued to experience positive, strong growth in 2006.

The CSO's 2007 estimates of GDP based on data that runs mostly up to September 2006 show that the economy grew by 5.8 percent in 2006. For a sustained period of eight years, the growth performance of the Zambian economy has been favourable, with an average real GDP growth rate of 4.3 percent between 1999 (when positive growth first registered) to 2006. Between 2001 and 2006, the average real GDP growth rate was 4.7 percent per year while over 2003-2006, real GDP grow at an average 5.4 percent per year. This shows that average growth performance has been growing increasingly strong over time.

In the empirical literature on growth prospects for Zambia, many growth scenarios have been given, each based on a separate set of assumptions and each predicting a different growth path. Ultimately, there have been many views about the overall growth outlook for the country in the future, but with little consensus on which projected outcomes are more likely or more plausible.

Figure 3.1
Real GDP Growth

Source: Authors' own construction using MOFNP data



For instance in a debt sustainability analysis publication in 2005 (IMF, 2005), the IMF predicted long-term GDP growth rates for Zambia to be steady at 5 percent per year during 2001-2004, 2005-2013 and 2014-2023, with underlying assumptions of accompanying restrictive fiscal and monetary policies during the long-term period. Weeks and McKinley (2006) have challenged the IMF projections as being too optimistic and dubious compared to the economic record prior to the country's HIPC Completion Point. Under similar policies to those assumed by the IMF, the actual average growth rate of 4.7 percent for 2000-2004 reported in Weeks and McKinley (2006) (or similarly, of 4.7 percent for 2000-2006 (see above)) was slightly less than the IMF prediction. For a historic perspective it is easy to appreciate that the IMF estimated GDP growth rates are unusually high and unprecedented (especially on a sustained basis) compared to the country's performance of the previous decade.

However, given that Zambia has sustained positive GDP growth for about eight years now and maintained this growth at above five percent for four year straight while edging towards six percent in the final year (2006), a lesson here is perhaps that historical performance trends are not very reliable indicators of future outturns. This is more so for countries under reform and in transition that are under significant internal and external pressures to show dramatic growth results. It is clearly hard to predict what the growth outturns will be for Zambia over the medium- to long-term. However, from the forgoing two things are clear:

- Firstly, a five percent growth rate is less than the seven percent assumed in the FNDP and required to fulfill the poverty reduction and developmental aspirations outlined therein;

- Secondly, as highlighted earlier, five percent GDP growth is far less than the 9-10 percent or higher growth rate, which is required for meeting the MDG on extreme poverty reduction.

A fundamental aspect reflected in the FNDP and reiterated earlier in this paper concerns the responsiveness (or elasticity) of poverty to growth. The evidence seems to suggest that the links between growth and poverty are extremely weak so that whatever growth is being realized in the economy is not readily translated into poverty reduction. The poor are excluded from using their labour to contribute to economic activity and therefore to their well-being. A discussion on the lacking linkages between employment (or economic activity) areas of the poor and contributions to GDP is briefly followed up in Section 3.4. The section also reinforces from a microeconomic perspective the widely known fact that for a long time Zambia has been characterized by high income inequality, with a Gini Coefficient of about 57 percent in 2002-2003 (CSO, 2005).

3

3.2 Key Macroeconomic Indicators

The macroeconomic environment underpinning the above economic activity remained stable and largely favourable in 2005, with improvements in inflation, a decline in interest rates and a slight accumulation of international reserves. Performance of the fiscal budget also improved, though somewhat less dramatically – with a marginal (one percentage point) reduction in domestic borrowing (see Table 3.1).

Table 3.1 Key Macroeconomic Indicators and Targets: 2003-2008

	2003	2004	2005	2006 Proj	2007 Proj	2008 Proj
Real GDP Growth Rate	5.1	5.4	5.2	5.8**	7.0	7.0
Inflation Rate (end period)	17.2	17.5	15.9	9.1	5.0	5.0
Inflation (period average)	21.4	18.0	18.8*	14.4	6.3	4.9
Nominal GDP (K' Billions)	20,479	25,916	32,456	38,586**	42,184	46,581
Current Account Deficit Incl. grants (% of GDP)	(7.5)	(4.8)	(4.6)*	(4.7)	(3.1)	(4.2)
Domestic Borrowing (% of GDP)	5.2	2.2	1.8	1.6	0.7	0.5
GIR months of Import Cover	1.3	1.2	1.4	1.5	1.8	2.2

* Projections; ** Preliminary estimates (CSO 2007)

Source: MOFNP (2006c), other MOFNP data and IMF documents

The PRSP progress report observes that spending on poverty reduction programs was

steadily scaled up from 2002 onwards. Preliminary macroeconomic indicators for 2006 also looked largely favourable, and many commentators have argued that stabilization is largely on track for the country.

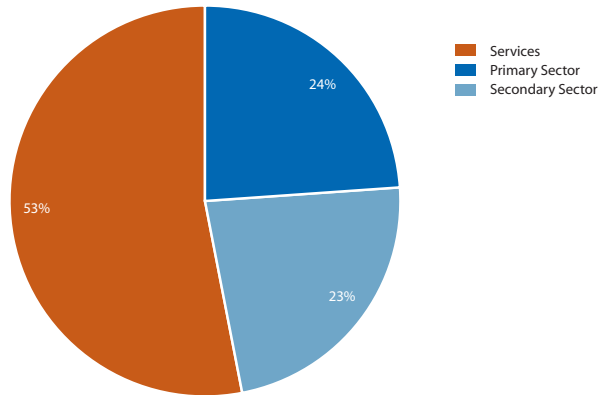
3.3 Composition of the Economy

In terms of the economic composition, for a long time Zambia tended to engage more in primary sector activities, but since the 1990s, the services sector has become the largest source of economic activity (see Figure 3.2).

In 2005, the services sector made the largest contribution to GDP, accounting for 53 percent of the total. Within the services industry wholesale and retail services followed by real estate provided the most dominant contributions to total economic activity. The services sector was followed by the primary sector, wherein agricultural activities dominated mining in contributing to sectoral GDP. In the secondary sector, manufacturing dominated the contributions to GDP.

Figure 3.2
Economic Activity
Composition

Source: Authors' own construction using MOFNP data



Following on the broad economic composition highlighted above, more details of Zambia's economic structure are presented in Table 3.2 by economic activity. Among the main highlights, the agriculture, forestry and fishing sector, which had recorded a decline of 0.6 percent in 2005, was anticipated to grow by 2.4 percent in 2006 mainly driven by good rains and therefore good harvest. The favourable agriculture outturn was important for keeping inflation low through lowered food price changes, and also for keeping a large number of people receiving some benefits from gainful employment.

Growth in mining (and quarrying) was expected to be 11.8 percent compared to

a growth of 7.9 percent in 2005. The impressive outturns in mining were fostered by significant copper production driven by substantial increases in international copper prices in 2004, 2005 and 2006.

Significant growth in the economy was expected to emanate from transport and communications, hotels, bars and restaurants, community, social and personal and construction sectors.

Table 3.2 Preliminary Percentage Changes in GDP at Constant 1994 Prices, 2000-2006

Kind of Economic Activity	2000	2001	2002	2003	2004	2005	2006*
Agriculture, Forestry and Fishing	1.6	(2.6)	(1.7)	5.0	4.3	(0.6)	2.4
Mining and Quarrying	0.1	14.0	16.4	3.4	13.9	7.9	11.8
Manufacturing	3.6	4.2	5.7	7.6	4.7	2.9	3.3
Electricity, Gas and Water	1.2	12.6	(5.2)	0.4	(1.7)	5.4	1.3
Construction	6.5	11.5	17.4	21.6	20.5	21.2	9.0
Wholesale and Retail trade	2.3	5.4	5.0	6.1	5.0	2.4	3.9
Restaurants, Bars and Hotels	12.3	24.4	4.9	6.9	6.4	11.7	10.0
Transport, Storage and Communications	2.4	2.8	1.8	4.8	6.4	11.0	13.4
Financial Institutions and Insurance	(0.6)	0.1	3.5	3.5	3.5	3.3	4.0
Real Estate and Business services	17.0	3.5	4.4	4.0	4.0	3.2	3.2
Community, Social and Personal Services	(0.5)	5.8	1.6	1.6	0.6	11.4	12.4
Less: FISIM	2.5	2.5	2.5	2.5	2.5	2.5	2.5
Total Gross Value Added	3.4	4.6	4.6	6.0	6.2	5.8	6.6
Taxes on Products	5.2	7.0	(6.8)	(2.8)	(3.1)	(1.5)	(3.7)
Total GDP at Market Rates	3.6	4.9	3.3	5.1	5.4	5.2	5.8

*Preliminary (up to third quarter 2006)

Source: CSO 2007

In terms of industry shares of GDP at constant 1994 prices, wholesale and retail trade remained the industry with the highest share at 18.3 percent in 2006. This was followed by the agriculture, forestry and fishing sector at 14.2 percent and manufacturing at 10.6 percent. Construction and real estate and business services had the fourth largest shares at 9.1 percent each. Mining and quarrying had the fifth largest contribution at 8.6 percent.

Table 3.3 Preliminary Percentage Activity Shares in GDP (Constant 1994 Prices) 2000-2006

Kind of Economic Activity	2000	2001	2002	2003	2004	2005	2006 *
Agriculture, Forestry and Fishing	17.2	16.0	15.2	15.2	15.0	14.2	14.2
Mining and Quarrying	6.4	7.0	7.9	7.7	8.4	8.6	8.6
Manufacturing	10.5	10.4	10.7	10.9	10.9	10.6	10.6
Electricity, Gas and Water	2.9	3.1	2.9	2.7	2.6	2.6	2.6
Construction	4.9	5.3	6.0	6.9	7.9	9.1	9.1
Wholesale and Retail trade	18.3	18.4	18.7	18.8	18.8	18.3	18.3
Restaurants, Bars and Hotels	1.9	2.3	2.3	2.4	2.4	2.5	2.5
Transport, Storage and Communications	6.3	6.2	6.1	6.1	6.1	6.5	6.5
Financial Institutions and Insurance	8.2	7.8	7.9	7.7	7.6	7.5	7.5
Real Estate and Business services	9.5	9.4	9.5	9.4	9.3	9.1	9.1
Community, Social and Personal Services	7.7	7.8	7.7	7.4	7.1	7.5	7.5
Less: FISIM	(4.9)	(4.8)	(4.7)	(4.6)	(4.5)	(4.4)	(4.4)
TOTAL GROSS VALUE ADDED	89.1	88.9	90.0	90.7	91.5	92.0	92.0
Taxes on Products	10.9	11.1	10.0	9.3	8.5	8.0	8.0
TOTAL G.D.P. AT MARKET PRICES	100.0	100.0	100.0	100.0	100.0	100.0	100.0

*Preliminary (up to third quarter 2006)

Source: CSO 2007

Although agriculture, the mainstay economic activity of many poor people in Zambia, accounts for a very large proportion of economic activity, it is clear from the ensuing discussion below that the sector has not worked for the poor in reality.

3.4 Employment

This part of the paper seeks to describe how the Zambian labour force has been employed in generating economic outputs and how labour has been rewarded (or not) in terms of per capita shares of economic activity and well-being.

Table 3.4 below highlights the sectoral employment outturns and per capita contributions of the various sectors (or industries) to GDP in Zambia based on the numbers of persons employed in each sector. The table is based on 2003 LCMS data (from CSO), which coincide with counterpart 2003 data from CSO (2007) on GDP shares. The main intention of the table is to highlight the distribution and equity of economic activity in Zambia.

The majority (about 72 percent) of employed persons in Zambia are engaged in the

agricultural sector, mainly as small-scale farmers residing largely in rural areas. Table 3.4 illustrates that although the agriculture, forestry and fisheries sector makes some of the highest contributions to GDP overall, it also employs the largest proportion of the labour force. Thus, on a per capita basis, it makes by far the smallest contribution to national economic activity. This goes to underscore the fact that although agriculture is generally a significant part of total economic activity in Zambia, the rewards to the labour – main factor of production – in the sector are very low. There are many people working in agriculture, but on average each person is only able to generate a very small amount of income (or GDP).

Table 3.4 Selected Sectoral Indicators on GDP and Employment: 2003 (1994 Prices)

Kind of Economic Activity	Total no. of employed persons	Sector contribution to GDP (%)	GDP (K billion)	per capita GDP (K million)	Per capita GDP (\$)
(I)	(II)	(III)	(IV)	(V)	(VI)
All Zambia	3,517,371	100	2,847	0.81	175.67
Agriculture, Forestry and Fishing	2,525,510	15.2	433	0.17	37.19
Mining and Quarrying	49,528	7.7	219	4.43	960.65
Manufacturing	121,898	10.9	310	2.55	552.53
Electricity, Gas and Water	10,488	2.7	77	7.33	1,590.72
Construction	45,281	6.9	196	4.34	941.58
Wholesale and Retail trade	309,223	18.8	535	1.73	375.67
Restaurants, Bars and Hotels	33,014	2.4	68	2.07	449.20
Transport, Storage and Communications	55,076	6.1	174	3.15	684.37
Financial Institutions & Insurance	50,124	7.7	219	4.37	949.22
Community, Social & Personal Services	313,978	7.4	211	0.67	145.63

Note: 2003 exchange rate: K 4,607 = US\$ 1

Source: Authors' own construction using CSO (2004) (LCMS III) and CSO (2007) data

Although the above per capita contribution from agriculture is severely low relative to other sectors, the statistics actually hide further gross intra-sectoral inequalities. In 2003, 98.3 percent of the labour force in agriculture consisted of small-scale farmers while only 1.7 percent comprised of medium- and large-scale farmers. Typically, the latter groups earn significantly more than small-scale farmers and are therefore able to make a

far greater contribution to GDP. In this way, despite being a major part of the Zambian population, the small-scale farmers are unfortunately currently among the poorest members of society. And, although the agricultural sector has seen overall growth for more than a decade and makes a significant contribution to GDP, the majority of smallholder farmers have experienced an erosion of their asset bases, greater exposure to risks, and vulnerability to poverty (see Text Box 3.1). The observed disparities simply reflect that the vast potential of the agricultural sector is in reality characterised by gross inequalities

3.1 Socio-Economic Status of Small-Scale Farming Households:

- In the CSO analysis of the LCMS III, low-income groups covered incomes of K600,000 and below. Meanwhile, small scale farmers earned mean month incomes of K270,059.
- Small scale agricultural households (92%) had the largest proportion of households in low-income groups.
- Small scale farmer households were exactly in the middle of the range of moderately poor (earnings of K323,483) and extremely poor (K228,331) households.
- On a per capita basis (with an average household size of 5.3 persons per household), small-scale agricultural households had the lowest mean per capita income (K59,136), compared with large-scale agricultural households who received the highest per capita incomes (K298,549).
- Female-headed small-scale agricultural households (K61,011) agricultural households had a higher per capita income than male-headed small-scale agricultural households (K58,514).
- Incomes in the low income group are inadequate for the minimum expenditures required for the national goods basket. Hence, households in this income group are expected to rely mainly on borrowing, begging, assets (especially for moderately poor households) or transfers such as household-to-household or government-to-household charity, gifts and donations. Clearly, such income is not stable and the income sources are not necessarily sustainable.

