

TRANSITION FINANCE CHALLENGES FOR COMMODITY-BASED LEAST DEVELOPED COUNTRIES: THE EXAMPLE OF ZAMBIA

Country pilot

Jieun Kim, Olivier Cattaneo, Arnaud Pincet and Konstantin Poensgen



OECD DEVELOPMENT CO-OPERATION WORKING PAPER 49

Authorised for publication by Jorge Moreira da Silva, Director, Development Co-operation Directorate

Background

In 2017, the OECD DAC launched work to understand the implications of economic transition in developing countries and to agree on best practices to support countries' development pathways in the SDG era (para 26). During its 1 February 2018 meeting, OECD DAC members mandated the DCD secretariat to implement a roadmap on transition finance and how it relates to countries most in need, including LDCs, LICs, SIDS, LLDCs and Fragile/Conflict Affected States. [DCD/DAC(2017)17] and [DCD/DAC(2018)4] A methodological paper is currently being developed in order to lay the ground for analytical work on transition finance in 2019-20 PWB.

The transition finance agenda is an important emerging component of the Financing for Development Agenda. The Addis Ababa Action Agenda calls to promote “integrated national financing frameworks” (para 9) – or strategies to finance economic transition within the context of the 2030 Agenda for Sustainable Development. The AAAA recognises that national financing strategies must be supported by international actors at all levels and tailored to different development contexts. As a growing diversity of country-led financing strategies emerge (e.g. UNDP DAFs, WB Systematic Country Diagnostics, Voluntary National Reviews, etc.), co-ordination among all development partners will be essential.

The Global Outlook on Financing for Sustainable Development (forthcoming 2018) provides the foundation of the OECD's revitalised, holistic approach to Financing for Sustainable Development (FSD). It highlights the importance of data, policies and concrete solutions to navigate the new global development finance architecture, and to ultimately maximise all forms of finance in support of inclusive and sustainable development. It provides new evidence to develop a broader understanding of the challenges that countries face at key stages of their development, and to study how development co-operation tools and instruments can best support countries through transitions.

To implement this new work, the OECD DAC called for policy analysis and recommendations at country-level (DCD/DAC(2018)4). The Zambia country pilot was selected to illustrate the key transition challenges of low-income countries moving towards the lower middle-income threshold. Further, Zambia belongs to the group of least developed countries (LDC), which are among the most vulnerable and most in need. For LDCs lack of funding is among the biggest challenges in their implementation of sustainable development targets (UN OHRLLS, 2017^[1]). For many LDCs, official development assistance (ODA) is the most important source of external financing and remains crucial for government expenditure.

Moreover, Zambia is a resource-rich country with a high reliance on copper mining. The forthcoming methodological paper shows that resource abundance can help countries gain better access to different sources of finance in the form of private investment and public revenues (OECD, forthcoming^[2]). However, the financing mix of resource-rich countries is often characterised by vulnerabilities. For example, due to excessive reliance on revenues from commodity exports, the financing situation for these countries is under stress during commodity price shocks. Easy access to finance during commodity price booms can also degrade the institutional quality of fiscal systems and the financial sector.

The Zambia pilot study can point development partners to areas to target external assistance so that it is better aligned with national financing strategies. A one week field mission

(October 29 – November 2 2018) was carried out with the support of the Zambian government and the Government of Ireland. A wide array of actors were interviewed during the mission, including members of the Zambian government, OECD DAC CPs, non-DAC CPs, private sector and civil society. The interviews contributed to understanding the roles of the different actors in the transition finance context.¹

The study is structured along the three dimensions: “**Assessing, Benchmarking, and Counselling**” or the **ABC’s approach**². Each component seeks to address a set of targeted questions, outlined below:

- **Assessing:** Where does Zambia stand in the transition along the development continuum? How has access to financing for sustainable development been impacted by the transition?
- **Benchmarking:** What are the substitution effects between public, private, domestic and international resources as the country transitions? How does this substitution of broader flows compare with country peers undergoing similar transitions? What lessons and best practices can be drawn from other country contexts?
- **Counselling:** How can development partners help the phasing out of ODA and secure the progressive growth of other sources of financing (e.g. private or domestic)? How could development partners help design long-term support strategies that go beyond ODA? How can development partners provide support to avoid setbacks when ODA is no longer an option? What kinds of capacity building efforts could be fostered by ODA to smooth the transition?

¹ A pilot on Chile is planned that will help contrasting the challenges of countries with similar abundance in one commodity (copper) but at different stages of transition.

² The forthcoming methodological paper proposes a Transition Finance Toolkit that is structured along the ABC dimensions (OECD, Forthcoming^[2]).

Table of contents

Background.....	3
Executive summary	8
1. Assessing: Where does Zambia stand in the transition?.....	10
1.1. Social and economic vulnerabilities have persisted despite sound economic performance in the 2000s.....	10
1.1.1. Zambia became a middle-income country after period of high growth	11
1.1.2. However Zambia is highly vulnerable to economic shocks	12
1.1.3. Zambia has relatively low levels of human development	16
1.1.4. Zambia has ambitious plans to overcome the development challenges	18
1.2. Zambia was not sufficiently prepared for the shift in financing resources	21
1.2.1. Zambia’s debt situation is alarming	22
1.2.2. The relative weight of official development finance (ODF) has declined	25
1.2.3. Private investment has a narrow focus	32
1.2.4. Domestic Resources are not growing quickly enough	34
2. Benchmarking: How to compare Zambia’s transition finance with other peer groups and countries?	36
2.1. Zambia’s hybrid status as both an LDC and LMIC is reflected in its financing mix	36
2.2. A more specific look: Zambia in comparison to regional and structural peers.....	38
2.2.1. Who are Zambia’s peers?.....	38
2.2.2. Rising debt levels across benchmarking countries put pressure on available financing resources.....	39
2.2.3. Official development finance is still important but may not be sufficient	43
2.2.4. Domestic public resources are below expectations	47
2.2.5. Private investment is an important source of financing but is heavily concentrated	50
2.2.6. Remittances are very low possibly leading to a financing gap in social sectors	52
3. Counselling: Recommendations for the DAC and its partners: Promoting mixed transition finance strategies	54
3.1. The Co-operative Approach: Managing debt while investing in socio-economic progress	54
3.1.1. Overcoming the risk of debt distress.....	54
3.1.2. Targeting social vulnerabilities with scarce sources official development finance	57
3.1.3. Strengthening governance for self-sustainable financing for development	59
3.2. The Competitive Approach: Making the most of domestic resources while promoting the diversification of the economy.....	60
3.2.1. Improve the enabling environment and investment climate.....	60
3.2.2. Increasing the mining sector’s contribution to sustainable development.....	61
3.2.3. Promoting private sector development for more economic diversification	65

Tables

Table 1.1. Government debt is increasing while commercial debt and Chinese debt make up the largest portion.....	25
Table 2.1. Zambia’s regional peers	38