Source: CSO, 2004

with small-scale farmers bearing the brunt of marginalization and poverty. This underscores the earlier argument that Zambia's growth is currently not pro-poor.

It is against the backdrop of such stark observations that several observers have reiterated the need to generate growth that has more relevance to poverty reduction, through allowing the poor to use their labour more meaningfully to participate in the national economy and improve their well-being. To the extent that GDP growth rates of up to 10 percent may not achieve adequate poverty reduction, the current poverty-growth linkages are very worrying.

Moreover, it is widely held that international trade is an important catalyst for growth and development. However, for poverty reduction,

export-led growth will not be meaningful if the poor are excluded from supplying their outputs to export markets. Diversification of export orientation to include other sectors such as small-scale agriculture in the export equation is a necessary step that has not taken place in Zambia. Efforts at export diversification have at best been pursued in a piecemeal fashion, with few if any sustained tangible results.

To date, the poor have been marginalized in export trade since agricultural products (such as maize), which the majority of rural small-scale farmers can produce within their competences and environments, have been highly politicized. Maize exports often face domestically imposed bans by the authorities in the interest of so-called “food security.” Whether such products are actually internationally competitive or not is not brought into question. Due to such strategies as the domestically imposed export bans, the goods are automatically excluded from export markets. Moreover, maize and other food products also encounter other politically motivated indirect price controls on domestic markets, often to the extent that the rewards to the producers are insufficient compensation for their factor inputs, especially their labour.

Further still, the supply-side constraints imposed by poor and dilapidated infrastructure in transport, communication, and energy, as well as weak extension services, research and emergency response systems within the agricultural sector all contribute to limiting market access, export diversification, growth and development. Lacking infrastructure (roads, railway line, communication lines, etc), a weak steward for the agricultural sector – the Ministry of Agriculture and Cooperatives (MAC) – and weak agricultural services and systems are perhaps the most important factors that have limited the realization of Zambia’s agricultural potential.

In that regard, the government should in practice – not only in principle – treat agriculture as a real priority. Dedicating more resources to the MAC and the agriculture sector will help to increase the ministry’s internal capacity to manage and use human and financial resources. As a result this could ease the above-mentioned supply-side constraints, leading to improvements in the agricultural systems and structures, and the sector’s ability to conduct scientific research and deliver extension veterinary and cropping services. Through such policies and strategies, benefits could be expected for instance in the development of early maturing, drought resistant crop varieties; more productive seeds with higher germination rates; more environmentally friendly and cost effective fertilizers and pesticides; more effective and locally compatible livestock vaccines; better livestock epidemic early warning systems; improved credit, micro financing and extension service systems; etc. Ultimately, one would expect significant improvement in livestock and crop inputs, productivity and outputs in agriculture.

Given the significance of the population that directly depends on agriculture for a livelihood and considering that most of that population includes poor and vulnerable people residing in disadvantaged rural areas, improving performance in the agriculture sector is likely to yield important and sustainable poverty reduction outcomes.

Towards achieving these gains, the MAC should provide considerably more leadership and policy oversight on how business shall be conducted in the agricultural sector. Preferably, competitive markets for agricultural products should be fostered through the consistent application of appropriate policies and strategies. The application as is often done of blunt, inconsistent and highly inequitable instruments such as ‘across-the-board’ export bans obviously interferes with market pricing and efficient resource allocation in the agriculture sector, much to the detriment of poor and vulnerable subsistent farms. One must bear in mind that small scale and subsistence farmers receive payments for their economic participation only once a year, when they sell their harvest. If this happens at less than competitive prices (i.e., at prices below market prices), then the farmers are heavily disadvantaged since they not only wait one year to get the rewards of their labour, but also get paid less than what the market would have determined in the absence of market interferences such as export bans¹⁸.

3.5 International Trade: Structure and Performance, Policies and Prospects

In a wider context, using the international trade restrictiveness index of the IMF, Zambia has one of the most liberal trading regimes in Africa (Yagci and Kirk, 2005). This largely stems from the government’s implementation since 1992, of a comprehensive trade reform program in the context of a broader liberalization package. The trade reforms included a significant reduction in import duties and other charges, the elimination of quantitative restrictions and export taxes, the introduction of a market determined exchange rate, and the introduction of a system of export incentives (duty drawback, manufacturing under bond). These reforms started to establish a more appropriate environment for encouraging diversification away from copper and for augmenting the economic growth rate.

To date, however, Zambian international trade performance and profile has largely designated the country as a net importer. The country experienced trade surpluses in the 1990s with the highest surplus recorded in 1999. From 2000 onwards however, the trend reversed as a trade deficit has been recorded since the turn of the century, which is projected to persist during 2007 and 2008.

The export structure is dominated by traditional exports (of mainly copper and cobalt), with a few non-traditional exports (NTEs) such as sugar cane, electricity and cut flowers gaining some prominence in recent times (though not to the extent of overtaking the traditional exports). This reflects the traditional dependence of the Zambian economy on copper exports and the limited success of the country’s export

18 For that matter, agencies such as the Food Reserve Agency (FRA) should be provided with resources to ensure they are able to settle payments on demand for the crops (e.g., maize) that the government bans and commits to buying domestically during food insecurity times. Payments by promissory notes to poor and vulnerable people that get incomes only once a year are highly anti-poor biased, unjust and not acceptable.

diversification efforts.

The imports trade profile has been characterized by the highly valued consumption of intermediate and capital goods. This pattern of import trade is partially attributed to the high capital requirement for investment in the industrial (mainly mining and construction), agriculture, and transport and communication sectors amid domestic supply-side constraints that inhibit domestic production to respond to the demand for capital items; ultimately items have to be imported. Relatively high import values compared to revenue earnings on exports have perpetuated negative trade balances since 1999. South Africa dominates Zambia's trade profile as the main source of African imports for the country. Thus, while the EU's importance as a trading partner has decreased, SADC countries now account for over 75 percent of total imports, with South Africa accounting for almost 70 percent of this amount.

Unilaterally, Zambia does not have an explicit trade policy or clear trade strategies. Towards developing a national trade strategy, the national trade authorities (Ministry of Commerce, Trade and Industry (MCTI)) has been working with the Cooperating Partners and external consultants to develop an integrated framework through a Diagnostic Trade Integration Study (DTIS). The DTIS (Yagci and Kirk, 2005) reviewed Zambia's trade policies and performance, assessed its potential for export diversification, identified the main constraints to increasing exports, and developed an action matrix which summarizes the policy reforms and technical assistance needed to remove these constraints. The purpose of the DTIS was to support the Zambian government to (a) build national consensus around the reforms, (b) mainstream trade priorities into development and poverty reduction strategies, and (c) enhance trade capacity in and outside government to formulate and implement trade policies, to negotiate trade agreements, and to tackle supply-side challenges in responding to new market access opportunities.

Interestingly, with the crudely cross-matching information in the DTIS, which was finalized in October 2005 with information in the Commerce and Trade chapter of the FNDP, one gets the sense that the FNDP carries or reflects fairly well the sector-specific strategies formulated and proposed for implementation by the MCTI and its Cooperating Partners. Only a few points of emphasis in the Integrated Framework (IF) for trade such as the private-public mix in trade and the creation of a business enabling environment are somewhat less emphasised in the FNDP.

Zambia has essentially anchored its trade strategies to regional arrangements, including predominantly the Common Market for Eastern and Southern Africa (COMESA) regional arrangement and to a somewhat lesser extent, the Southern African Development Community (SADC) Trade Protocol. Pursuant to the COMESA Free Trade Area (FTA) Agreement, Zambia has since 2000 eliminated the tariffs on products originating from the other FTA members, and granted trade preferences to the COMESA states not in the FTA. The country is currently investigating the effects of the proposed COMESA Customs Union and the adoption of a common external tariff (CET).

One notable stumbling block to this end is Zambia's simultaneous membership in SADC, which is the main trade partner because of South Africa. The situation is further complicated by the forthcoming negotiation of the Economic Partnership Agreement (EPA) with the EU, which has to be done on a regional basis. This means firstly that Zambia has to decide on whether it will stick with its decision to negotiate within COMESA or will shift its negotiations to within SADC¹⁹, and secondly that the country may experience further revenue losses from integration. The former point is a political choice issue that we shall not comment on here. In relation to the latter, according to the regional comparative study of Munalula et al (2006)²⁰, relative to other Eastern and Southern Africa (ESA)²¹ countries, Zambia is projected to experience a somewhat modest overall tariff reduction of 12.7 percent (compared to 44.1 percent as the ESA average). Bearing in mind that Zambia has already expressed intentions to join the COMESA Customs Union as part of its regional integration ambition, Munalula et al assume – based on the COMESA Customs Union Roadmap – that this will happen before the ESA bloc negotiates to enter into the envisaged Free Trade Area (FTA) or EPA with the EU. During this transitional stage of entering into the Customs Union, Zambia is projected to experience overall revenue losses of about 4 percent as it phases down its tariffs within the Union to zero and aligns external tariffs to a Common External Tariff system. Thus, further integration into the EPA will result in overall revenue losses of about 8.7 percent as the revenue reduction directly ascribable to FTA integration. It is in this context that the assertion is made that the EPA will most likely not have an overly deleterious revenue consequence for Zambia if a COMESA Customs Union is first implemented and then the EPA is entered in to, in that order. Approximately one-third of the overall revenue losses will be absorbed during the transition to a Customs Union while the remainder will be from the EPA.

Another widely posited argument that is not extensively explored in Munalula et al

19 It will be noted that although Zambia is currently negotiating under the East and Southern African (ESA) group within COMESA, anecdotal claims from local officials are that the authorities are not fully satisfied with the expected benefits of trade integration under ESA compared to the potential benefits of a SADC-led EPA negotiation. The authorities have therefore continually commissioned studies to provide further policy information on whether Zambia should continue with the ESA negotiation or pull out of COMESA all together. As stated these claims are currently anecdotal to a large extent and presented here simply to underscore that Zambia's decision to pursue further trade integration through the ESA is not "cast in stone".

20 This study provides an extensive and rigorous simulation exercise of the potential revenue effects of an EPA between the EU and ESA states, including Zambia, under several scenarios and assumptions. It therefore presents a reasonable empirical assessment of what to expect from the EPA, controlling for other factors.

21 The ESA bloc (comprising of Burundi, Comoros, DR Congo, Djibouti, Eritrea, Ethiopia, Kenya, Madagascar, Malawi, Mauritius, Rwanda, Seychelles, Sudan, Uganda, Zambia and Zimbabwe) is the regional grouping within COMESA, which has committed itself to negotiating an EPA with the EU. The EPA will take the form of a Free Trade Area (FTA)

(2006) is that removing tariff restrictions on imports (such as under a Customs Union or the EPA) could create significantly more imports on which additional non-discriminatory taxes such as VAT can be applied, to the extent of compensating for the tariff revenue losses

Moreover, on the export side in relation to an EPA with the EU, it should be stressed that tariff-based market access restrictions are not currently a binding constraint to export growth. Most of Zambia's existing exports face zero or low tariffs and qualify for preferential access to the EU and regional markets. However, Zambia needs to participate actively in global and regional trade negotiations to ensure that its longer-term interests are adequately safeguarded in the outcome. It should work towards reversing its declining share in world exports by accelerating export diversification and regional trade.

Zambia is currently a beneficiary of preferential market access initiatives such as the Generalized System of Preference (GSP) and the US African Growth and Opportunity Act (AGOA). However, it has not been able to realize the potential benefits available in the initiatives. For instance, according to US import data, the impact of AGOA on Zambian exports has been insignificant. This comes as no surprise since most Zambian exports already benefited from duty-free status under the US GSP and, even before being AGOA eligible, Zambia was unable to fully exploit its GSP quota. Zambian producers have not been able to access the US market for agricultural produce since the required pest risk assessment has not yet been completed. In addition, trade information on opportunities and international requirements is generally scanty among the relevant local authorities and agencies, and thus does not reach potential exporter enterprises and individuals.

Reinforcing and strengthening the overstretched human and institutional capacity within the Zambian trade administration is of primary importance. This will also help to address the weaknesses in the formulation of trade policies and strategies and to improve support of export industries. Identifying trade-related constraints and proposing actions to be taken within efforts such as the Private Sector Development (PSD) program and the DTIS Action Matrix will be important for improving internal human resource and institutional capacity. The serious supply-side constraints alluded to above, including poor infrastructure, limited capacity of Zambian producers to meet quality and safety standards, and lack of a clear government export strategy, significantly hamper the realization of Zambia's full export potential; hence, these need to be further looked at and addressed.

Export Prospects

In the current trade setting, the IMF has used various export assumptions in its debt sustainability analysis (IMF, 2005) to project Zambia's export performance up to 2023. As reflected in the relevant parts of Table 3.5 below, the IMF has been optimistic about

Zambia's trade prospects in the future.

In terms of assumed export value, the IMF anticipated an annual average of US\$1,360 million over 2000-2004 compared to an average actual outturn of US\$1,073 million annually during the same period. Similarly export growth rates were estimated at 12 percent per year during 2000-2004 by the IMF compared to an actual outturn of 6 percent per year over 2000-2003. The IMF has perhaps been too optimistic about Zambia's export performance prospects, especially considering that the average exports to GDP ratio has actually declined from 32 percent during 1995-1999 to 27 percent during 2000-2005. Moreover, the earlier-mentioned supply-side constraints in the domestic economy coupled with Zambia's lack of trade policies and strategies simply underscore that the IMF's views and assumptions about strong export growth over the medium term are perhaps slightly too optimistic.

Table 3.5: Period (Annual and Average) Export Performance for Zambia:

	1995-1999	2000	2001	2002	2003	2004	2005	2000-2004	2005-2013	2014-2023
Export-to-GDP ratio (MOFNP)	32	31	26	27	24	32	26	27		
Export of Goods & Services (\$' millions):										
MOFNP Actual	989	746	871	916	1052	1779	2095	1073		
IMF Assumed		1036	1241	1413	1506	1604		1360	2297	3977
IMF Actual		861	1028	1052	1217	1820		1196		
Export Growth rates (%):										
MOFNP Actual	-9	-1.3	16.8	5.2	14.8	69.1	17.8	6*		
IMF Assumed			19.8	13.9	6.6	6.5		12		4
IMF Actual			19.4	2.3	15.7	49.5		12*		

* Average figures are for 2000-2003 and 2001-2003, respectively to avoid the upward bias in actual export growth outturn that would have resulted had 2004 figures been included (there was a significant positive and transient shock on exports in 2004).

Source: constructed from authors' recalculation of MOFNP and IMF data

On the other hand, the assumption that annual export growth will over the long term (2014-2023) slow down to 4 percent seems a bit too modest. The IMF argument is that major investment in mining (coupled with high copper prices during 2004-2006) and agriculture will spur export growth before the growth eventually slows down to 4 percent per annum.

While the past and current high international copper prices are appreciated as a significant factor in export performance, following on the assertion by Weeks and McKinley (2006) a point of caution concerning the assumed prospects for medium-term export growth is perhaps in order. The considerable instability of copper prices over the medium term should induce greater caution in the way that export projections for Zambia are made. Figures 3.3 and 3.4 illustrate this point, showing that between 1961 and 2004 copper prices increases were rarely sustained for periods of more than two years.

Figure 3.3
% Changes in LME
Copper Prices:
1961 - 2004

Source: constructed using UNCTAD data

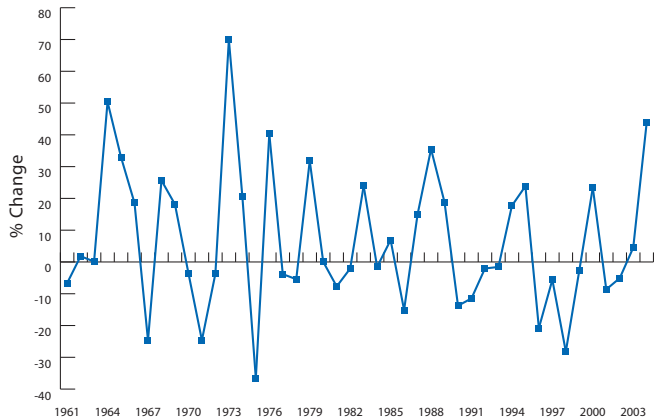
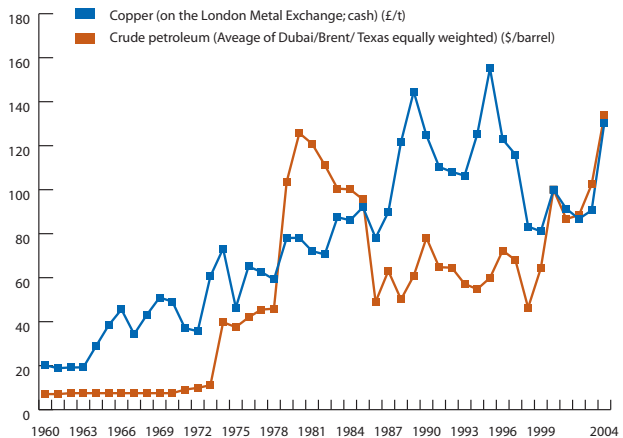


Figure 3.4
International Prices:
Copper and Crude
Petroleum
1960 - 2004

Source: Authors' construction using UNCTAD data



Being highly dependent on copper mining, Zambia will remain persistently exposed to the vulnerability of international economic shocks in copper prices. Without diversification, export incomes will continue to be uncertain. Moreover, the mines in Zambia are now largely in private ownership and government has been rather unimaginative about mobilizing additional revenue from the new mining enterprises.

Instead, there has been a rush for privatization and the creation of an enabling environment for foreign direct investment (FDI) with the government giving discretionary tax concessions to foreign investors in the mining sector. These generous tax incentive, rebates, breaks, holidays, etc have persisted in the sector.

With significant new activities in mining, one would expect the government to see the sector as an important source of fiscal revenue. However, recent developments suggest that the government appreciation or perhaps understanding of the revenue importance of mining is limited. In February 2007, China and Zambia launched a copper mining partnership whereby the Zambian government established a special economic zone for Chinese investors in the Copperbelt town of Chambishi. Within the zone, Chinese firms are exempted from import duties and value added taxes.

Perhaps the impetus for such decisions comes from the factor that China has reported commitment to writing off millions of dollars worth of Zambia's debt, to build schools and a sports stadium, train agricultural experts and provide a loan for road construction equipment. Indeed, Chinese president Hu also promised US\$ 800 million worth of new Chinese investment in mining, manufacturing and agriculture in Zambia during this year (2007). Thus, despite the favourable sectoral performance in the recent past (pushed by high investments, increased copper prices and greater production) and its sizable contribution to GDP, this sector is currently not appreciated as a viable option for domestic resource mobilization. This result is actually exacerbated by the political choices that reflect the sometimes myopic design of domestic commercial and tax policies.

A lot can be said about commercial policy inconsistencies:

- There is nothing by way of policy or strategy to foster change to domestic capital structures over time. This is to the extent that local economic agents are permanently excluded from firm ownership (Kane Consult et al, 2005) and presumably, from the recent high capital returns in mining and commercial agriculture²²;

22 Only the communication industry has been "ring-fenced" so that the government has instituted a piece of legislation that makes it mandatory for foreign communication firm's to transform their shareholding structure. Over time such firms are statutorily required to assume a structure with 51 percent capital ownership in Zambian hands and the minority 40 percent of capital in foreign ownership. Of course, given the political strategic importance of communication (with the largest mass-media establishment belonging to the Government), there is the strong possibility that the move to institute this requirement in the communication industry only was politically motivated.

- There are also widespread anecdotal claims by observers such as the Zambia Business Forum (ZBF) that with weak and ill-enforced labour laws and regulations, coupled with foreign enterprises or investors that are very selective about the type of labour they hire domestically, foreign firms setting up in Zambia often tend to take on mostly unskilled domestic labour; the higher paying, skills-intensive jobs are mainly reserved for foreign workers. And with little synchronization between the labour authorities and immigration authorities, skilled foreign workers are often able to acquire these jobs without meeting work permit requirements;
- Similarly, other anecdotal claims are that investment capital requirements are not monitored or enforced so that any foreigner who manages to enter the country can stay on as an investor. And as already seen, enforcement of immigration regulations is too porous to stay the situation;
- Profit repatriation regulations are hazy, poorly communicated when they exist and almost never enforced (Kane Consult et al, 2005).

These elements, among many others, all contributed towards limiting Zambia's trade, revenue generation and economic participation prospects.

In relation to the price instabilities reflected in Figure 3.4, since Zambia is significantly dependent on imports of crude oil to satisfy its petroleum fuel demand, the oil price instabilities mean Zambia will also frequently face adverse oil price shocks and will often import fuel inflation.

In addition, the continued dependence on rain for cropping in agriculture coupled with the frequent occurrence of droughts relegates the country to being extremely vulnerable to food insecurity. Between 1991 and 2007, Zambia experienced five droughts of varying intensity in the 1991/92, 1993/1994, 1994/1995, 2000/01 2001/2002 and 2004/2005 agricultural seasons (World Bank, 2007; Kalinda and Sikwibele, 2006).

Overall, the macroeconomic context reveals that although Zambia has achieved relative stability and sustained growth for about eight years, many challenges and imbalances still exist. Internally, a host of factors such as structural (supply-side) rigidities, public sector incapacities and lacking commercial policies, gross inequalities in rewards to factors of production, and political interference all add to hampering prospects for improving diversification, broad-based export performance and poverty reduction. In addition, the country's lopsided economic structure makes the economy vulnerable to external economic and natural shock. The macroeconomic context is therefore less optimistic than what is suggested in the assumptions and projections of many macroeconomic programs.

4 Public Debt and Fiscal Contexts

The public debt and fiscal aspects are the main considerations in many macroeconomic programs and framework as they establish financial viability. Thus, to understand in what ways and to what extent international and national policies and programs incorporate development and poverty reduction goals into their frameworks, it is important to look at public debt and fiscal aspects.

Public debt (also known as government debt or national debt) is money or credit owed by any level of government; either central, federal, municipal, or local government. As the government represents the people, public debt can be seen as an indirect debt of the taxpayers. Public debt is often categorized as domestic (or internal) debt, owed to lenders within the country and external (or foreign) debt, owed to foreign lenders. Governments usually borrow by issuing securities such as government bonds and bills. However if credit worthiness is eroded so that domestic and external agents prefer not to invest in government bonds and bills, countries sometimes resort to borrowing directly from commercial banks, bilateral creditors or international financial institutions (IFIs). In Zambia all government liabilities, including deferred pension payments and delayed payments for goods and services the government has contracted for but not yet paid are understood as part of public debt.

Another common division of public debt is in terms of duration: debt of one year or less is generally considered to be short term debt while debt of more than ten years is long term debt; medium term debt falls anywhere in the middle of these two forms.

The ensuing parts of this section consider the Zambian experiences with and future outlook of public debt, both external and domestic.

4.1 Zambia's External Debt Crisis and a Partial Resolution

This section considers external debt in terms of: a brief historical overview of the origins of external debt; the history and outcomes of debt relief and macroeconomic adjustment efforts; the quantity and structure of external debt before and under HIPC and MDRI relief (including consideration of key debt and creditor indicators); and other key considerations surrounding external debt.

What Were the Causes of the External Debt Crisis?

In the 1970s and 1980s, Zambia experienced serious economic misfortunes characterised by falling international copper prices, rising oil prices and increasing macroeconomic instability, which significantly dampened the country's ability to meet its social and economic ambitions. The history of Zambia's economic misfortunes and emerging macroeconomic and socio-economic issues is well documented in the literature (see

Bigsten and Kayizzi-Mugerwa, 2000; Langmead et al (ed), 2006) and is therefore not repeated in any elaborate way here. We focus instead on the origins of external debt and the related debt crisis.

Like many other low-income countries, Zambia's heavy indebtedness was a result of a complex interrelationship of political, economic and social factors. The mounting public debt was linked to domestic pressures and policy failures such as the public sector's huge desire to borrow to finance developmental programs and to address seemingly transient external shocks. Concerning the former, it was common in the 1970s and 1980s to take advantage of cheap petrol dollars and other sources of finance on international money markets and borrow for domestic investments. Zambia and other low income countries borrowed heavily in order to deliver pre-independence promises and to expand development programs. It is worth noting that some of the loans from international money markets were meant to close perpetual deficits in the balance of payment (BOP) current accounts. While it is generally argued by some observers that some of Zambia's borrowings were wasted on consumption activities and 'white elephant' projects such as subsidising loss-making state-owned enterprises (SOEs), others have argued that some of the loans were prudently invested in the development and expansion of the human capital, physical infrastructure and water reticulation systems, among many other things.

Zambia's heavy indebtedness also stems from exogenous forces that were beyond the government's control (e.g., persistent droughts, the above-mentioned high price volatility on international commodity markets and resultant poor terms of trade (TOTs), and the worsening political environment in the region, especially in the 1970s²³). In fact, Zambia's huge external debts can readily be traced to the external price shocks of the 1970s than to anything else. And the subsequent occurrences of regional and global recessions, increases in interest rates on international money and capital markets, accumulation of repayments arrears (since copper prices continued with their downward spiral) exacerbated the mounting debt problem and transformed it into a crisis. Over time, the country could not sufficiently cover its import needs using export earnings. The result was further borrowings from both bilateral and multilateral lenders. Thus, by the end of the 1980s, the country had one of the highest per capita debts and was one of the most highly indebted countries in the world. Its debt stock increased rapidly, rising from US\$3.3 billion in 1980 to US\$6.9 billion in 1990. There was a further dramatic increase in external debt after 1987 when the Government of Zambia broke ranks with

23 It is important to note the huge political role the country played in the liberation struggles in Southern Africa in the early 1970s and 1980s. Being surrounded by eight neighbours most of whom were waging liberation wars in the latter part of the 1970s and early 1980s, Zambia actively supported these liberation struggles particularly against the racist regimes in South Africa, Zimbabwe, Namibia, Angola and Mozambique. A study by the Jesuit Centre for Theological Reflection (JCTR, 2000) estimated that Zambia incurred a total debt of US\$5.3 billion in opposing the Apartheid system of governance and that is besides the human loss and physical infrastructure damaged through bombings from foreign aggressors.

the IMF and World Bank citing adverse effects of their structural adjustment programs on the Zambian people.

In this sense, it is clear that the debt crises were not confined to domestic issues of domestic policy failure, lacking good governance or piecemeal economic reforms, but also originated from significant external shocks that were poorly addressed by domestic authorities and the international financial institutions.

From SAPs to PRSPs

For over twenty years, the IMF and the World Bank have been requiring poor countries to implement a wide range of economic and social policy reforms, such as trade liberalisation, investment deregulation and privatisation in return for low interest rate loans. For example, according to the IMF, trade liberalization has been a key element of Fund supported programs over the past twenty years. These Structural Adjustment Programs (SAPs) were also supported and fostered by the World Bank. Several studies and policy discussions have questioned the appropriateness of policy prescriptions being foisted on developing countries, with many observers contending that the SAPs were contributing to increased inequality and marginalization of the poor. Empirical reports have repeatedly pointed out that these policies have been dominant in the poorest countries during the past two decades, a period of severe economic decline in sub-Saharan Africa and stagnation in Latin America (see, Situmbeko and Zulu, 2004; Sachs, 2002; Torero, 2003; Goldzimer, 2003; Situmbeko and Musamaba, 2002; Action Aid, 2002).

SAPs were eventually replaced by new strategic plans (so called PRSPs) drawn up by developing countries themselves. While in principle the PRSPs are meant to be developed by national governments in consultation with developmental partners such civil society and the international community, there are widely held concerns that in practice, the IMF and World Bank have retained their dominant influence and the power of veto. For instance, PRSPs typically require privatisation of public utilities, right-size of the public sector, deregulation, removal of subsidies (including those that benefit the poor), promotion of exports and foreign investment, and import liberalisation (where it has not happened already). Many observers feel that these are imposed on domestic economies as conditionalities that should happen irrespective of the views of domestic stakeholders. In this regard, many argue that although the name has changed, SAP-style policies still predominate.

Debt Relief Measures for Zambia: the HIPC Initiative

This sub-section looks at and tries to clearly understand the conceptual framework through which debt relief is granted. A slight historic perspective is useful for building the discussion.

The HIPC Initiative was first launched in 1996 by the IMF and the World Bank, with the aim of ensuring a permanent exit from unsustainable debt. The Initiative was

thus intended to deal comprehensively with the overall external debt burden of eligible countries, reducing it to a sustainable level within a reasonably short period of time. Under the initiative, a country would be considered to have achieved external debt sustainability when it was expected to be able to meet its current and future external debt-service obligations in full, without recourse to debt relief, rescheduling of debts, or the accumulation of arrears, and without compromising growth. In this sense, the international community had increasingly recognized that the unsustainable external debt of heavily indebted poor countries was becoming one of the sources of slow economic growth, persistent poverty, and weak social policies in these countries. Against this backdrop, the HIPC Initiative was established as an effort for coordinated national and international actions to reduce to sustainable levels the external debt burdens of all the Heavily Indebted Poor Countries (or HIPCs).

When the IMF and the World Bank jointly adopted the HIPC Initiative in September 1996, they formulated and prescribed strong programs of macroeconomic adjustment and structural reforms, which they ensured were carried out as close to prescription as possible.

The HIPC Initiative was enhanced in 1999, which culminated in the approval of a strengthened HIPC Initiative, designed to deliver deeper debt relief more rapidly to a wider range of countries. As the measurement of sustainable debt, the HIPC initiative focused almost exclusively on the ratio of the net present value (NPV) of a country's debt to its exports, and ignored the human cost of repaying the debts. Countries were only eligible for consideration for HIPC if the ratio of the NPV of their debt was greater than 150 percent of earnings from exports of goods and services. They also had to be poor with a per capita income below US\$785 and eligible for IDA-only borrowing terms from the World Bank.