Table 2.2. Zambia’s structural peers	39
--	----

Figures

Figure 1.1. Zambia’s per capita income level meets the LDC graduation criterion.....	11
Figure 1.2. Economic expansion was mainly driven by copper exports	12
Figure 1.3. Zambia has a high level of economic vulnerability, roughly on par with the LDC average.....	13
Figure 1.4. Zambia’s trade balance moves in tandem with copper prices.....	13
Figure 1.5. Trade, construction and mining are among the largest industries in terms of value- added.	15
Figure 1.6. The majority of the workforce is employed in the informal sector.....	16
Figure 1.7. Zambia has a low HAI, below the LDC graduation threshold.....	17
Figure 1.8. Budget revenue source composition	20
Figure 1.9. External finance has increased driven by FDI and especially debt.....	22
Figure 1.10. After Zambia benefited from HIPC initiative, debt levels are rapidly rising again	23
Figure 1.11. Debt servicing costs are rising rapidly, accounting for one third of domestic revenues...	24
Figure 1.12. Financing from bilateral DAC providers has decreased while multilateral providers picked up	26
Figure 1.13. Official development assistance is largely and increasingly allocated towards health.....	27
Figure 1.14. Health is the biggest priority for DAC providers, followed by energy, industry innovation, infrastructure	28
Figure 1.15. The share of loans in ODA is increasing reflecting the greater role of multilateral providers.....	29
Figure 16: Chinese development finance, USD current.....	30
Figure 1.17. The Blame Game – Cooperating partners have different perceptions that need to be reconciled	31
Figure 1.18. FDI flows have seen a sharp decline in 2016.....	32
Figure 1.19. In terms of GDP, FDI has recently declined from previously high levels	33
Figure 1.20. Domestic public revenues have been stagnant.....	34
Figure 2.1. Zambia’s external financing mix is over-reliant on long-term public debt.....	37
Figure 2.2. Zambia’s ODA receipts are located between LDCs and LMICs	37
Figure 2.3. Government gross debt increased across most benchmarking countries	40
Figure 2.4. External debt more than doubled in Zambia but volumes are substantially below those in Mongolia	41
Figure 2.5. Debt service costs have increased across benchmarking countries.....	42
Figure 2.6. The share of Zambia’s revenue going to interest payments has substantially increased ...	43
Figure 2.7. Official development finance relative to GNI signals differences between Zambia and its peers Botswana and Chile.....	44
Figure 2.8. ODF in Zambia is concentrated towards health	45
Figure 2.9. Financing gaps are more likely to appear in social sectors.....	46
Figure 2.10. Mongolia’s ODF receipts in mining outnumber its peers.....	47
Figure 2.11. Zambia’s tax revenue is relatively stagnant.....	48
Figure 2.12. Zambia relies more on income taxes than others and less on taxes from goods and services	49
Figure 2.13. Donor support to public finance management and domestic resource mobilisation is relatively large in Zambia.....	49
Figure 2.14. Zambia belongs to the top quartile in terms of FDI receipts among both LDCs and LMICs	50
Figure 2.15. FDI in Zambia has proven relatively stable over time	51

Figure 2.16. FDI largely targets natural resource sectors.....	52
Figure 2.17. Remittance inflow to Zambia is small	53
Figure 3.1. Zambia is a leading copper mining producer in the world but refined copper production leaves potential for growth.....	62

Boxes

Box 1.1. Historical Background	11
Box 1.2. What is in the Zambian 7th National Development Plan?	18
Box 2.1. Mongolia’s recent experience with public debt is comparable to Zambia.....	41
Box 2.2. Transition finance gaps and their implications for Zambia	46
Box 2.3. What DAC CPs do to support the mining sector in Zambia’s peer countries.....	46
Box 3.1. Managing Debt, what can the OECD do?.....	55
Box 3.2. What is happening on the CSR front in Zambia?	61
Box 3.3. How can CPs support local sourcing in the mining industry.....	62

Executive summary

After years of robust growth in the early 2000s, Zambia transitioned from the low-income to the lower middle-income (LMIC) category in 2011. However, Zambia still belongs to the group of least developed countries with persistently high levels of economic and social vulnerabilities. More than half of the population lives below the poverty line, while the Global Hunger Index 2018 ranks Zambia as the fifth hungriest country in the world. Moreover, Zambia has a high reliance on one single commodity, with more than 70% of exports being in copper. This exposes the national economy to volatile commodity price movements.

Zambia is undergoing a challenging transition with regard to its financing mix. With the reclassification to LMIC status, Zambia gained access to a wider range of financing options including international debt capital markets. The Government issued a series of Eurobonds starting in 2012, which amounted to a total of around USD 3 billion or more than 40% of public external debt.

At the same time, Chinese lending, especially in the form of export credit, plays a growing role in the country's financing landscape. In 2016, Chinese loans amounted to a quarter of Zambia's total external debt stock. Conversely, the share of concessional finance from DAC providers in the overall financing mix decreased, and the influence of DAC providers has declined accordingly.

This has implications on the costs of debt servicing and the prospects of restructuring. After having been one of the major beneficiaries of the Heavily Indebted Poor Countries (HIPC) and Multilateral Debt Relief (MDRI) initiatives in the early 2000s, Zambia is again in a situation that raises serious concerns around debt sustainability. External debt rose to levels as high as 65% of GDP and one third of all domestic revenues is devoted to debt servicing. Unlike in the 2000s, the majority of the debt is not held by Paris Club members, which can make a potential debt restructuring difficult.

Comparing Zambia to a group of peer countries highlights the challenges Zambia is facing. The pace of the increase in debt levels has been particularly pronounced in Zambia, and the implications on debt servicing costs have also been more severe. Growth in domestic public resources lags behind the rapid increase in government spending. Although official development finance still makes up a sizable portion of the country's external financing, Zambia receives less than countries with similar vulnerabilities. Moreover, official development finance is concentrated in health, with relatively less funds going to the infrastructure and production sectors.

The Government of Zambia set out the goal to become a "prosperous Middle-income Nation" by 2030. The ambitious National Development Plan will need to be backed by a sound and sustainable financing strategy that takes into account the transition challenges of Zambia's development finance landscape. OECD DAC partners can support Zambia to overcome these transition finance challenge and ensure continued progress along the development continuum. A strategy to accompany the country's transition should have two dimensions.

On the one hand, the country needs to build resilience against possible transition setback through good governance and social safety nets ("Co-operative approach"). CPs can accompany this process by providing targeted support for debt restructuring and management as well as public financial management and investment management, while ensuring that ODA contributes to strengthening domestic capacities in health and education systems to avoid socioeconomic risks.

On the other hand, Zambia has to continue efforts to generate self-sustained financing including through domestic public revenues. This will involve the development of a vibrant private sector, which will present a broad tax base. To support this aspect of the transition, CPs are encouraged to scale up support for private sector development and economic diversification, which can lead to foreign and domestic investment and ultimately more public revenues.

1. Assessing: Where does Zambia stand in the transition?

After years of robust growth in the early 2000s, Zambia transitioned from the low-income to the lower middle-income (LMIC) category in 2011. However, Zambia still belongs to the group of least developed countries and its middle-income country status masks stubbornly high levels of economic and social vulnerabilities.

- Excessive reliance on copper, which presents more than 70% of exports, exposes the national economy to volatile commodity price movements.
- 57.5% of people in Zambia live below the poverty line. The ratio is 77% for rural areas.
- The Global Hunger Index of 2018 ranked Zambia as the fifth hungriest country in the world.

The government has ambitious plans to tackle these development challenges, but financing is a huge challenge. After having been one of the major beneficiaries of the Heavily Indebted Poor Countries (HIPC) and the Multilateral Debt Relief Initiative (MDRI) in the early 2000s, mounting debt levels again raise concerns around the government's ability to honour its repayment obligations.

- The stock of external public and publicly debt is estimated to have reached 40% of GDP in 2018.
- Debt service is programmed to account for 42% of domestic revenue in 2019, diverting funds away from spending on social sectors.

Zambia's unstable financing situation illustrates the challenges of countries undergoing transition. With the reclassification to LMIC status, Zambia gained access to a wider range of financing options including international debt capital markets. The share of concessional finance in the overall financing mix decreased, while domestic public revenues did not pick up fast enough to fill the gap.

As such, Zambia's case provides important lessons for countries in transition and for co-operating partners (CPs) seeking to support them. Overcoming the transition finance challenge is key to ensuring continued progress along the development continuum.