A string of conditions had to be met before countries could reach the "decision point" in the HIPC process and three years of successful implementation of reforms were normally required before the country reached "completion point", when irrevocable debt relief was conferred by the creditor institutions. In this light, many observers felt that with the advent of HIPC, the World Bank and IMF had yet another route through which to push structural adjustment since not only were policies such as privatisation, investment deregulation and trade liberalisation being attached to the provision of new loans, their implementation had also now become a central feature of HIPC debt relief. During the spring and summer of 2002, it was reported that at least 11 of the 20 countries that qualified for interim debt relief (i.e. some debt relief before they reach 'completion point') were being denied it because they had not fully implemented the policies required by the World Bank and IMF.

Thus, while the far reaching debt relief initiatives (discussed further below in the Zambian context) are duly noted as positive occurrences, the conditionalities have been equally repeatedly pointed out as negative facets. In this regard, although it is

important to push for further relief from the unpayable debts of the poorest countries, it is perhaps also critical to foster the de-linking of debt relief and debt cancellation from the sometime constrictive and inappropriate economic policies pushed by the IMF and World Bank.

Another major criticism that has been leveled against the HIPC initiative is that it does not provide deep enough relief. In using only debt-to-export or debt-to-revenue ratios, the IMF and the World Bank both set the ratios too high to be serviced sustainably and also failed to consider vital ongoing obligations such as key social imperatives in education, health and infrastructure spending that must be met by the poorest countries. Its stringent macroeconomic and structural conditionality is also difficult to observe especially for countries that are faced with the HIV/AIDS pandemic, which requires increased public spending for its control. The HIPC initiative further had overly ambitious assumptions and projections about growth as reflected in decision point documents that in most cases were not in tandem with economic performance of poor countries. Under these circumstances, HIPC cannot be expected to provide a “robust, long-term exit from unsustainable debts.”

As noted by CCZ, EFZ and ZEC (2006, p. 1) “some of our detractors and pessimists alike dismissed our calls for ‘total debt cancellation.’ They saw a mission that was bound to fail, as no creditor would entertain ‘debt cancellation.’ However, the moral case for debt cancellation prevailed. Today not only is debt cancellation a reality for Zambia, but for many African countries as well. We note that the cancellation of Zambia’s external debts from US\$7.1 billion in 2004 to US\$502 million in 2006 is a culmination of unrelenting pressure by a wide range of civic and faith organisations in the global Jubilee movement, government’s commitment to donor conditionality and the sacrifices made by the people of Zambia.” This amplifies that civil society played an important role in achieving debt relief.

The levels of awareness in Zambia about the debt problem and the role of civil society in championing the campaign to bring down the debt are evidenced in the public opinion poll undertaken by M and N Associates Limited at the request of the Jubilee-Zambia Campaign and CCJP/JCTR Debt Project in 2001/2002 (Jubilee-Zambia, 2002).

HIPC and MDRI Impacts: the Stock of External Debt and Debt Repayment Outturns

Through consistent international pressure mainly from civil society and national governments to re-look at the debt problems and prescribed solutions, the thinking on external debt solutions gradually changed to include more outward looking options for debt reduction. As seen above, eventually the HIPC Initiative was formulated and spearheaded as the “new” international option for debt reduction. In December 2000, the Executive Boards of the IMF and the International Development Association (IDA) agreed that Zambia had met the conditions to reach its Decision Point under the enhanced HIPC Initiative. The Fund and IDA thus defined a set of conditions for Zambia

to reach the Completion Point²⁴ at which time the debt relief committed at the decision point would become irrevocable²⁵. At the Decision Point, Zambia became eligible for debt relief in the amount of US\$3.9 billion over time (or US\$2.5 billion in net present value (NPV) terms)²⁶. Based on a debt sustainability analysis (DSA) using end-1999 data, the full delivery of this assistance would reduce the ratio of the NPV of Zambia's external public sector debt to exports to 150 percent—the threshold for sustainability under the enhanced HIPC Initiative. Employing the principle of equal burden sharing, all creditors would reduce the NPV of their claims on Zambia by a common reduction factor of 62.6 percent after full use of the traditional debt relief mechanisms. For the IMF and IDA, the resulting commitments amounted to US\$602 million and US\$488 million in NPV terms, respectively.

During the interim period between the decision and completion points, the IMF provided debt relief of US\$452 million in NPV terms, while IDA provided relief of US\$98 million (IMF, 2005a). Zambia has also benefited from interim assistance granted by the African Development Bank (AfDB), the OPEC Fund for International Development, the European Union (EU), and the Paris Club creditors. Total HIPC Initiative assistance to Zambia was in excess of US\$380 million in NPV terms during the interim period and the Paris Club creditors provided interim relief beyond HIPC Initiative assistance.

Multilateral Debt Relief Initiative (MDRI)

Debt relief, including under the recent Multilateral Debt Relief Initiative (MDRI), has put more countries in a situation where current debt is now well below any thresholds associated with risks of debt distress. Some commentators (e.g., Goldsborough and Cheelo, 2007; Harding, 2006) have observed that this initiative for debt relief is one that truly provided additional resources for poverty reduction investments.

However, evidence in countries where MDG costing exercises have been done is that the estimated resource requirements for countries to meet the MDG's by 2015 are large and significantly surpass the volumes of resources that will be made available by MDRI.

According to Gunter (2006), based on preliminary estimates, the benefits of the MDRI to the 18 completion point HIPCs over the next 10 years (2006-2015) amounts to US\$8.5 billion, of which US\$7.2 billion are estimated to benefit the 14 African completion point HIPCs. Assuming that all African HIPCs would reach the HIPC completion point within the next 5 years [from 2006], the total debt service savings from the MDRI to Africa are estimated to add up to about US\$10 billion during 2006-

24 The Completion Point is the stage at which after Zambia had implemented the PRGF successfully, the country received a stock of debt relief and the bulk of assistance under the Enhanced HIPC Initiative.

25 See IMF (2000); also at www.imf.org/external/country/ZMB No.P7410-ZA (11/20/00)

26 IMF (2005a)

2015. Comparing these US\$10 billion in MDRI debt relief over the next ten years to the additional development expenditures needed to achieve the MDGs in Africa (which are estimated to amount to about US\$750 billion over the next ten years) shows that the direct financial contribution of the MDRI remains small (a little over one percent!) to the actual additional financing needs of Africa.

The main point above is not that MDRI is insignificant or unimportant in its contribution to reducing debt and potentially alleviating poverty, but rather that even with truly development-oriented initiatives such as the MDRI, there is still a significant financing gap that needs to be address. Unfortunately, addressing this raises yet other questions about whether the full extent of resources that would fill the financing gap could actually be absorbed and used effectively in recipient countries. Both issues about the resource gaps and about management and absorption capacities should be borne keenly in mind as one looks at Zambia's brief to date and potential future experiences with MDRI.

Under the G8 Gleneagles proposal of 2005 also known as Multilateral Debt Relief Initiative (MDRI), the IMF Executive Board approved significant debt relief for Zambia in December 2005. As part of the Initiative, the IMF agreed to provide 100 percent debt relief for Zambia on all debt incurred by Zambia to the IMF before January 1, 2005 that had remained outstanding. IMF debt relief amounts to approximately US\$577 million, or US\$572 million excluding remaining assistance under the Heavily Indebted Poor Countries Initiative. This debt relief became available in early January 2006 as soon as the remaining consents of the contributors to the PRGF Trust Subsidy Account had been received. The international community had made these additional resources available to help Zambia make progress toward the MDGs (IMF, 2005a).

How did the IMF analyze the wider range of potentially feasible fiscal policy options available for Zambia following debt relief? A late 2005 assessment (IMF, 2006) concluded that with the attainment of the completion point under the HIPC and even before MDRI debt relief, Zambia's external debt and debt service indicators would remain quite low over the long term compared with the various threshold indicators of potential debt distress. The assessment followed the recently introduced IMF-World Bank Debt Sustainability Assessment (DSA) framework. That framework, discussed in more detail further below sets indicative, country-specific debt burden thresholds that depend on the quality of a country's policies and institutions. As measured by the World Bank's Country Policy and Institutional Assessment (CPIA), Zambia ranks as a "medium performer" in terms of policies and institutions. The indicative thresholds of potential debt distress for countries in this category are a net present value (NPV) of debt-to-exports ratio of 150 percent, an NPV of debt-to-reserve ratio of 250 percent, an NPV of debt-to-GDP ratio of 40 percent, and debt-service-to-exports and revenue ratios of 20 and 30 percent, respectively. Zambia's debt indicators remained well below these threshold levels both under the baseline scenario and under most stress tests, except for

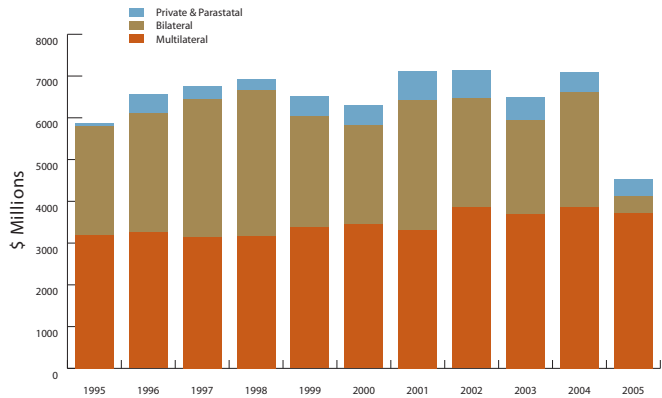
a scenario involving a sharp fall in copper prices. After MDRI debt relief, debt and debt service burden indicators never came close to their respective thresholds even in such an adverse scenario. This essentially means that with MDRI Zambia's likelihood of encountering debt distresses in the future is very low²⁷.

Largely due to the debt relief from the HIPC initiative, at the close of 2005, Zambia's overall external debt stock reduced by 36.1 percent to US\$4.5 billion from US\$7.1 billion at end-2004. According to the Ministry of Finance (MOFNP, 2006), the dramatic overall reduction in the country's debt stock emanated from the cancellation of debt by members of the Paris Club following Zambia's ascension to the HIPC Completion Point, which was not coupled with significant further borrowing from the Club. The stock of Paris Club debt in 2005 declined by 95.3 percent to US\$117.5 million (from US\$2,483 million in 2004), implying a debt write off of US\$2,365.5 million by the Club (see Figure 4.1).

4

Figure 4.1
Structure and
Dynamics of External
Debt

Source: Authors' construction using MOFNP data



On the other hand, despite the impressive debt relief figures on multilateral debt highlighted above (presumably achieved through HIPC), official Ministry of Finance data show that there was only a marginal change to the stock of multilateral debt from 2004 to 2005. The multilateral debt component declined by only 4 percent from US\$3.9 billion in 2004 to US\$3.7 billion in 2005. Without giving any specific details on the types, sizes and purposes new loans the Ministry of Finance (MOFNP, 2006) reports that this was mainly because of the contraction of new multilateral loans that negated

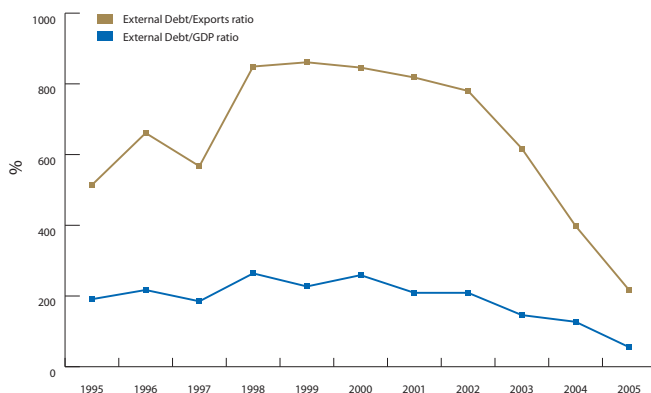
²⁷ Of course, as discussed above and in other parts of the paper, the debt sustainability that would be fostered by MDRI and other initiatives will not necessarily fully address Zambia's resource gap and absorptive capacity problems. These require other solutions as further discussed elsewhere in this paper.

the debt relief gains made on the multilateral component. Hence, overall, although Figure 4.1 shows a general decline in the debt levels, there was an increase in debt owed to the World Bank, African Development Bank and Non-Paris Club members due to contraction of new debt.

As would be expected given the foregoing, relative to both exports and GDP, total external debt has reduced considerably, declining steadily from 1999 to 2002 and then quite dramatically from 2002 to 2005 (see Figure 4.2). This simply provides further evidence of the contribution of HIPC debt relief to debt reduction outturns.

Figure 4.2
External Debt
Indicators

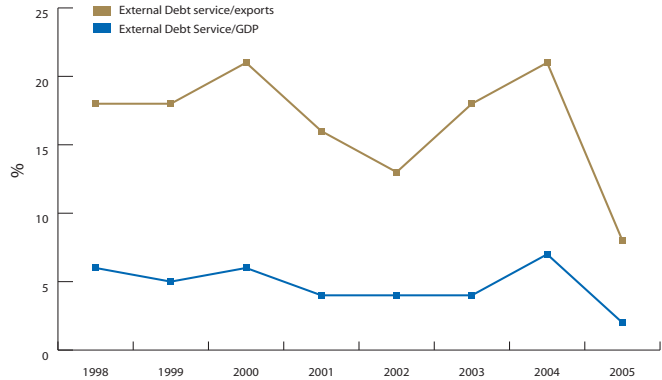
Source: Authors' construction
using MOFNP data



Generally, a key concern regarding external debt management is usually the cost of the debt to export earnings in terms of debt service payments, but judging from the country's recent debt service record, this does not seem to be a significant concern in the case of Zambia. As a proportion of exports, external debt servicing in 2005 was 7.7 percent, down from 20.9 percent the previous year. Figure 4.3 below illustrates the external debt service-to-export and external debt service-to-GDP dynamics from 1998 to 2005. Clearly, the debt relief efforts realized in 2005 reduced the country's debt service costs and burden.

Figure 4.3
External Debt Service
Ratios: 1998 - 2005

Source: Authors' construction using MOFNP data



In absolute terms, external sector's service payments, excluding amortisation, amounted to US\$33.5 million in 2005, a reduction of 2.5 percent from US\$34.3 million in 2004. The bulk of the payments – amounting to US\$23.8 million or 71 percent of total payments – were to multilateral institutions. Payments to Paris Club and Non-Paris club creditors for 27.9 percent and 0.1 percent of the total, respectively.

4.2 Implications of External Debt Levels

Having benefited from the HIPC initiative and currently also benefiting from the MDRI, Zambia has already had a significant proportion of its external debt obligations written off, allowing the country to channel some of the debt resources to poverty reduction spending. The foregoing discussion clearly shows the track record of external debt reduction.

However, as earlier highlighted in detail, the resources needed to achieve the goals of the FNDP and MDGs are likely to exceed those freed up under the debt relief initiatives. While it would be expected that in response the government will continue to make efforts to increase its domestic resource mobilization, the earlier discussion showed that there will be clear limits to the size of domestic resources that can be generated. And as we further explain later on, although scope may exist for reallocating expenditures within the national budget, the will to make hard reallocation choices to priority areas will most likely be found wanting; pro-poor expenditure switching will be limited in practice, unless perhaps external impetuses are exerted.