1.1. Social and economic vulnerabilities have persisted despite sound economic performance in the 2000s

Zambia's economy grew rapidly in the 2000s, recording annual growth rates of over 7%. As a result, per capita income levels grew from USD 330 in 2000 to USD 1,390 in 2011 when the country was re-classified from a low-income to a lower middle-income country.

Despite relatively high levels of national income, however, Zambia still belongs to the group of LDCs. The country meets two of three LDC criteria, namely a high economic vulnerability (40.5 compared to threshold of >36) and a low human asset index (58.6 compared to threshold of <60).

The former is due to an excessive reliance on copper, which exposes the national economy to commodity price shocks. The latter can be explained by persistently high levels of poverty, especially in rural areas, and poor public health conditions.

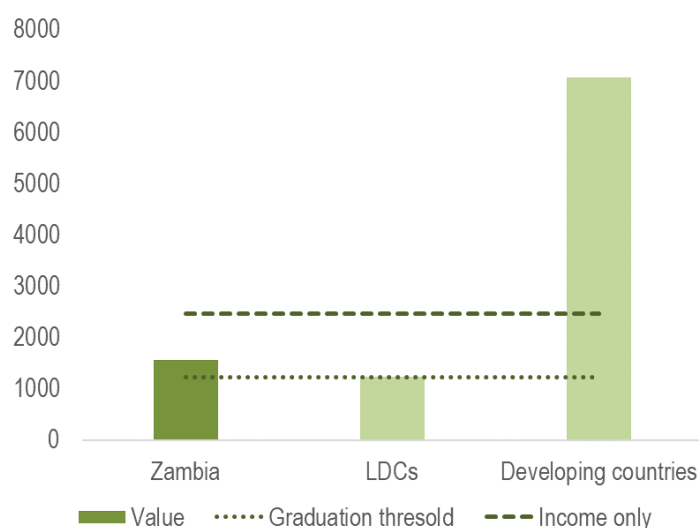
Box 1.1. Historical Background

- Upon independence in 1964, Zambia was one of the richest countries in South-Saharan Africa, mainly due to the abundance in copper resources.
- Under socialist rule beginning in the late 1960s, the economy was to some extent run by central planning. Private companies were nationalised and incorporated into large state-owned conglomerates. Lack of investment in the mining sector eventually led to low levels of copper output. The country started experiencing high levels of unemployment and underemployment.
- During the 1980s and 1990s, economic stagnation, poor revenue from the copper sector and a heavy debt burden forced the Zambian government to cut its expenditures on social sectors. The underfunding led to a substantial decline in health and education.
- Since the early 1990s the Zambian government undertook major economic reforms which included trade liberalisation and privatisation including in the copper sector.
- Helped by the HIPC debt relief initiative, the country experienced an economic take off in the 2000s. Zambia became a lower middle-income country in 2011.

1.1.1. Zambia became a middle-income country after period of high growth

Zambia is a lower middle-income country with a per capita national income of USD 1,562 in 2018. This exceeds the LDC graduation requirement of USD 1,230. (Figure 1.1)

Figure 1.1. Zambia's per capita income level meets the LDC graduation criterion



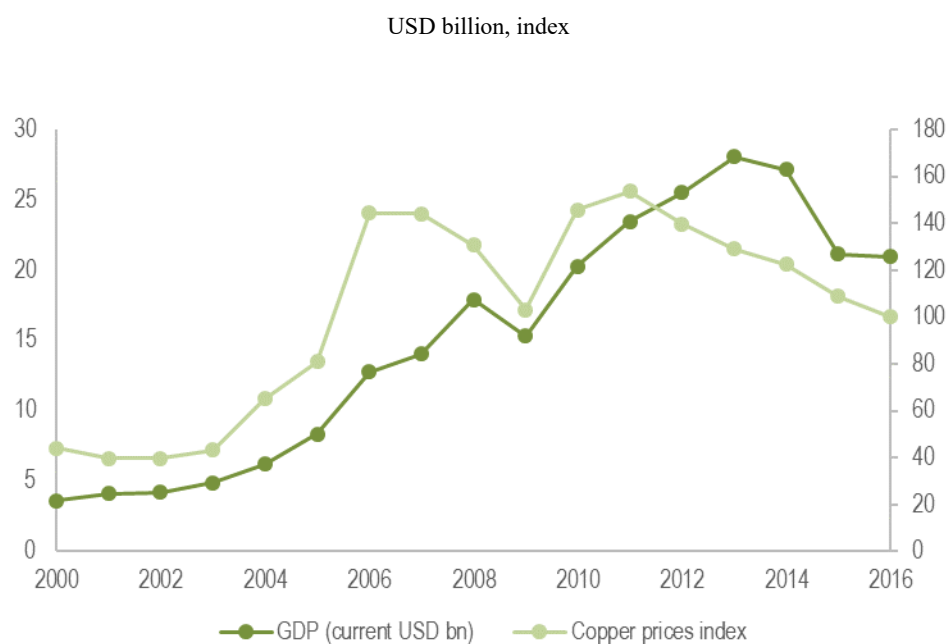
Source: United Nations Committee for Development Policy Secretariat (2018_[3]). Triennial review dataset 2000 - 2018.

Economic liberalisation in the 1990s brought foreign investment into the country and fuelled economic growth. This was helped by favourable external conditions such as high commodity prices and massive demand from emerging economies, especially the People’s Republic of China (“China”). The average annual growth rate from 2000 to 2010 was over 7%, mostly driven by an increase in copper prices, which more than tripled during the period. As a result, Zambia reached middle-income country status in 2011.

In the same year, Fitch Ratings awarded Zambia a sovereign credit rating of B+, which allowed Zambia to access international debt capital markets. The first-time issuance of a sovereign bond in 2011 amounting to USD 750 billion was met with strong investor appetite. The 10-year Eurobond was heavily oversubscribed, attracting USD 12 billion of orders. The event was welcomed as a sign that Zambia no longer had to rely on development assistance and could tap into a wider choice of financing options (Prizzon, 2013^[4]).

Starting in 2012, however, a slowdown in copper demand from China and plummeting copper prices have put a strain on the Zambian economy. The annual growth rate fell to 4.7% over the 2011-2017 period, while GDP per capita growth fell to 1.6%. Figure 1.2 shows how GDP growth was closely related to the increase in copper prices during the 2000s and was, in turn, affected by the subsequent price decline.

Figure 1.2. Economic expansion was mainly driven by copper exports



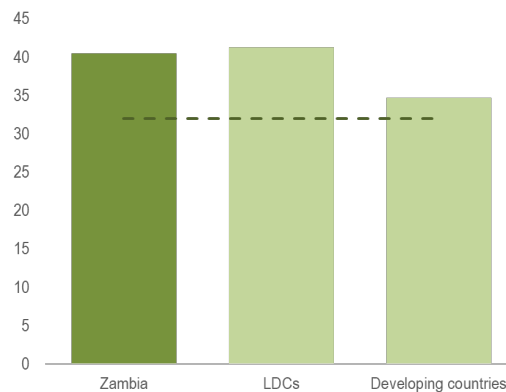
Source: World Bank, (2018^[5]), “World Development Indicators” (database), <http://wdi.worldbank.org/tables>

1.1.2. However Zambia is highly vulnerable to economic shocks

Recent economic problems demonstrate the high level of economic vulnerability, which is primarily due to Zambia’s excessive reliance on copper.

According to the Economic Vulnerability Index (EVI), which measures a country's structural vulnerability to economic and environmental shocks, is 40.5, classifying the country as a least developed country (36 or above). Zambia's EVI value is only slightly below the average for all LDCs, which is the group of the most vulnerable countries in the world. This is mainly due to the facts that Zambia is a landlocked country, remote from world markets, and has a high reliance on a single commodity, namely copper.

Figure 1.3. Zambia has a high level of economic vulnerability, roughly on par with the LDC average



Source: United Nations Committee for Development Policy Secretariat (2018^[3]). Triennial review dataset 2000 - 2018.

Over 70% of Zambia's exports are in copper, making Zambia's economy vulnerable to copper price fluctuations. Copper prices dropped by almost a third from their peak in February 2011 to US\$4,595 per metric ton by February 2016 (LME). As a consequence, the current account moved from a peak surplus of 5.4% of GDP in 2012 to a deficit of 4.5% of GDP in 2016. Zambia's currency, the kwacha, depreciated sharply against the dollar through 2016, increasing inflation from an annual rate of 7% in mid-2015 to nearly 23% in February 2016.

Figure 1.4. Zambia's trade balance moves in tandem with copper prices



Source: World Bank, (2018^[5]), "World Development Indicators" (database), <http://wdi.worldbank.org/tables>

Economic vulnerabilities translate into constraints on the availability of financing for sustainable development: Drivers of economic growth are primarily in construction, mining and (informal) trade, but not particularly conducive to external and domestic resource mobilisation.

The copper boom attracted foreign investment but without spillover to the broader economy.

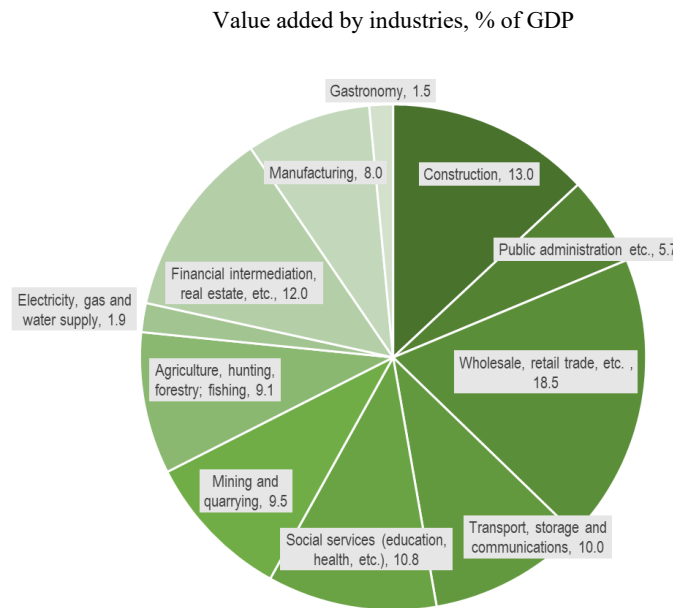
The privatisation of the mining sector led to an influx of private sector resources. FDI, which took off in the 2000s, was largely concentrated in the mining sector, where 73% of FDI stock in Zambia are held in 2016. (Bank of Zambia, 2017^[6]) However, this did not translate into spillover benefits for the broader economy.

After privatisation of the mining sector, many of the domestic companies that had been supplying to the state-owned mining company, Zambia Consolidated Copper Mines (ZCCM), exited the industry, as they could not compete with imported goods from foreign suppliers the new mine operators had access to. Instead, there was a rise in the number of importers, comprising specialized, value-added service providers, as well as ad hoc traders. (Fessehaie, 2015^[7]) Currently, most of the industrial products needed as mining inputs are imported, notably from South Africa (Fessehaie, 2015^[7]), while only supplies characterised by low capital and skills intensity are supplied locally (Copenhagen Business School, 2014^[8]).

Moreover, investment and growth in the mining sector do not seem to have immediately generated benefits in the form of higher tax revenues. Generous concessions, which were made to investors to take over the ailing mines, resulted in a low tax-intake initially, despite rising copper prices and output. Estimates about the contribution of the mining sector the overall government revenues between 2000 and 2007 are as low as 2% (Simpasa et al., 2013^[9]), while the share of mining in GDP is close to 10% Figure 1.5, and the share in exports is close to 80%.

Industries that can be conducive to private investment perform below their potential, while the large size of the informal sector puts another constraint on domestic resource mobilisation.

Figure 1.5. Trade, construction and mining are among the largest industries in terms of value-added.



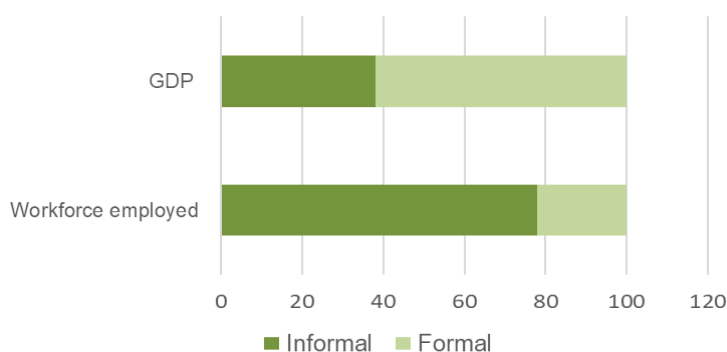
Source: United Nations Statistics Division, “National Accounts Official Country Data”, <http://data.un.org/Browse.aspx?d=SNA>

Construction comprises a sizable portion (13%) of GDP, and is one of the driving factors behind economic growth. However, since it is primarily related to public infrastructure projects contracted by the government, it is often exempted from tax.

Despite its endowment with vast natural resources, the potential of tourism remains largely untapped. The number of tourist arrivals in 2016 was 956,000. The number was lower than that of neighbouring countries such as Zimbabwe (2,168,000 in 2016), Botswana (1,528,000 in 2015). (UNWTO,(n.d.)^[10]) The direct contribution of tourism to GDP is estimated at 3.2% in 2017. Out of 185 countries, Zambia ranked 127th in terms of the relative share of tourism to GDP (WTTO, 2018^[11]).

Although commercial farming in Zambia expanded in recent times, agriculture presents only a small share of less than 9% in GDP. (Figure 1.5) Given that this sector employs a large part (53% in 2017, (World Bank, 2018^[5])) of the working population and tends to be more labour-intensive than mining, it could become a driver for Zambia’s diversification and poverty eradication. (Merotto, 2017^[12]) However, agriculture is mainly based on large-scale subsistence farming, while subsidies as well as price and export controls create distortions that hamper the scaling up necessary for large-scale high-value production. The productivity in the sector has been declining, as the value added per worker fell from USD 843 in 2000 to USD 664 in 2017. (World Bank, 2018^[5])

The informal sector employs as much as 78% of the workplace (World Bank, 2018^[5]), and presents 38% of GDP (Medina, Jonelis and Cangul, 2017^[13]). Next to agriculture, many trade activities take place in the informal sector. Trade accounts for 18% of Zambia’s GDP (AEO 2017), and the fact that many companies engaging in trade are not registered with the Zambia Revenue Authority (ZRA) puts severe constraints on the potential to generate domestic public revenues.