In the medium term Zambia will need to significantly supplement the rather limited domestic resources with those provided by donors. A key issue is therefore about the terms on which Zambia will receive these external resources – whether as grants, or as loans. The FNDP intention is clear; government intends to make every effort to mobilize additional resources to achieve the goals of the Plan. The viability of this strategy for financing development has been commented on in many parts of this paper. Basically,

it is clear to see that an increasing preference for grant (ODA) financing to invest in the FNDP and MDGs will be inevitable. Naturally, the issue is then one of trying to forecast the size and predictability of future aid inflows. And what should Zambia do if that grant financing is insufficient or unpredictable?

Of course, considering that Zambia has been given a new lease of ‘life after debt’, new loans will increasingly become an option for development financing. The question is; will Zambia be able to borrow on a concessional basis? If it will, how much debt will it be able to successfully negotiate for and for how long? Section 5 attempts to provide answers to these among other questions.

On the other hand, there is the possibility that some amount of non-concessional (i.e., on market terms) borrowing will be undertaken. Then the concern will be that the debt may again build up to be an unsustainable future liability. It therefore becomes important to try and understand, if additional loans will be entered into what should constitute a ‘sustainable’ level of debt in respect of the human development imperative? The issues raised in the preceding three paragraphs are picked up again further below in Section 5 after a consideration of domestic debt issues.

A Global Problem Needs Global Solutions

From a global historical perspective, starting with the Mexican debt crisis of the 1980s, the international financial community using various debt relief instruments has been providing assistance to many debtor countries. The idea behind these policy instruments is to reduce external debt burdens of poor countries in order to foster growth, reduce poverty, and attain external viability. This assistance has taken the form of the provision of concessional financing from international financial institutions, debt relief from official creditors mainly in the context of Paris Club rescheduling, and, in some cases, through bilateral action by the creditors.

These measures have resulted in considerable success in alleviating the external debt burdens of many middle-income countries. Many poor countries, especially those in sub-Saharan Africa, continue to suffer from unacceptable levels of poverty and heavy external debt burdens owing to a combination of factors including imprudent external debt-management policies, lack of perseverance in structural adjustment and economic reform, deterioration in their terms of trade, and poor governance. In part, these observations have led to some changes in the thinking of the international financial institutions about when to view external debt as sustainable or not.

The Debt Sustainability Framework (DSF)

The International Monetary Fund (IMF) and the World Bank have designed a recent framework called the Debt Sustainability Framework (DSF), which serves as the IMF and World Bank’s new framework for managing debt of low income countries (LICs) early in 2005. The DSF applies only to LICs and excludes middle income countries.

Among the LICs, the DSF applies to those countries that have either never entered or already graduated from the HIPC initiative. Countries in between would have assessments based on both DSF and HIPC framework carried out. The difference between the HIPC and the DSF initiatives is that the former is backward looking, mainly dealing with historical debts, while the latter is forward looking focusing on the future capacity of countries to carry debts without compromising human development.

An important characteristic of the DSF is that, unlike the HIPC initiative, it is not used as a basis to calculate debt relief. The policy consequence of lower debt thresholds under the HIPC initiative was to flag the need for greater debt relief. Instead, the policy consequence of a lower debt threshold under the DSF is decreased access to lending in non-concessional terms and the need to finance remaining development and poverty reduction goals via grants, with the option of debt relief being ruled out.

Again unlike HIPC, the DSF does not rely on pre-set numerical indicators but rather on country-specific debt thresholds. The establishment of thresholds is arrived at through a method based on three pillars. The definition of debt thresholds is dependent on the quality of policy of the indebted country, assessment of actual and projected debt burden indicators based both on baseline and stress test scenarios, and a comparison of the country's debt burden against these indicators, leading to an overall assessment of the country's risk of debt distress. It is on this final conclusion that subsequent financing decisions are meant to be based. Country-specific debt thresholds are generated on the basis of the quality of their policy and institutional environments, measured using the Country Policy and Institutional Assessment (CPIA) methodology.

The CPIA system compares a country's institutional and policy framework against a set of pre-established criteria, receiving a score based on a particular view (defined by the World Bank) of what is considered a good performance. It can be commended for the practice of rating implemented rather than intended policy actions. Depending on their CPIA ratings, countries are placed into three categories (poor, medium and strong), and for each of the five fiscal measures used, are assigned a threshold debt level range.

The DSF makes important efforts to assess the future capacity of countries to carry debt without compromising human development. Though it is a considerable improvement over the backward-looking assessment system in the HIPC initiative, some important criticisms have been launched against the DSF. To begin with, greater clarity is needed on how the assessments are incorporated into the actual macroeconomic programs of the IMF such as the PRGF. The view is that the DSF is only weakly integrated into the financing programs of the IMF. In this sense, it is debatable whether human development is actually incorporated into debt sustainability considerations or for that matter, macroeconomic programs.

Secondly, many stakeholders, particularly at the national level in LICs have raised concern that the new DSF seems somewhat discriminatory and unfair, applying only to LICs and not to middle income countries. The framework has therefore not been fully

accepted in LICs as a tool for development. Moreover, the CPIA methodology, which is a key element for determining the country-specific debt thresholds, is said to not be transparent because its formulation or application has not been publicly available. Many commentators feel that the CPIA system is applied unevenly in practice, and are reluctant to accept this as the approach for determining the “goodness” of a countries policies and institutional environment. Moreover, the fact the CPIA process is a fairly closed one limited the appreciation of World Bank’s discourse policy on the Assessment²⁸. Greater transparency on the part of the World Bank in including stakeholders in the CPIA process, and sharing information about the CPIA methodology and results is called for if the DSF is to be widely accepted as a framework for establishing debt thresholds. In the absence of such transparency, considerable pressure to revise the DSF can be expected from many circles, some of whom will have simply misunderstood the DSF and the CPIA system.

4.3 Domestic Debt in Zambia

As is the case in many sub-Saharan African countries, domestic debt is not a recent phenomenon of the Zambian economy. The country’s history of borrowing domestically is perhaps as long as its post-independence economic history. However, due partly to the enormity of the external debt component until recently and for a long time, domestic debt issues were ignored in Zambia. In addition to this lackluster attention to domestic debt issues, the country did not have a formal domestic debt statement until 2003 because domestic debt was (and continues to be) managed and reported by different government institutions and departments within the government system. Domestic debt information is not centralized and the aggregates are not well known. The various components of the debt are kept in different institutions such as Treasury Bills at the Bank of Zambia, expenditure arrears at the Accountant-General’s Office, government guarantees and parastatal debts at the Department of Investment and Debt Management, MOFNP.

From a historical perspective, before January 1993, the Bank of Zambia used government securities to solve liquidity problems in the commercial banking system at a controlled interest rate. In the near hyperinflation situation, which started in 1992, the authorities undertook to fight inflation primarily to avert the impending hyperinflation. A cash budget system and opening of tender for government securities at market-determined interest rates were therefore conceived as the two policies for monetary and fiscal policy to control government spending and liquidity in the market.

Starting in May 1993, there was reportedly a systemic failure to meet the financing

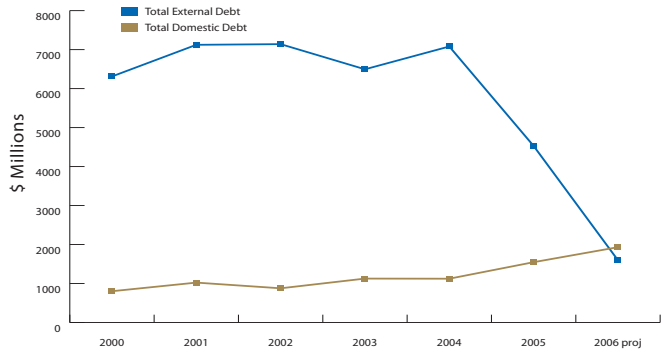
²⁸ On September 7, 2004, the Board approved the disclosure of the CPIA ratings for IDA-eligible countries. Beginning with the results of the 2005 exercise, for all IDA eligible countries the numerical scores for all the CPIA criteria, as well as the overall score, are disclosed as the IDA Resource Allocation Index (IRAI). This disclosure policy does not affect the IBRD countries.

of maturing debt and interest due on government securities. This in turn provoked the high cost of rolling over the maturities and interest. By December of the same year the cash budget had completely broken loose due to shortfalls on anticipated donor inflows. The government therefore resorted to borrowing from the Bank of Zambia in order to meet service obligations on domestic and external debt through bridge loans.

Considering that external debt levels have ultimately been drastically reduced, issues of domestic debt and its consequences are now coming to the fore in national and international debate. The authorities have had to face up to the problems created from years of rolling over domestic debt maturities and interest, and from maintaining, over a prolonged period, the cash budget which was originally intended as a very temporary solution. A major concern is that the service costs of domestic borrowing were historically much higher than the costs of servicing external debt. With the stock of Zambia's domestic debt projected to overtake the size of external debt (see Figure 4.4), issues of domestic debt and its costs must be paid close attention to.

Figure 4.4
Domestic and
External Debt
Dynamics

Source: Authors' own construction using MOFNP data



The average ratio of domestic debt in the region has increased only marginally to 26 percent of GDP during 2000-2005 from 25 percent in the 1980s²⁹. Although Zambia's total domestic debt has remained fairly stable over time, its domestic indebtedness is rather high by regional standards³⁰. Zambia has relied extensively on domestic debt, making considerable use of its government securities market and as a result, experiencing a sizable domestic debt burden.

29 The outlook of domestic debt in the 1990s in terms of the average debt-to-GDP ratio is not very clear due to data inconsistencies that were observed during the comparability and consistency checks (through data triangulations/data cross-matching exercises) in this study

30 The average debt-to-GDP ratio in the COMESA region for instance was about 15 percent during 2001-2003 (COMESA, 2004).

In connection with the development of the domestic debt market, Christensen (2004) observed that generally the domestic debt burden in [then] HIPC countries such as Zambia was significantly lower than in non-HIPC countries. He argues that this was indicative that HIPCs, which almost by definition, had relied heavily on foreign financing, had not developed their domestic debt markets to the same degree as non-HIPCs.

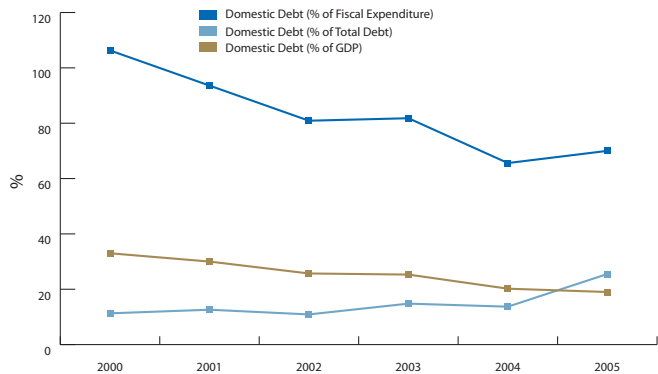
Interestingly, in Zambia, extensive use has been made of the domestic debt market. Mainly the impetus for domestic borrowing has been the financing of fiscal deficits, the financing of monetary policy and the payment of interest charges on public works and statutory contributions. Occasionally, domestic borrowing was also resorted to for financing external debt servicing when external pressures mounted.

The recent upward trend from 2004 (see Figure 4.4) is a source of some concern because, given its ambitious developmental and poverty reduction programs, the country could easily become more heavily domestically indebted as it attempts to finance much needed expenditures out of domestic sources.

A closer look at selected debt indicators however reveals that domestic debt has been on a downward trend in nominal GDP and fiscal spending terms (see Figure 4.5). The increase in the domestic debt-to-total debt ratio is mainly on account of the drastic reduction in external debt. Although these outturns are largely encouraging, they are still considerably below the expectations of the International Financial Institutions. The IMF indicates that, in line with the MTEF, government domestic borrowing needs would be reduced to about 0.5 percent of GDP by 2007, to show spending discipline. Considering the governments borrowing outturn, which increased the total domestic debt stock by 18.4 percent in 2005 implies a total stock of 19 percent of GDP that year, the country still has a long way to go to satisfy the IMF domestic borrowing requirements.

Figure 4.5
Domestic Debt
Indicators

Source: Authors' construction using MOFNP data



Domestic Debt Composition

The composition of domestic debt in Zambia is in terms of:

- Government securities (i.e., Treasury bills (TBs) and government bonds);
- Borrowing from the banking system (including BOZ);
- Outstanding debt to suppliers of goods and services;
- Called up guarantees and parastatal debt, and;
- Outstanding statutory payments (i.e., pension contributions and litigation against GRZ).

4

According to the Ministry of Finance and National Planning, the residency of the creditor defines domestic debt in Zambia. Therefore, even if debt is denominated in foreign currency and the creditor is domiciled in the domestic market, the debt is understood as domestic debt. The structure of Zambia's domestic debt is highlighted in Table 4.1. Government securities (Treasury bills, GRZ Bonds and Central Bank Loan and Advances) are historically the largest part of domestic debt – accounting for 57 percent of the debt in 2005 – followed by consolidated bond and then domestic areas. The main holders of overall official domestic debt in the Zambian debt market are the non-banks institutions, holding about 47 percent of all outstanding domestic debt in 2005. Obviously, the government has relied more on deferring payments falling due to pensioners and goods and services suppliers, and settlements of awards, compensations and contingent liabilities than on borrowing from commercial banks and the Bank of Zambia. The latter institutions accounted for 37 and 17 percent, respectively, of total domestic debt in 2005.

Table 4.1: Domestic Debt Structure (K' billions)

	2000	2001	2002	2003	2004	2005	period avg.
Government Securities	1,533.2	1,820.3	1,700.0	2,261.7	2,522.6	3,242.5	2,180.1
BoZ Kwacha Bridge loan to GRZ	186.3	221.2	467.8	261.0	82.0	289.0	251.2
Consolidated bond	989.7	1,174.9	1,233.5	1,646.7	1,646.7	1,646.7	1,389.7
Domestic arrears	335.2	397.9	433.6	578.9	557.4	509.3	468.7
Pension Arrears	215.3	255.6	270.7	322.1	344.3	414.0	303.7
Contingent liabilities	6.1	7.2	6.2	15.0	15.0	0.4	8.3
Awards and compensations	51.0	60.5	70.0	100.7	58.4	87.5	71.4

Source: various MOFNP Economic Reports

Specifically in terms of government securities, commercial banks are the largest holders of this debt category with 59 percent of government securities. The Bank of Zambia holds 27 percent of securities largely due to restructuring of part of the government's debt to the Bank into bonds while the non-bank public holds 14 percent.

While the commercial banks enjoy a relatively high income from government securities, their large holdings of these securities also reflects some fundamental shortcomings in their commercial banking operations (Christensen, 2004) as well as shortcoming in the broad financial policy environment. These shortcomings include institutional weaknesses that undermine lending to the private sector given ineffective screening and monitoring capabilities of loans, a small amount of reliable information on creditworthy borrowers, and weak legal systems (such as the absence of commercial courts to settle payments disputes). These weaknesses combined with high interest rates on government securities in the past made commercial bank lending to the private sector considerably less attractive than holding financial assets in securities. In that sense, private investment was considerably crowded out, ultimately compromising prospects for growth. The core reasons have yet to be established for commercial banks' continued holding of large amounts of government securities even after real interest rates have declined considerably (e.g., from 14.3 percent in 1995 to 0.6 percent in 2005).

When one considers the Zambian company tax rate structure, it is even more surprising that commercial bank subscriptions to government securities remain so high. Langmead et al (ed) (2006) highlights that commercial banks are subjected to the highest company tax rates among enterprises operating in Zambia. Commercial banking income is taxed at the standard company tax rate of 35 percent for banks earning incomes of less than or equal to K250 million and an increased rate of 45 percent for banks above K250 million. Against observations of high economic rent associated with large interest rate spreads (i.e., high base lending rate and low base deposit (or savings) rates), the authorities' rationale for imposing a higher tax rate on high income earning banks was that this would "cream-off" some of the economic rent. Apparently this has not worked as well as the authorities had anticipated since the environment is presumably still conducive enough for banks to buy into government securities instead of lending to the private sector and remain in business.

On the other hand, though the non-bank sector is seen to be the biggest holder of debt, often this segment is probably not a willing party to being a domestic debt creditor. As highlighted above, the government is able to "borrow" from the non-bank sector by simply delaying payments to retirees, retrenched persons, goods and services providers, and other such economic agents to which government can make deferred payment.

4.4 Benefits of Frontloading, and Cost Implications of Domestic Debt

In the dominant economic policy generally ascribed to theories of Keynesian economics,

there is tolerance for fairly high levels of public debt to pay for public investment in lean times, which can be paid back with tax revenues that rise in the boom times. Through the proliferation of this theory in the 1930s globally, many nations took on public debt to finance large infrastructure capital projects such as highways or large hydroelectric dams. The thinking was that this would initiate a virtuous cycle and a rising business confidence since there would be more workers with money to spend.

Benefits of Frontloading

Given the financing gaps entailed by the current design of national developmental programs and anticipated difficulties in future financing (e.g., limited concessional external borrowing, uncertain ODA inflows, limited tax revenue avenues domestically, etc) as Zambia strives to implement the FNDP and ultimately achieve the MDGs, it is fairly obvious to see why Keynesian-type economics focused on domestic borrowing may be politically attractive. Taking on more debt would allow the frontloading of targeted public investment in key areas.

Following along similar lines of argument, Roy et al (2006) assert that although there is inconclusive evidence on whether or not public investment in infrastructure has a significant positive impact on growth, there is a strong consensus on the positive effect of infrastructure investment on productivity and output in different regional and sectoral settings. This suggests that “well designed public investments, including infrastructure, do have a direct positive impact on the MDGs” [p.i].

Based on such Keynesian-type economic principles, many observers therefore argue that the benefits of frontloading certain priority development investments in terms of the associated potential for making faster strides towards meeting developmental goals within set timelines justifies taking on more domestic debt (see, Weeks and McKinley, 2006; Christensen, 2004, Adam et al, 1999).

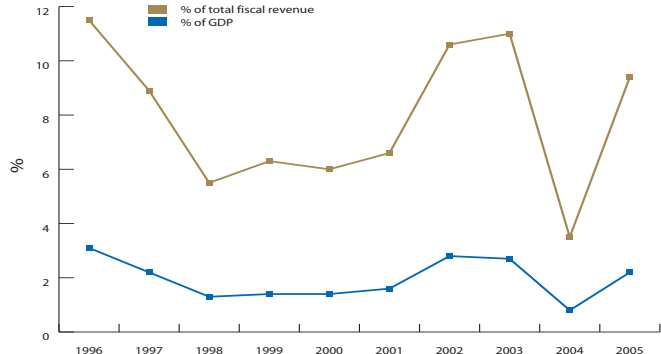
Domestic Debt Service Cost Issues

A key concern regarding domestic debt management is the cost, in terms of interest payments to the budget. Domestic interest payments are sizeable compared with revenues and GDP.

Over 1996-2005, average interest payments on domestic debt as a percent of revenues have been fitful with some significant and alarming increase in some periods (see Figure 4.6). And as interest repayments on external debt continue their HIPC-aided downward trend, it seems likely that the domestic interest repayments burden will become more severe. In 2005, domestic interest payments increased sharply to almost 10 percent of Zambia’s revenue.

Figure 4.6
Interest Payments on
Domestic Debt

Source: Authors' construction
 using MOFNP data



It is quite clear that domestic debt has fast become a significant problem in Zambia because while both the domestic debt stock (relative to GDP and revenue) and real interest rates are declining, a significant repayment burden still remains. Moreover, the country's ambitions to address its Millennium human development challenges mean that new pressures to generate finance for its FNDP programs are only just beginning to mount. This is a strong likelihood of future domestic borrowing and an increase domestic debt stock. For example, it has been reported that although the servicing cost of domestic debt has started to decline recently due to lower real interest rates, the volume of government issued securities is still rising.

Notwithstanding the growth and poverty reduction benefits that can be realized from the targeted use of government borrowing, Zambia also remains vulnerable to interest rate rises which would significantly increase the cost of servicing its internal debt. A rapid sensitivity analysis of domestic debt payment obligation to real interest rate changes (i.e., changes in the difference between the interest rate and the inflation rate) shows that service costs are very sensitive to real interest rates (Table 4.2).

Table 4.2: Sensitivity Analysis of Domestic Debt Service Costs to Interest and Inflation

Meta-data:	(1)	(2)	(3)	(4)	(5)
	Scenario 1: Avg (1996-2000)	Scenario 2: Avg (2001-2005)	Scenario 3: (Scenario 2 with moderate inflation)	Scenario 4 (Scenario 2; with low inflation)	Scenario 5 (2005 figs; with low inflation)
Weighted Average Treasury Bill Rate (WATBR)	36.5	21.7	21.7	21.7	16.5
Weighted Average Lending Base Rate (WALBR)	37.5	34.4	34.4	34.4	27.6
Average Lending Rate (ALR)	45.9	41.6	41.6	41.6	33.9
Average Savings Rate (ASR)	11.5	6.9	6.9	6.9	6.1
Real WATBR	12.4	2.4	6.7	12.7	7.5
Real WALBR	13.4	15.1	19.4	25.4	18.6
Real ALR	21.8	22.3	26.6	32.6	24.9
Real ASR	-12.6	-12.5	-8.2	-2.2	-2.9
Overall period average inflation	24.1	19.3	15.0	9.0	9.0
Domestic debt service costs (K' billion)	410.1	123.5	347.2	659.2	464.2
nominal GDP (K' billion)	10,071.9	23,846.4	23,846.4	23,846.4	32,648.6
Fiscal revenue (K' billion)	2,336.5	5,828.8	5,828.8	5,828.8	7,743.1
Indicators:					
Domestic debt interest payments (% of GDP)	4.07	0.52	1.46	2.76	1.42
Domestic debt interest payments (% of fiscal revenue)	17.55	2.12	5.96	11.31	6.0

Notes and Assumptions:

The real interest rate (real WATBR) is used as the proxy rate of domestic debt service, worked out as WATBR – Overall period average inflation.

The first two data columns (Scenarios 1 & 2) are based on actual historic data, with no projections. The last three columns (Scenarios 3, 4 and 5) are projections based on different assumptions about inflation and nominal interest rate outturns. Moderate inflation is defined as 15%, which is the end-year 2005 period figure

Low inflation is defined as 9 percent, which is among the lowest inflation rates that the Zambian economy has achieved in over three decades.

The real interest rate projections: in Scenario 2 assume 2001-2005 interest rates with 2005 inflation; in Scenario 3 assume 2001-2005 interest rates with low inflation; and in Scenario 4 assumes 2005 interest rates with low inflation.

Source: Author's construction using BOZ and MOFNP data

As would be expected, with high real interest rates (e.g., Scenarios 1 and 4), the domestic

debt interest payments (both as a percentage of GDP and fiscal revenue) would be very high. The opposite is equally true of low real interest rates (see Scenarios 2, 3 and 5). Scenario 4 highlights some important underpinnings about the potential service costs on domestic debt. If nominal interest rates should rise while inflation is kept at the current low levels, the real interest payment obligations would increase considerably to 2.8 percent of GDP and 11.3 percent of fiscal revenue.

Such payment obligations would further squeeze out priority investment in areas such as those identified in Zambia's FNDP. The considerable sensitivity of the domestic debt repayment costs to changes in the real interest rate is therefore well illustrated in the above table. It demonstrates that low inflation targets should be coupled with low interest rate targets. A situation that combines low inflation with relatively high interest rates (e.g., Scenario 4) would potentially bring significant domestic debt service costs to bear on the economy. Inflation movements and changes in the nominal interest rate readily translate into sizable domestic debt interest repayment movement, as a share of both GDP and fiscal revenue. In that regard, an important policy message is that strategies and policies for inflation management should be applied in tandem with measures for lowering interest rates on borrowing as well as managing the spread between lending and saving rates. Such measures have the potential to save substantial amounts of funds by averting some of the costs of domestic debt service.

The significant domestic debt problem, particularly the potential for incurring a huge repayment burden, raises concern about fiscal sustainability. Some observers have suggested that in the worst case, this problem may call for further reaching reforms on the domestic front. One option would be to pursue debt reduction schemes for domestic debt similar to the HIPC Initiative. Many have cautioned however that an outright reduction in domestic debt could increase the liquidity in the system and thereby endanger macroeconomic stability.

Another suggestion found in the literature (Weeks and McKinley, 2006; Christensen, 2004, Adam et al, 1999) is for the Zambian authorities to restructure domestic debt by extending the maturity structure of the debt. Alternative restructuring options have been suggested by the various commentators. These recommendations are against the background that Zambia's past debt markets have tended to be of short duration (273 day maximum on Treasury bills and 24 month maximum duration on bonds) (see, Table 4.1). The restructuring of government's domestic debt owed to the Bank of Zambia into a 10-year bond in 2004 is perhaps a step in the right direction³¹.

4.5 Domestic Resource Mobilization in Zambia

As has been discussed in a number of earlier parts of the paper, the scope for generating additional domestic revenue is currently relatively constrained. With a narrow tax base,

³¹ That is, assuming that Christensen's prescription is correct.

a regressive tax structure, low tax efficiency, and tax buoyancy that has reached its limit under the current circumstances, tax performance has stagnated below levels necessary for financing forthcoming development programs in the FNDP. Other (non-tax) revenue options do not contribute significantly to domestic revenue.

Some commentators have recommended taking on more debt while ensuring to restructure the domestic debt market. Although some of the specific suggestions for the restructuring have been debated and criticized, the fact is increased domestic borrowing with debt restructuring is a possible source of additional domestic resources.

On the other hand, many commentators argue that there is significant scope to reallocate resources toward priority (more pro-poor) sectors within the existing budget. For instance, officials in the Ministry of Finance indicated that there is significant room within the current wage bill ceiling (of 8.1 percent of GDP) to down-size some less priority areas and increase spending in priority health, education and growth sectors. Similarly Weeks and McKinley (2006) argue that there is scope of up to 3.3 percent of GDP to switch expenditure from General Public Services, Defense and Public Safety to priority areas for poverty reduction and meeting the MDGs.

Unfortunately, the political choices of the country in terms of budgetary allocation do not always reflect the priority pro-poor spending allocations required in various development plans (FNPDP, PRSP, TNDP). There seems to be little real political will to realize pro-poor allocations within the budget unless external impetuses are exerted (the example was earlier given about how priority poverty reduction spending in health sometimes has to be forced (see Figures 1.2 and 1.3 presented earlier)).

It will be critical in Zambia's development and poverty reduction process for the authorities to muster the political will to make hard choices that shift resources to priority poverty reduction spending. In this regard, it will be important to improve the integration of the MTEF framework with the National Development Plan (NDP) and sectoral plans. Given that the NDP and sectoral plans are a closer reflection of the true costs of development and meeting the MDGs, the national financing framework – the MFET – should be the one to respond to the requirements of these plans, not the other way round. In this sense, even in the circumstance of constrained availability of additional domestic resources, political choices will be based on pro-poor and MDGs-consistent plans which will foster appropriate allocation of national resource to priority poverty alleviation areas.

5 Future Financing and Debt Sustainability in Zambia

5.1 On Future Debt in Zambia: National Authority and Creditor Views

In Section 4.2, two important issues were raised; (a) about Zambia's prospect for future borrowing and on what terms (i.e., from concessional and non-concessional sources); and (b) about how much more/less borrowing space the country might realize (on both concessional and non-concessional arrangements) and for how long. These two aspects are considered in more detail in this section.

Firstly, how much debt will Zambia be able to successfully negotiate for as concessional borrowing? The answer to this question depends on the agency that one considers. For instance, in the FNDP the MOFNP has indicated that external loans will average 1.0 percent of GDP or US\$ 160 million per annum, inclusive of already existing loans that are programmed to be disbursed over the implementation period of the FNDP. New external borrowing is expected to be in the region of US\$ 50 to 60 million per year, mostly in the form of concessional loans from the World Bank and the ADB. Beyond the time horizon of the FNDP (i.e., 2006-2010), the outlook on further concessional borrowing is not clear.

On the other hand, according to the IMF, new external borrowing by the Zambian government will be required to remain in line with trends that form the basis of projections in the 3-year PRGF-supported program, partly reflecting a shift to greater donor assistance in the form of grants (ODA). Thus, new external borrowing, excluding IMF disbursements, is assumed to be about US\$120 million a year over the medium term, mostly from IDA and the African Development Bank. This figure would fall to US\$105 million in 2009, as a greater share of donor assistance comes in the form of grants. From this level, new external borrowing will remain constant in real terms from 2010 onwards.

According to the Ministry of Finance (MOFNP 2004c), the bilateral partners perform better than the multilaterals on "condition precedent" in that they have fewer conditions which are less difficult to comply with. Thus, as a strategy, the authorities declared that "it is recommended that countries like China and Belgium be pursued for assistance as they have proved to be non-conditional in their deliverance of aid". In this regard, in August 2007, the Chinese government approved a US\$39 million loan to Zambia for infrastructure development, mainly road construction (see also, MOFNP ranking or Donors/Creditors in Table 5.1 below).

Table 5.1: MOFNP Ranking of Donors/Creditor

Priority Rank	Bilateral	Multilateral
Priority 1 - Grants	Canada	AfDB/ADF
	Denmark	EU
	Netherlands	IDA
	Norway	OPEC
	Sweden	IFAD
	Ireland	
	Finland	
	Japan	
	Belgium	
Priority 2 - Grants	UK (DFID)	BADEA
	USA	
	German	
	Brazil	
Priority 1 - Loans	China	ADF
	Belgium	EDF
		IDA
		IFAD
Priority 2 - Loans	Kuwait Fund	BADEA
	Saudi Fund	OPEC
		IMF
		NDF
		AfDB
		EIB
		IBRD

Source: MOFNP (2004c)

Comparing the perspective of creditors (signaled by IMF views and assumptions) with that of the national authorities, it is clear to see that in principle the government is willing to take on only 42 to 50 percent of the concessional borrowing that has been indicated as available to Zambia by donors.