Figure 1.6. The majority of the workforce is employed in the informal sector

Source: World Bank, (2018^[5]), “World Development Indicators” (database), <http://wdi.worldbank.org/tables>

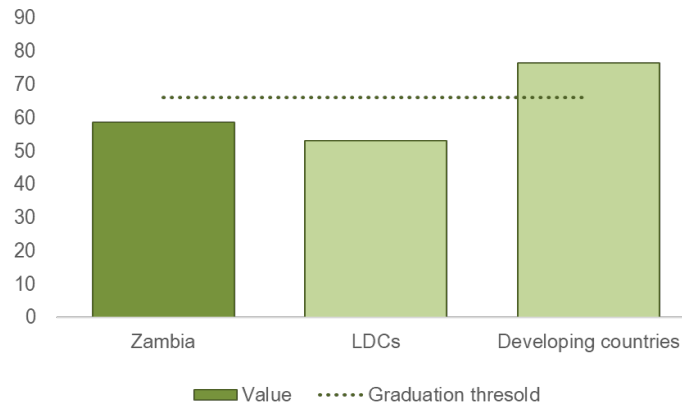
An underdeveloped financial sector and weak infrastructure are among the bottlenecks holding back private sector financing (World Bank, 2018^[14]).

Limited access to capital is among the key constraints to domestic private investment. Although there was progress in terms of individual financial inclusion, with account ownership increasing from 35.6% to 45.9% between 2013 and 2017 (Demirguc-Kunt et al., 2018^[15]), SME financing is at critically low levels. The 2017 IMF Financial Sector Assessment Program found that access to finance for SMEs is lower than in the rest of the region. Only 8% of SMEs had a line of credit, compared to the sub-Saharan average of 17%. Mounting levels of government debt, which have resulted in crowding out of private debt, and a rise in interest rates has exacerbated these problems. (IMF, 2017^[16])

Weak infrastructure especially in the power sector is another bottleneck. The energy sector suffered from underinvestment in generation capacity during the last two to three decades. Low rainfall during the raining season in 2014/15 has hit hydropower production in 2016, leading to severe power shortages and daily blackouts. During this time, electricity subsidies for mining companies who are responsible for over 50% of the electricity consumption in the country have proven costly. Between September 2015 and May 2016, and electricity subsidies around USD 26 million per month. (Smith, 2016^[17])

1.1.3. Zambia has relatively low levels of human development

Zambia’s Human Asset Index (HAI) score (0.579) is low compared to countries with similar levels of per capita income. In 2015, the country ranked 139th of 188 countries and territories (Figure 1.7).

Figure 1.7. Zambia has a low HAI, below the LDC graduation threshold

Source: United Nations Committee for Development Policy Secretariat (2018_[3]). Triennial review dataset 2000 - 2018.

Poverty in Zambia remains persistently high, especially in rural areas, and inequality rates are among the highest in the world.

As of 2015, 57.5% of people in Zambia live below the poverty line. (World Bank, 2018_[18]) Most of them live in rural areas, where the poverty headcount ratio is 77%. Approximately half of the country is undernourished, and the Global Hunger Index of 2018 ranked Zambia as the fifth hungriest country in the world (von Grebmer et al., 2018_[19]).

Inequality as measured by the Gini coefficient has increased from 42.1 in 2002 to 57.1 in 2015, the fifth highest in the world (World Bank, 2018_[18]). Between 2010 and 2015, the national share of consumption of the bottom 40 percent fell from 11.5 percent to 9.4 percent, while the share earned by the top 10 percent rose from 41.0 percent to 43.4 percent (World Bank, 2018_[14]). Economic growth has benefited select areas around the provinces of Lusaka and the Copperbelt, thereby widening the gap between urban and rural areas. The poorest tend to live in remote areas that are barely connected to markets and the cash economy.

Zambia faces a number of health issues including an HIV/Aids epidemic, malaria and tuberculosis.

The HIV/Aids prevalence rate was estimated at 11.5% among adults (ages 15–49) in 2017 (UNAIDS, 2018_[20]), but trends indicate a continuous drop in HIV prevalence.

Malaria is endemic in both urban and rural areas, and predominantly attacks the most vulnerable populations, with one in five children under age five infected (Zambia National Malaria Elimination Centre, last accessed Nov 2018_[21]). Tuberculosis is another major public health threat, and the risk of in co-infection with HIV are very high (Centre for Infectious Disease Research in Zambia (CIDRZ), Last accessed Nov 2018_[22]).

Economic growth did not translate into jobs, and unemployment rates are high, especially among the youth.

From 2000-2014, when annual economic growth averaged 7.3%, employment grew by only 2.8% per year. (Merotto, 2017^[12]) The unemployment rate stands at 7.8% in 2017, down from 12.9% in 2000 (World Bank, 2018^[5]) However, the jobs created in this period have been mostly in low productivity sectors, as the economy remains largely rural and agricultural. (Merotto, 2017^[12])

One of the biggest problems is the growing number of unemployed youths. The youth (age 15-24) makes up almost two thirds of the country's working-age population, but in 2017, 15.3% of them were unemployed. (World Bank, 2018^[5]) At the same time, fertility rates (5.0 in 2016) are slightly higher than the sub-Saharan Africa average of 4.8, suggesting that a high number of youth will enter the labour market each year.

1.1.4. Zambia has ambitious plans to overcome the development challenges

Zambia has a relatively stable political environment but governance indicators show a mixed picture.

Zambia's political landscape has remained stable, especially in comparison to some neighbouring countries. Multi-party elections were introduced in 1991 and transition of power between parties has occurred smoothly. Zambia is ranked 18th of 54 African countries on the 2018 Ibrahim Index of African Governance, down from 9th in 2016 (Mo Ibrahim Foundation, 2018^[23]).

Zambia has received a score of 3.3 in the World Bank Country Policy and Institutional Assessment Index 2017 (CPIA) with 6 being the highest score and 1 being the lowest. This is slightly higher than the average score of 3.1 for Sub-Saharan African countries. The CPIA considers four clusters of governance, which are economic management (2.8), structural policies (3.8), policies for social inclusion and equity (3.3) and public sector management and institutions (3.2). Zambia's performance in the area of economic management has declined over the years, from 3.7 in 2008 to 2.8 in 2017 (World Bank, 2017^[24]).

Zambia's government has shown a commitment to sustainable development, embedding the SDGs into the current 7th National Development Plan (7NDP; 2017-2021) (Zambia Ministry of National Development Planning, 2017^[25]).

The key focus of the 7NDP is on economic diversification and job creation, based on the promotion of export-oriented agriculture, mining, and tourism, while investment in energy, transport, infrastructure, water resources management as well as information technology are seen as critical development enablers.

Box 1.2. What is in the Zambian 7th National Development Plan?

The Zambian 7th National Development Plan (7NDP) is a blue-print for the development of Zambia for the 2017-2021. It is embedded in a longer-term strategy developed by the government that aims at putting Zambia as a "prosperous Middle-income Nation" by 2030.

The 7NDP was designed through a consultative process involving multiple stakeholders such as private sector, government officials, academics, CSOs but also CPs including DAC members. Working groups were organised around the different strategic areas of the plan, and at different geographical levels: national, provincial, and at the district levels.

Instead of listing the policies that pertain to a distinct sector, the 7NDP takes a holistic approach to address Zambia's main development challenges, which are aligned with the Sustainable Development Goals. The policy areas are organised around five different strategic areas, which are:

- **Economic diversification and job creation:** Key areas of focus are export oriented agriculture and mining sector, development of tourism, improvement of infrastructures (energy, water, transport, ICT, etc.), and better integration in regional and international markets.
- **Poverty and vulnerability reduction:** The objective is to enhance welfare through better social protection and implementation of pension reform.
- **Reduction of developmental inequalities:** Inequalities will be addressed through rural development, promotion of urban and peri-urban economies, and tackling gender inequalities.
- **Enhancement of human development:** The focus is on improving health and health services, education, as well as water supply and sanitation.
- **Creation of a conducive governance environment:** The plan proposes to improve the policy environment through implementation of consultative structures and acceleration of decentralisation policies.