Whether the above is a realistic stance or not is debatable. Parastatals such as ZESCO and ZAMTEL have highly ambitious investment plans. During 2006-2008, it is expected that the operations of utilities in the energy and telecommunications sectors (i.e.,

ZESCO and ZAMTEL) will be improved through commercialization. Furthermore, ZESCO's Power Rehabilitation Project entails major developments and investments in the energy sector such as the development of the Kafue Gorge Lower power station (at an estimated cost of US\$600 million) and the Kariba North Bank (at a cost of US\$300 million). Other large capital investments include the rail infrastructure projects that are planned in the Infrastructure chapter of the FNDP.

The core FNDP cost estimates exclude the above-mentioned very large capital programs, which are expected to be financed through private public partnerships or wholly private capital. Thus, while the IMF and the authorities have made room within the borrowing plans to provide ZESCO some breathing space to build a track record of credit worthiness, the new borrowing on concessional terms (mainly from the World Bank) guaranteed by the government is permitted only up to US\$40 million and this was only until the end of 2005 (IMF 2005). Looking ahead, the prospects of attracting private capital to fill the investment gaps are very unclear. Should private capital not be forthcoming, pressure for recourse to non-concessional borrowing to meet the investment requirements may become significant.

This raises the possibility that some amount of non-concessional (i.e., on market terms) borrowing will be undertaken. According to Harding (2006), the issue of free-riding by some non-concessional creditors on the HIPC and MDRI debt relief is coming to the fore. This can be seen to some extent by the interest of commercial/investment banks in Zambia's short-term securities markets. Several financial institutions are also looking to offer longer term non-concessional lending to the government or quasi-government institutions (e.g. parastatals such as ZESCO), who have highly ambitious investment plans. The temptation to take up these offers of financial support will be difficult to resist for a government that wishes to meet public expectations of rapid improvements in the provision of public goods and services, including infrastructure.

The concern here is that the debt may again build up to be an unsustainable future liability. It therefore becomes essential to understand, in respect of the human development imperative, if additional loans will be entered into what should constitute a 'sustainable' level of debt? This question raises sufficient room for us to argue that the concept of debt sustainability should not be limited to financial viability of debt repayment, but should be re-looked at, within the context of meeting the MDGs.

5.2 Aid Trends to Zambia – Donor Views on Prospects

It is widely understood that the IMF influences greatly the prospects for aid in any given country given the signals it sends on macroeconomic stability. The role of the IMF in providing signals to the rest of the international donor community about the consistency and coherence of a recipient government's macroeconomic program is well established. In most LDCs that are following a PRGF program, this is principally operationalized in the form of the regular PRGF review missions and associated IMF Board papers. These

are, as the IMF recognizes and intends, extensively scrutinized by donors for evidence of continued government commitment to “sensible” macroeconomics and agreed reforms and hence some assurance that donor resources disbursed to a multitude of programs, but mainly projects, will contribute positively to developmental objectives and outcomes (Harding, 2006).

It is therefore clear that the IMF’s signaling role – through its assumptions and projections about policy and macroeconomic commitment as well as specific assumptions about required aid outturns – is critical for donor decisions about whether or not to scale up aid flows to Zambia. Naturally, it is therefore important to see how the IMF has set the aid assumptions within its macroeconomic programs.

Goldsbrough and Cheelo (2007) find that the initial IMF programs were based on conservative assumptions about future aid, once account is taken of the unusually low starting position following the 2003 slump in aid (see Table 5.2). This reflects earlier experience when performance-related disruptions to aid complicated macroeconomic policy.

Table 5.2: Selected Fiscal, Domestic Composition and Aid Trend Indicators, 2000-2006

	2000	2001	2002	2003	2004	2005	2006 est.
Fiscal (in percent of GDP):							
Grants	8.0	5.7	5.8	8.3	7.0	5.5	5.6
Revenues	17.7	19.4	19.2	17.9	18.0	18.3	17.4
Total expenditures	26.5	27.9	29.7	27.2	27.1	23.2	23.0
Overall balance, before grants	-12.0	-12.7	-13.8	-14.6	-13.5	-7.2	-8.2
Overall balance, after grants	-4.0	-7.0	-8.0	-6.3	-6.6	-1.7	-2.6
Domestic Composition (in Percent of GDP):							
Gross capital formation*		20.1	22.9	26.2	25.4	27.0p	30.5 p
Public*		11.9	11.8	11.5	9.9	9.4 p	10.0 p
Private*		8.2	11.1	14.7	15.5	17.6 p	20.5 p
External Sector:							
Total external aid inflows (US\$ million)**			754.1	406.4	519.8	652	
Foreign Direct Investment (FDI) (US\$ million)**			(1,203.5)	(1,392.5)	(1,726.9)	(2,160.8)	
FDI (in percent of GDP)			2.3	2.6	2.6	3.0	

External current account balance, before grants (% of GDP)	-19.2	-20.8	-17.3	-15.9	-12.2	-11.8	-2.3
Gross external reserves (in months of imports of goods & services)	0.9	1.0	2.2	1.3	1.2	1.6	

Note: *p* implies projections based on AfDB/OECD (2005) calculations

Source: IMF documents, AfDB/OECD* and **FNDP

Subsequent programs incorporated the rebound in aid that occurred in 2005 (helped by the finalization of HIPC debt relief), but still included rather conservative baseline assumptions about aid prospects for the medium term, projecting that aid would remain flat in dollar terms. In effect, these later programs assumed the level of aid would plateau at its existing level or would decline slightly.

Thus though higher levels of non-debt ODA would be welcome, the IMF is conservative in its program assumptions, anticipating stagnation and declines in external aid over time. This is in sharp contrast with fundamental commitments made in the HIPC initiative that debt relief would not replace ODA and further commitments in the Gleneagles Summit that donor aid to Africa would be doubled.

The inherent risk in the IMF's conservative position is that other donors may start to raise concern about whether Zambia can manage to absorb increased aid flows and use them effectively. Indeed, with an understanding by some donors that the role of the IMF is to highlight the risks and the potential benefits of increased aid in Zambia, these donors already feel that should the risks of aid scale-up outweigh the benefits then they should withhold additional aid flows. This withholding of aid should be maintained until the conditions for the effective use of such resources are put in place. Furthermore, similar concerns of particular relevance to Zambia have been raised by David Bevan of the Centre for Study of African Economies (CSAE), University of Oxford (cited in Harding, 2006; p.2):

- “If donors are prepared to raise aid to a country very substantially, is there a level at which it would be wise to turn some of this aid away/be selective about which aid to accept?”
- “Whatever the new level of aid is to be, how fast can aid prudently be increased from current levels?”

The real risk is that without a clear signal from the IMF to donors on the speed at which aid levels can be scaled up without compromising macroeconomic stability and without resulting in a further decrease in the efficiency and effectiveness of aid, the conservative

aid assumptions in IMF programs can easily be misconstrued as a signal to withhold aid or reduce commitments on grounds that the country does not possess the right environment for taking up more aid. Clearer and sharper signals from the IMF are required both within and outside its programs.

5.3 Role and Limitations of Private Finance

Table 5.1 above shows that the private sector is starting to play an increasingly more substantial role in the overall economy. Gross private sector capital formation is projected to have overtaken public sector formation, accounting for about 67 percent of total gross capital formation. Private investments have been mainly in mining, commercial agriculture, tourism and urban construction. The buoyant performance in agriculture and mining also supported manufacturing performance.

5

Despite the positive outturns in private sector participation in the economy, many sectors remain constrained by a series of bottlenecks, including the high cost of credit, the high cost base (mainly due to Zambia's landlocked status), administrative barriers and unfavourable duties on inputs compared to the rest of the region, which reduce competitiveness vis-à-vis neighbouring countries. Entrepreneurs and business associations have also complained about the lack of an overall vision and of a long-term development strategy, which translates into an inadequate/outdated regulatory framework. This includes protracted delays in the approval of the new Investment Act. Various domestic and external efforts are being attempted to redress the bottlenecks and in many respects significant progress is being made. Observers expect that these initiatives together with spillover effects from continued investment in mining and agriculture will benefit private-sector activity in the medium term.

Finally, while overall outturns on private capital formation have become increasingly more favorable during 2002-2006, outturns in foreign direct investment (FDI) have improved only marginally from 2.3 percent of GDP in 2002 to 3 percent in 2005. This suggests that the contribution of FDI to the dramatic increases in private capital formation has been marginal. Like many sub-Saharan African countries, Zambia has just not been attractive as a destination for FDI.

5.4 The Loan Contraction Process

In the mid 2000s, the authorities in Zambia initiated a process to develop a new loan contraction strategy on external borrowing. The impetus for this effort came largely in the form of pressure from civil society, which pushed the government to realize that it is has the responsibility towards its citizens to establish the necessity and desirability of all loans. It is government's responsibility to negotiate beneficial and sustainable terms of repayment, to account for the success of loan performance, and to ensure that loan repayments do not curtail the country's ability to achieve the MDGs. To fulfill these responsibilities, the government needed a transparent, inclusive and accountable

mechanism of loan contraction and debt management; hence, the idea of formulating a Debt Management Strategy (DMS) was conceived.

Such strategies are important for protecting the country and its citizens from bearing the brunt of unscrupulous loans and deals. Zambia has had a number of bad experiences with the so-called Vulture Funds, which it could have been protected from had there been a debt management framework in place (see, Annex 4 cases for illustrations). These funds deprive the country of much needed resources.

While the DMS is widely recognized as an important element for loan contraction, particularly given Zambia's past debt experience, recent inquiries of the authorities revealed that little progress to date has been made in actually formulating a plan. No explanation could be obtained to highlight the sources of the delay.

This raises many questions about transparency and accountability in Zambia's loan contraction process. With the lack of transparency about debt contraction, the national authorities can enter into loan agreements without ever being held accountable for the funds once these are received or even for the performance of the loans. Similarly, creditors are able to grant loans even when they have little or insufficient evidence that the ventures they are supporting will be productive or support sustainable human development. The main problem in this overly closed arrangement is that the risks and losses associated with bad debts and debt repayment difficulties are passed on to the (sometime desperate) recipient country and its population.

Looking forward, it will be prudent for the national debt management authorities to take serious steps towards finalizing the DMS, as the DMS would be an effective mechanism through which transparent loan contraction processes are achieved. The formulation of the strategy should therefore equally follow a fully inclusive consultative process to foster greater transparency, accountability and national acceptance. Furthermore, the final DMS should ensure that all salient (legal, social and economic) features for effective and efficient debt management are contained in the strategy. A sound DMS will be important for preventing the accumulation of unproductive, unnecessary and costly external debts, and will also help to prevent corruption, bribery, fiduciary risks and leakages in loan contraction.

6 Conclusions and Recommendations

Towards understanding what makes for sound financing and debt strategies that are not only financially viable, but are also consistent with achievement of human development imperatives such as the MDGs, this paper has made several important observations. We offer these insights along with key recommendations as inputs to the debate on a renewed overall understanding of MDG consistent debt sustainability. In summary, the following are the main insights and conclusions:

Firstly, Zambia is clearly no longer in an external debt trap. Several illustrations have been given to show that the external debt has been brought down to financially sustainable levels (according to the conventional definition of “debt sustainability”). Related to this, the country’s growth and stability performance in recent times has been largely favourable; the country seems poised for even better performance in the future.

However, as reiterated several times in the paper, the growth that has been seen in recent times has failed to translate into meaningful poverty reduction. The poor have been marginalized in the growth process, being unable to gainfully offer their labour in employment since most of the country’s economic activities have anti-poor biases (i.e., are capital intensive and are therefore not pro-poor). In addition, Zambia’s prospects for spurring growth to the levels that are consistent with meeting the MDGs are severely constrained by several factors including: (1) various domestic policy failures (such as the lack of trade and commercial policies and strategies, protracted delays in formulating other policies and strategies, missing or incapacitated institutions, etc); (2) a limited ability to mobilize domestic resource – since tax revenue performance seems to be at its upper limit and non-tax revenues are meager; (3) supply-side rigidities and diversification constraints that impose narrow-based and inadequate growth; (4) domestic and external policy restrictions that limit further domestic and external borrowing; and (5) low external contributions to domestic development financing since FDI and ODA have not performed according to expectation. With all these constraints, the possibility of Zambia not meeting at least some of the MDGs cannot be ruled out.

While no longer heavily indebted, Zambia finds itself in an ‘MDG trap’ as it has insufficient access to financing resources. As already noted domestic resource generation is low and external grants continue to be limited despite the commitment of the Gleneagles G8 Summit. Meanwhile the new Debt Sustainability Framework and PRGF conditionalities do not allow the country to borrow (externally or domestically) to levels that would be adequate for financing development to the extent of achieving the MDGs.

As possible options for mitigating the threats to Zambia’s prospects for meeting developmental objectives, including the MDGs, we make the following recommenda-

tions:

- **Exploring alternative feasible fiscal options:** In considering external debt as a source of future financing for the MDGs, the IMF and the national authorities in Zambia should explore alternative feasible fiscal options. Following the extensive debt-relief that Zambia has received, experts believe that there are many fiscal paths that are consistent with avoiding renewed risk of debt distress. The IMF should do more to help Zambia's policy-makers in exploring the macroeconomic consequences of the various feasible paths. A key question in such assessments should be how effective will any additional spending be? Answers to this question will require integrating the macroeconomic analysis and programs with a consideration of sector-specific and broader development plans.
- **Rationalizing permissible new external borrowing:** Similarly, more efforts will be required of the national authorities and the IMF to adequately and transparently rationalize the principles and assumptions that govern the levels at which permissible external borrowing has been set. The CPIA approach of the World Bank and the DSF approach of the World Bank and IMF have been criticized for lacking clarity about how far they are integrated into the macroeconomic programs and actually incorporate human development into the programs. There have also been concerns about differential application of the DSF and CPIA system as well as lacking transparency about the CPIA system. All these issues should be resolved by the IMF and for the sake of national acceptance by the national authorities and other national stakeholders.
- **Reconsideration of the international definition of debt sustainability:** Although this paper has not provided an explicit understanding or definition of the "right" or sustainable level of debt, it has shown empirically that inconsistencies between macroeconomic program objectives and financing requirements entailed in development plans calls for a reconsideration of the national and global understanding of debt sustainability. International developmental agencies should intensify efforts to formulate a new definition of debt sustainability that fully include consideration of the human development imperative. It should be recognized that while financial viability and absorption effectiveness are important for debt management, increased priority spending and expenditure mixes that strike an appropriate balance between administrative, productive and social sector spending are essential for a far greater outcome, namely human development.
- **Appropriate prioritization of poverty reduction spending:** In relation to the point above, re-allocating money away from less priority sectors such as defense (which is currently capturing increasingly larger shares of the national budget in the MTEF) to MDG spending such as in health (which is actually losing out

under the current framework) is strongly recommended as a salient strategy for improving financing to the MDGs. Commitment to the MDGs will have to be backed up in practice by pragmatic steps in allocating more resources to priority MDGs area.