The key sectors of interest

While identifying access to finance and better infrastructure as the two cross-cutting enablers for economic growth in Zambia, the 7NDP seeks to strengthen specific economic sectors, which are agriculture, mining and tourism.

Agriculture: Investment in value chain development, better infrastructure, and access to finance are seen as the key fundamentals to be reinforced.

Mining: In the copper sector, the objective is to upgrade the value chain especially at the supplier level. The 7NDP also seeks to explore the potential of other minerals besides copper (e.g. gemstones, cobalt). Emphasis is put on developing small-scale mining to favour local employment.

Tourism: The emphasis is on infrastructure development and the restoration of national parks. The plan also seeks to develop domestic tourism to make it more resilient to external shocks or currency depreciation.

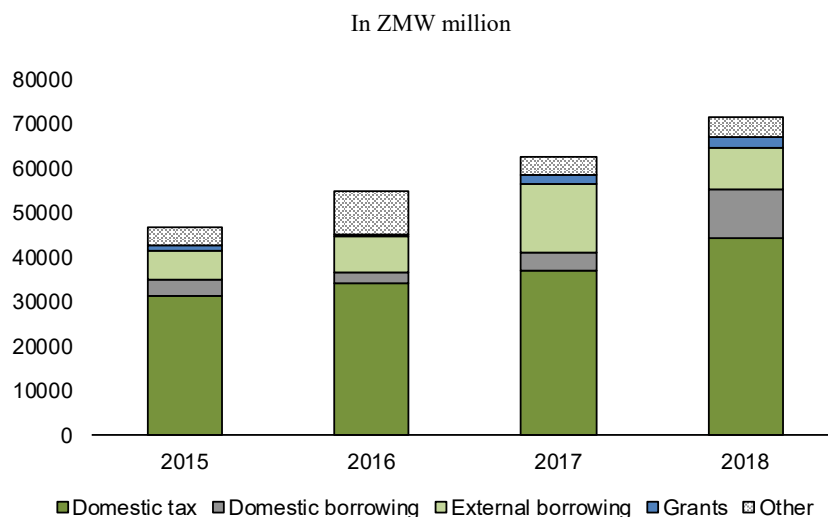
However, given concerns around the country's debt levels, financing the government's sustainable development strategy is likely to be challenging.

The Zambian government has budgeted USD 5.7 billion annually to finance the 7NDP. Nonetheless, there remains a financing gap, as 10% of planned expenses are currently not accounted for by revenue forecasts.

Domestic financing is set to represent the bulk of the resources to finance the plan. The plan is to increase the share of domestic public revenues from 67% of total budget in 2017 to 80% in 2021. The Government plans to increase mineral royalties and export duties on precious metals in order to reach a minimum tax-to-GDP ratio of 18%, the average tax-to-GDP ratio of SADC members. However, the viability of these plans remains debated, and the forecast increase in tax revenues may be overly optimistic (World Bank, 2018_[26]).

External financing will represent 20% of total resources, with a low contribution of concessional finance (4% of the overall budget).

Figure 1.8. Budget revenue source composition



Source: KPMG (2018_[27]), 2019 Budget Highlights, <https://home.kpmg.com/content/dam/kpmg/xx/pdf/2018/10/tnf-zambia-oct17-2018.pdf>

Current debt levels and the resources spent on servicing the debt, put a constraint on the government’s ability to access more financing. In 2017, Standard & Poor’s and Moody’s Investors Service downgraded Zambia’s credit ratings to B- and Caa1, respectively. A joint IMF-World Bank Debt Sustainability Analysis (DSA) released in October 2017 elevated Zambia’s risk of external debt distress to high from medium in 2015. Program discussions with the IMF over a potential aid package were put on hold in summer 2018 due to failure to agree on a sustainable borrowing plan.

Weak governance allows vested interests to have a strong influence on public resource allocation.

Fiscal policies and the allocation of public resources are highly politicised, and risk entrenching rather than alleviating distortions in the economy. For example, policies tend to favour urban constituents, which have been decisive to electorate turnover (Pruce and Hickey, 2016_[28]). This resulted in relatively large and poorly targeted subsidy programs for maize production, electrical power, and fuel, which have helped to sustain the fiscal deficit. (O’Riordan et al., 2016_[28]) Weak institutions and limited transparency and accountability give disproportionate space to vested interests, hindering the effective use of scarce resources and the curbing down of public debt levels (World Bank, 2018_[29]).

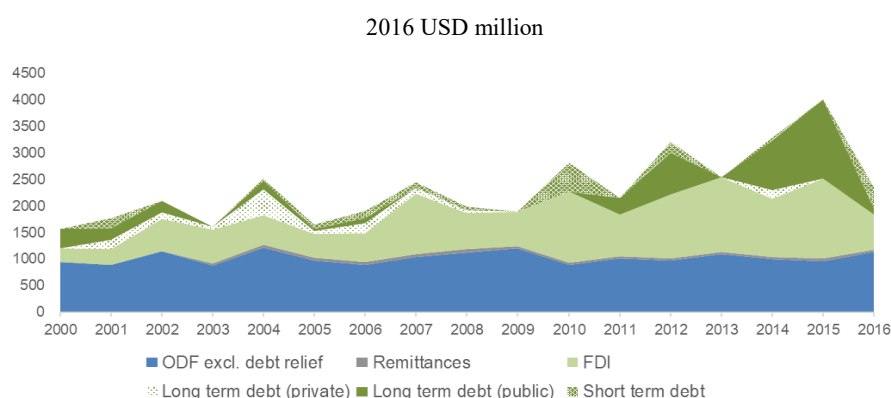
The Corruption Perception Index 2017 by Transparency International ranks Zambia 96th of 180 countries. (Transparency International, 2018_[28]) The 2018 Afrobarometer Survey found that 66% of Zambians feel corruption has increased over the past year, up from 55% in 2014. 70% find that the government is handling the fight against corruption “fairly badly” or “very badly”, representing a huge increase from 42% recorded in 2013 (Afrobarometer, 2013_[29]) (Afrobarometer, 2017_[30]). In September 2018, a presidential inquiry investigated the alleged misappropriation of USD 4.3 million in social assistance programs funded by DAC

providers. The United Kingdom, Sweden, Finland and Ireland have suspended their assistance, pending the outcome of this investigation.

1.2. Zambia was not sufficiently prepared for the shift in financing resources

Zambia's current difficulties in financing its development plans have to be seen within the context of the transition finance. The country has undergone a transition, which can be summarised as follows:

- **There has been a surge in long-term commercial debt.** The access to international debt markets was facilitated by favourable ratings due to the economic growth that Zambia had enjoyed in the 2000s, as well as a global easing of financing conditions. Access to other sources of commercial debt in particular export credit has also increased. Commercial debt and export credit now account for 77% of the external debt portfolio.
- **The importance of non-commercial debt, notably official development finance (ODF) from DAC providers, has declined.** But in absolute amounts, the amount of ODF stayed relatively stable over time, and has acted as a shock absorber. As a share of overall external finance, ODF from bilateral DAC and multilateral providers made up close to or more than 60% of external finance during times of economic crises (60% in 2000; 64% in 2009 after the Global Financial Crisis; 32% at the end of the commodity cycle in 2011).
- **FDI has grown considerably, but is heavily concentrated.** FDI increased from an average annual amount of under USD 500 million in the period between 2000 and 2005, to USD 870 million over 2006-2010, and over USD 1 billion over 2011-2016. Most FDI (>70%), however, has been concentrated in the mining sector, and the effects on poverty reduction and inequality have been contested.
- **Remittances are insignificant, possibly leaving a gap in financing for health and education.** Remittances make up only 1% - 3% of external finance. While in countries transitioning from LIC to LMIC status, remittances can often play a role in the health and education sectors and poverty eradication, the lack of remittances in Zambia points to possible financing gaps that have to be met with other resources.

Figure 1.9. External finance has increased driven by FDI and especially debt

Source: IMF (2017^[31]), “World Revenue Longitudinal Data”, <https://data.world/imf/world-revenue-longitudinal-dat>; OECD (2018^[32]), “Global Revenue Statistics Database”, <https://stats.oecd.org/index.aspx?DataSetCode=REV>; OECD (2018^[33]), “Creditor Reporting System” (database), <https://stats.oecd.org/Index.aspx?DataSetCode=crs1>; World Bank (2018^[34]), “Migration and Remittances Data”, <http://www.worldbank.org/en/topic/migrationremittancesdiasporaissues/brief/migration-remittances-data>; IMF (2017^[35]), “Balance of Payments” (database) 2017, <http://www.imf.org/external/datamapper/datasets/BOP> for private investment data.

- **Domestic public resources remain below their potential.** In 2016, the tax to GDP ratio was 12.9%, down from 14.4% in 2015¹. Over the last 10 years, the tax-to-GDP ratio has mildly fluctuated around an average of 14.2%. Tax revenues experienced significant decline from the early 1980s where tax-to-GPD ratios were above 20%. This decline was partially due to the provision of extensive tax benefits for investment.

1.2.1. Zambia’s debt situation is alarming

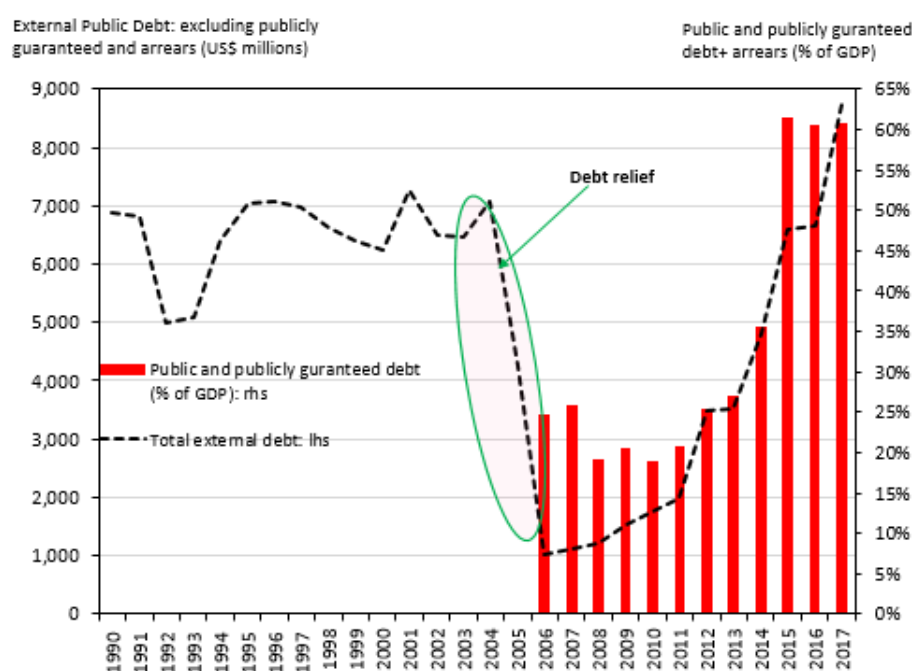
External financing through debt is a key element of any development strategy (UNCTAD, 2018^[36]). Debt can be a powerful tool to finance productive investments such as public infrastructure. However, recently, rising debt levels in developing countries raise concerns around the sustainability of government finances. The IMF (2018^[9]) reports that fiscal balances have deteriorated in 70% of low income countries and public borrowing was associated with higher levels of public investment in only 10 out of 34 countries.

Zambia is among the countries where handling the debt situation presents the most pressing challenge with regard to financing for sustainable development.

High levels of debt have also been a problem in the not so distant past. At that time, however, a large part of the debt was held by multilateral lenders and Paris Club members (see Table 1.1), and debt relief was provided through the heavily indebted poor countries (HIPC) initiative and the Multilateral Debt Relief Initiative (MDRI).

Zambia received USD 3.9 billion of debt relief over time, making the country one of the largest recipients of debt relief in per capita terms. External debt stock declined from around USD 7 billion at the end of 2004 to USD 635 million in December 2006 (IMF, 2006^[37]).

Figure 1.10. After Zambia benefited from HIPC initiative, debt levels are rapidly rising again



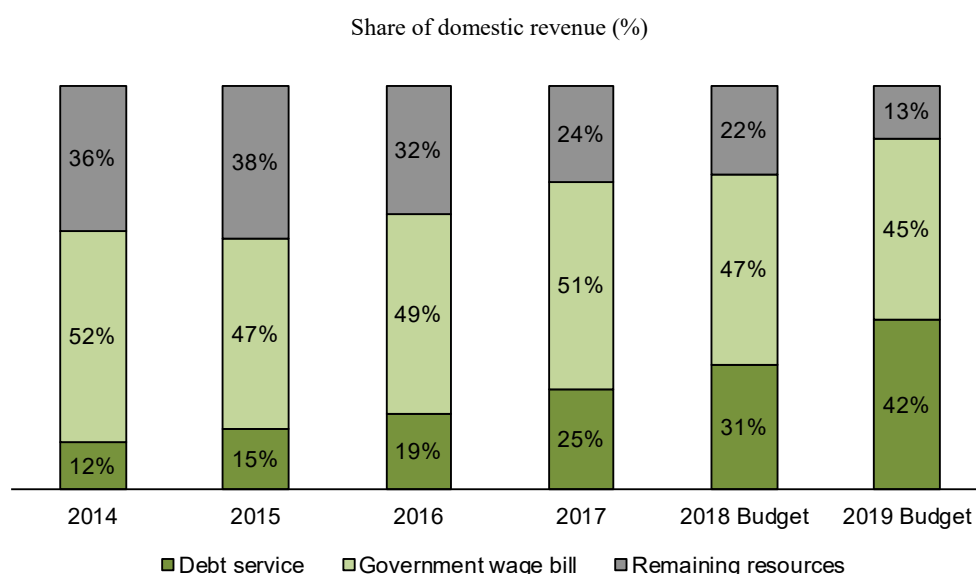
Source: Chinzara, Heumesser and Dessus, (2018^[38]), An Agro-Led Structural Transformation, <http://documents.worldbank.org/curated/en/200841537368334665/An-Agro-Led-Structural-Transformation>

However, Zambia's debt is rising again to potentially unsustainable levels. The total stock of public and publicly guaranteed debt increased to about 64% of GDP in 2017. A joint IMF-World Bank DSA downgraded Zambia's debt sustainability rating from moderate to high risk of debt distress in October 2017.

Moreover, public financial management practices leave room for improvement, posing challenges to the effective and efficient use of the resources. While much of the debt proceeds are channelled into infrastructure, the quality of procurement remains weak (IMF, 2017^[38]). A World Bank study in 2017 found that Zambia paid USD 360,000 per kilometre, which is more than twice the African average (USD 175,000 per kilometre) (World Bank, 2017^[39]).

Increasing costs of debt servicing reduce the fiscal space even more, crowding out spending on production and social sectors. In 2018, debt servicing is estimated to make up about one third of domestic revenues. For the 2019 budget, the share is expected to rise to 42% (Figure 1.11). This leads to a decline of sources available for other spending. Only 22% of domestic revenue were left available in 2018 after deducting interest payments and the (large but relatively constant) government wage bill. This will further decrease to 13% in 2019.