- **Formulating internal debt management strategy:** The importance of Zambia's own debt strategy cannot be overemphasized. Zambia's past experiences with external debt suggest that the national debt management authorities should take serious steps to finalize the DMS as the basis for loan contraction. Development of the strategy should follow a fully inclusive consultative process, which will ensure transparency, accountability and national acceptance, and will help to reduce corruption, bribery, fiduciary risks and leakages related to external debt and loan contraction. In addition, accounting for the funds released from debt relief efforts such as the MDRI, which is highly development oriented in principle, and ensuring that such funds are applied to the priority MDGs expenditure areas they are meant for will be critical elements of the overall debt management strategy in Zambia.
- **Sustaining macroeconomic stability:** The authorities supported by the IFI should continue with efforts to keep the country on a stable growth path. Macroeconomic stability (with low inflation and low lending interest rates) will reduce the costs of domestic debt servicing and will potentially make it more financially viable to increase domestic borrowing for investment.
- **Furthering Research:** Many domestic debt relief proposals have been variously made, including proposals for domestic debt restructuring as the basis for further domestic borrowing domestically and outright domestic debt reduction initiative (similar to the HIPC). Given the on-going debate about the viability and appropriateness of domestic debt relief (with fears by some that such options may increase the liquidity in the system and thereby endanger macroeconomic stability), there is need for further research in this area.
- **Addressing domestic imbalances and inconsistencies:** Domestically, many imbalances need further redressing. For instance, now that private investments in the mining sector have fully taken root, the government should explore options for closing the tax benefits (rebates, holidays, etc.) that have been given to mining companies and use the extra taxes for additional financing to the FNDP/MDGs.
- **More on tax policies:** Still on the domestic front, tax policy should be revised towards transforming the tax system to a more progressive one. Tax revision options may include increasing taxes on luxury imports, improving the progressiveness of consumptive taxes such as VAT and of direct taxes such as P.A.Y.E, and so on.
- **Paying attention to specific sectors:** In agriculture, given the large number

of rural poor persons and households that depend on the sector for a livelihood and considering the need to increase decent employment and the growth/poverty elasticity, prioritization of the agriculture sector should be realized through greater public investments into the sector, ensuring to improve the technology of agricultural inputs such as seeds, fertilizers, pesticides, vaccines, etc. and enhance the technical competences of agricultural and related systems (such as extension service systems, micro-financing and credit systems, transport systems, cooperative systems for enhancing markets access, etc.).

- **Sustaining private sector development:** The notable progress towards creating private-public partnerships and enhancing capacity for private investments, export trade and domestic trade through efforts such as the Private Sector Development Program and Zambia's involvement with the Integrated Framework for Trade Related Technical Assistance is commendable and should be continued in the interest of furthering capacity strengthening in the various sectors and institutions.
- **Enhancing donor support:** Externally, in relation to ODA the role of donors should be to foster an effective scaling up of aid. They should use their greater resource endowment and information advantage to push for the government to muster a strong will in making hard political spending choices and establishing appropriate institutions and conditions for the effective and efficient use of additional aid. However, donors should also provide time-consistent prior information about when resources will be made available and likely volumes so that this information can be effectively incorporated into medium-term planning and budget processes. Donors should also ensure a fair degree of predictability that committed aid will be converted into disbursed aid.
- **Signalling of the IMF:** The IMF also has an important role to play in setting the international size, pace and sequencing of ODA. As the main IFI changed with signalling, the IMF should send clearer and sharper signals to donors on the speed at which aid levels can be scaled up without compromising macroeconomic stability and without resulting in a further decrease in the efficiency and effectiveness of aid. In this respect, the conservative aid assumptions inherent in IMF's PRGF programs bear the risk of being misconstrued by donors as a signal to withhold aid or reduce commitments on grounds that the country does not possess the right environment for absorbing additional ODA.
- **Costing the MDGs:** Related to the above, the national authorities jointly with their developmental partners should continue with efforts to understand the true costs of developmental commitments and plans such as the FNDP and MDGs. FNDP/MDGs resource mobilization efforts should be guided by insights on the real costs of plans, programs and initiatives.

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Annex 1: The Millennium Development Goals and Targets

GOAL 1 Eradicate poverty and hunger	Target 1 Halve between 1990 and 2015 the proportion of people whose income is less than US\$1 per day. Target 2 Halve between 1990 and 2015, the proportion of people who suffer from hunger.
GOAL 2 Achieve universal primary education	Target 3 Ensure that by 2015, children everywhere, boys and girls alike, will be able to complete a full course of primary schooling.
GOAL 3 Promote gender equality and empower women	Target 4 Eliminate gender disparity in primary and secondary education, preferably by 2005 and in all levels of education no later than 2015.
GOAL 4 Reduce child mortality	Target 5 Reduce by 2/3 between 1990 and 2015, the under-five mortality rate.
GOAL 5 Improve maternal health	Target 6 Reduce by three-quarters, between 1990 and 2015, the maternal mortality ratio.
GOAL 6 Combat HIV/AIDS, Malaria and other diseases	Target 7 Have halted by 2015 and begun to reverse the spread of HIV/AIDS. Target 8 Have halted by 2015 and begun to reverse the incidence of Malaria and other major diseases.
GOAL 7 Ensure Environmental sustainability	Target 9 Integrate the principle of sustainable development into country policies and programs and reverse the loss of environmental resources. Target 10 Halve, by 2015, the proportion of people without sustainable access to safe drinking water and basic sanitation. Target 11 Have achieved by 2020 a significant improvement in the lives of at least 100 million slum dwellers.

<p>GOAL 8 Develop a global partnership for development</p>	<p>Target 12 Develop further an open, rule-based, predictable, non-discriminatory trading and financial system (including a commitment to good governance, development, and poverty reduction - both nationally and internationally).</p> <p>Target 13 Address the special needs of Least Developed Countries including tariff – and quota-free access for Least Developed Countries’ exports, enhanced program of debt relief for Heavily Indebted Poor Countries (HIPC)s and cancellation of official bilateral debt and more generous official development assistance for countries committed to poverty reduction.</p> <p>Target 14 Address the special needs of land-locked developing countries and small island developing states (through the program of action for the sustainable development of small island developing states and 22nd General Assembly Provisions).</p> <p>Target 15 Deal comprehensively with debt problems of developing countries through national and international measures in order to make debt sustainable in the long term.</p> <p>Target 16 In cooperation with developing countries, develop and implement strategies for decent and productive work for youth.</p> <p>Target 17 In cooperation with pharmaceutical companies, provide access to affordable essential drugs in developing countries.</p> <p>Target 18 In cooperation with the private sector, make available the benefits of new technologies especially information and communication technologies.</p>
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Annex 2: MDGs Progress Status at a Glance – on progress towards the MDGs

Table A1: Zambia’s progress towards the MDGs (2003-2005)

Goal	Will target be met		State of national support	
	2003	2005	2003	2005
Extreme Poverty	Unlikely	Likely	Weak but Improving	Strong
Hunger	Unlikely	Likely	Weak but Improving	Good
Universal Primary Education	Potentially	Likely	Strong	Strong
Gender Equality and Women Empowerment	Potentially	Likely	Fair	Good
Child Mortality	Potentially	Potentially	Fair	Good
Maternal Mortality	Potentially	Unlikely	Weak but Improving	Weak
HIV/AIDS	Potentially	Likely	Fair	Good
Malaria and other Major Diseases	Potentially	Potentially	Fair	Good
Environmental Sustainability	Potentially	Unlikely	Weak but Improving	Good
Water and Sanitation	Potentially	Potentially	Weak but Improving	Good

Source: Adopted from UNDP (2005), with modifications

Table A2: Summary of Zambia’s progress towards the MDGs

Summary:	No. of Goals with indication	
	2003	2005
Likely	0	5
Potentially	8	3
Unlikely	2	2

Source: Adopted from UNDP (2005)

Annex 3: Interim Performance Assessment Framework (iPAF) Indicators

Table A1: Performance in Education, Zambia

Indicator	Definition	Source	Baseline	Target	Actual	Target	Comments
			2003	2004	2004	2005	
Net primary enrolment for girls (grade 1-7)	Enrolment of the official (girl) age group for a given level of education expressed as percentage of the corresponding population.	MOE- Data Base	69.4%	72.8%	84.7%	74.5%	All (revised) targets are met. A number of factors have contributed to this success, including the improvement of the data base, but also the construction of new classrooms. In total, there are 16 indicators that comprehensively cover the education sector. Inclusion of additional indicators of education system quality in iPAF being considered
			Revised 76.4%	Revised: 75.4%		Revised: 85.5%	
Net primary enrolment for boys (grade 1-7)	Enrolment of the official (boy) age group for a given level of education expressed as percentage of the corresponding population.	MOE- Data Base	71.8%	74.6%	85.7%	76.0%	
			Revised 78.8%	Revised 77.3%		Revised: 86.5%	
Primary Completion Rate for girls (grade 1-7)	Students (girls) completing a specific grade minus repeaters in the grade by the official school-age population for the grade.	MOE- Data Base	51.6%	60.2%	65.8%	65.0%	
			Revised 58.2%	Revised 65.5%		Revised: 67.0%	
Primary Completion Rate for boys (grade 1-7)	Students (boys) completing a specific grade minus repeaters in the grade by the official school-age population for the grade.	MOE- Data Base	64.6%	68.8%	78.3%	71.1%	
			Revised 70.5%	Revised 74.6%		Revised: 81.0%	

Source: Adopted from DFID Zambia, 2006. "Zambia: PRBS Annual Progress Report 2005", Final, March

Annex 4: Zambia's Experiences with Vulture Funds

Zambia's involvement with vulture funds is not new. For instance, it has involvement with Camdex International, an international commercial firm, stemming from 1988 when Zambia and Kuwait entered into a Deposit Agreement for road construction (Park et al, 2003). Some time after the agreement was entered into, in the early 1990s, Zambia, which had already experienced a history of debt repayment difficulties, began to default on scheduled payments on the Kuwaiti credit. In responses, the Central Bank of Kuwait, which was legally responsible for the loan on the Kuwaiti side, assigned all the debts due under the 1988 Deposit Agreement to Camdex International. Camdex International thereafter initiated a litigation process against the Bank of Zambia, which was at the time legally charged with managing the debt repayments on behalf of Zambia.

The Bank of Zambia appealed against Camdex International's litigation claims. In the Court of Appeal in *Camdex International vs. Bank of Zambia*, it was noted that written notice of the assignment was given to the Bank of Zambia, which did not dispute its debt to the Central Bank of Kuwait, or the amount due, but contested the validity and enforceability of the assignment under English law in circumstances where Camdex International knew, or ought to have known, at the date of the assignment that the underlying debts (in which Camdex International had no pre-existing interest) would have to be recovered by means of litigation.

The Court held that this did not make the assignment invalid or unenforceable. If a debt was bona fide, it did not become unassignable merely because the debtor chose to dispute it. In the absence of bad faith, suing on an assigned debt was not contrary to public policy, even if the assignor retained an interest. The Bank of Zambia's petition for leave to appeal to the House of Lords was dismissed (Dickinson, 2004).

Unfortunately for the Zambian people, who ultimately bore the full burden of the debt, the case of bad faith in the original contraction of the Deposit Agreement was never pursued. Essentially, what this means is that some unscrupulous persons in a strategic positions in Zambia signed for a loan from Kuwait, Zambia failed to pay back due to a host of factors³² and so Kuwait minimized its losses by selling the debt to Camdex International. The firm then sued Zambia in the English courts and won.

That odious debts were being contracted did not come into question. Most leads on this case suggest that no one could find the documents to show who agreed to the loan in the first place. It is actually claimed that no one knows who agreed to the loan. So while Kuwait and then Camdex International recovered their debt in full, the original

32 Some of these included: limited growth prospects due to a persistent economic downturn; poor performance of the loan with limited developmental impacts to the extent that the Zambian government became increasingly reluctant to honour the debt.

loan funds seem to have disappeared into thin air without anyone ever being held accountable for contracting the loan and managing the project funds.

More recently, litigation against Zambia was put into process in the English Court by a Vulture Fund, which saw the Zambian authorities mounting a defence to protect Zambia citizens from once again bearing the brunt of an unscrupulous debt whose origins and repayment dynamics are unclear. This time, more meaningful outcomes were realized due to the government's efforts and also the important email campaign on the vulture fund litigation against Zambia by Jubilee Zambia and Oxfam. This and the moral incorrectness of the vulture fund operations resulted in the following response from the British government:

Clearly, some members of the international community sympathize with Zambia and other least developed countries, given such experiences with Vulture Funds. As an internal solution for Zambia, a debt management strategy is therefore imperative for protecting the country and its citizens from the unscrupulous operations of vulture fund s and from incurring odious debt burdens in the future.

We share your sense of outrage about the activities of vulture funds and the problems they cause for countries that have received debt relief under the Heavily Indebted Poor Countries (HIPC) Initiative.

Zambia worked very hard to complete the HIPC Initiative and received significant debt relief under HIPC and the Multilateral Debt Relief Initiative (MDRI), reducing its external debt from \$7.1 billion in 2004 to \$0.5 billion at the end of 2006. It has used some of its savings from debt relief to abolish health fees in rural areas. As a result, thousands of people are receiving free healthcare. The behaviour of vulture funds undermines these successes and diverts much-needed resources away from the fight against poverty.

We congratulate the Government of Zambia on the strong defence it mounted in this legal case. This is the first defence in a case of this kind that has ever been even partially successful, and its impact will be felt across the world. Vulture funds cannot continue to expect to profit from the world's poorest countries.

We are determined to limit the damage done by such funds. The UK will therefore:

- call on the World Bank to make the IDA Debt Reduction Facility available to HIPC countries before they reach Decision Point, in order to help countries to eliminate their commercial debts at the earliest possible opportunity and thereby reduce the likelihood of debts being sold on to aggressive creditors;

- stand ready to scale up our contribution to the Debt Reduction Facility in support of this policy change;
- take forward talks with leading commercial creditors on a voluntary code of conduct that will set out the actions that responsible creditors should take to help reduce the risk of litigation, including the requirement to participate in collective action to reduce unsustainable debts;
- work with our G8 partners to develop a Charter on Responsible Lending that includes a commitment to protect developing countries from vulture fund activity;
- work to ensure that HIPC's have access to the legal assistance they need to defend themselves against litigation, including by supporting proposals at the African Development Bank to develop a Legal Assistance Facility to help countries facing legal action gain access to technical and legal support;
- continue to strengthen debt management capacity amongst HIPC's.

We continue to raise this issue in international fora. At the G8 Finance Ministers meeting on 18th May Ministers expressed their concern about the actions of some litigating creditors against Heavily Indebted Poor Countries and agreed to work together to identify measures to tackle this problem, based on the work of the Paris Club. We will continue to work with our international partners on this issue.

I hope this is helpful.

Yours sincerely,

GORDON BROWN

HILARY BENN

Source: http://www.hm-treasury.gov.uk/documents/international_issues/international_development/development_vulturefund

financing
development
debt 2015
poverty
sustainability goals
macroeconomic
millennium



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