Figure 1.11. Debt servicing costs are rising rapidly, accounting for one third of domestic revenues



Source: Chinzara, Heumesser and Dessus, (2018^[38]), An Agro-Led Structural Transformation, <http://documents.worldbank.org/curated/en/200841537368334665/An-Agro-Led-Structural-Transformation>

In addition, the composition of debt has shifted from concessional towards non-concessional debt, which has implications on the costs of debt servicing. Before 2011, the largest source of external public loans was from multilateral creditors, including the World Bank, European Investment Bank (EIB), African Development Bank (AfDB). Collectively, multilateral and bilateral debt accounted for an average of 88% of the total external debt during 2006- 2011 (Banda-Muleya and Nalishebo, 2018^[40]).

After being classified as an LMIC and gaining access to international debt capital markets, the share of commercial debt increased from 0% in 2011 to 77% in 2018, mainly due to the issuance of Eurobonds in 2012, 2014 and 2015. (USD 750 million in 2012, USD 1 billion in 2014, and USD 1.25 billion in 2015) At later rounds of issuance, the coupon rate for the bonds became higher, from 5.375% in the 2012 bond to 8.5% and 9.97% in 2014 and 2015, respectively. Moreover, the depreciation of the kwacha against the US dollar (by close to 20% per year in 2014 and 2015) adds to the debt burden by increasing the local currency value of the debt. The effective borrowing cost (coupon plus the average annual kwacha depreciation) is three to four times the nominal interest rate (IMF, 2017^[38]).

At the same time, export credit especially from China also makes up a larger share. Chinese debt was nearly a quarter (26%) of Zambia's total external debt stock in 2016. The true size of debt to China, however, may be understated due to a lack of transparent disclosure of the amounts and terms of loans. Concerns are also raised over the fact that key strategic assets such as roads, airports, electric power plants, etc. financed by Chinese loans may be designated to be collateralized, providing for the possibility of takeover in the case of the Government's default (Cheelo, 2018^[41]).

Table 1.1. Government debt is increasing while commercial debt and Chinese debt make up the largest portion

Values in USD million

	2015	2016	Share of overall debt (2015-2016)
Multilateral	1503.97	1560.48	22%
World Bank (IDA)	695.79	747.51	11%
ADB/ADF	351.86	376.5	5%
IMF	256.82	182.09	3%
Others	199.5	254.38	3%
Bilateral	450	458.69	7%
Paris Club	195.32	219.92	3%
Non-Paris Club	254.68	238.77	4%
Export & Suppliers' Credit	1598.85	1621.58	24%
Export Import Bank of China	1313.35	1398.59	20%
Catic	210.66	150.46	3%
Others	74.84	70.17	1%
Commercial Debt	3151.55	3305.96	47%
China Development Bank	136.31	225.96	3%
Eurobond	3000.00	3000.00	44%
Others	80	424.6	4%
Total Government External Debt	6704.37	6946.71	100%
Total Chinese debt	1449.66	1624.55	23%

Source: Cheelo, C., (2018^[41]) Financing the Economic Stabilization and Growth Programme (Zambia Plus) in the Shadow of the IMF, https://www.africaportal.org/documents/18160/ESGP_in_the_shadow_of_IMF.pdf

1.2.2. The relative weight of official development finance (ODF) has declined

Official development finance (ODF) is crucial source to target the most pressing development needs. ODF is the financing from bilateral (e.g. government, national development agencies) and multilateral providers to support the economic, environmental, social and political development of developing countries. It can be either concessional, in which case it qualifies as “official development assistance” (ODA) or non-concessional or “other official finance” (OOF). Since the formal mandate of ODF providers requires them to explicitly target the most pressing development needs, this source of financing for sustainable cannot easily be replaced by alternative sources, especially in the case of the most vulnerable countries (OECD, 2018^[42]).

The shift in the composition of external debt from mostly multilateral concessional to commercial forms shows that the relative importance of official development finance has been declining.

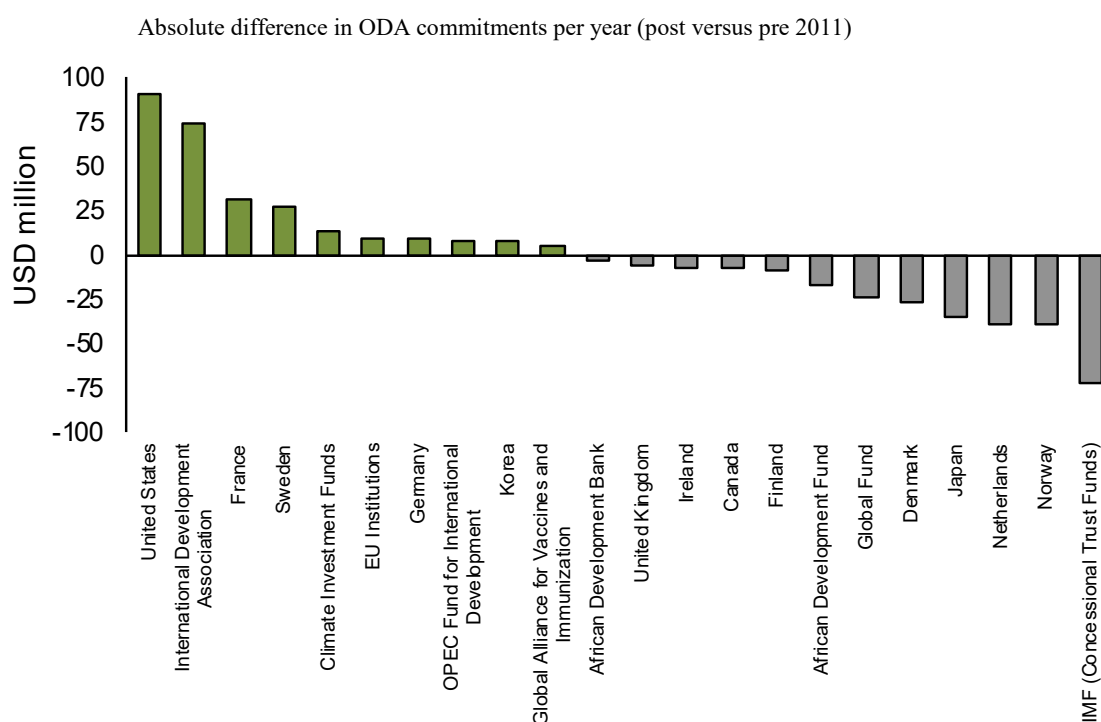
DAC providers supplied significant amounts of official development finance for Zambia’s development, mostly in the form of concessional finance or “official development assistance” (ODA)². Up until the early 2000s, reliance on these flows was significant, and the share of ODA over government expenditure was as high as 136% in 2002. Among major co-operating partners were the United Kingdom, the United States, Netherland, Norway, Denmark and the EU.

With growing income levels, the importance of official development finance from DAC providers decreased. As a share of GNI, ODA has decreased from 23.0% in 2000 to 12.7% in 2006 and further to

4.9% in 2010. Several DAC providers decided to exit or scale down their operations Zambia as the country joined the LMIC group in 2011. Netherlands and Denmark announced a phase-out in 2011, Norway closed its embassy in 2016.

One reason for the predominance of ODA in official flows is that for multilateral lenders such as the World Bank and the African Development Bank, Zambia is still eligible for concessional lending, suggesting that the need for development assistance is still there. The World Bank, for example, has increased their financing to the country compared to 2011.

Figure 1.12. Financing from bilateral DAC providers has decreased while multilateral providers picked up



Note: DAC providers with most significant changes only

Source: OECD (2018^[33]), Creditor Reporting System, <https://stats.oecd.org/Index.aspx?DataSetCode=crs1>

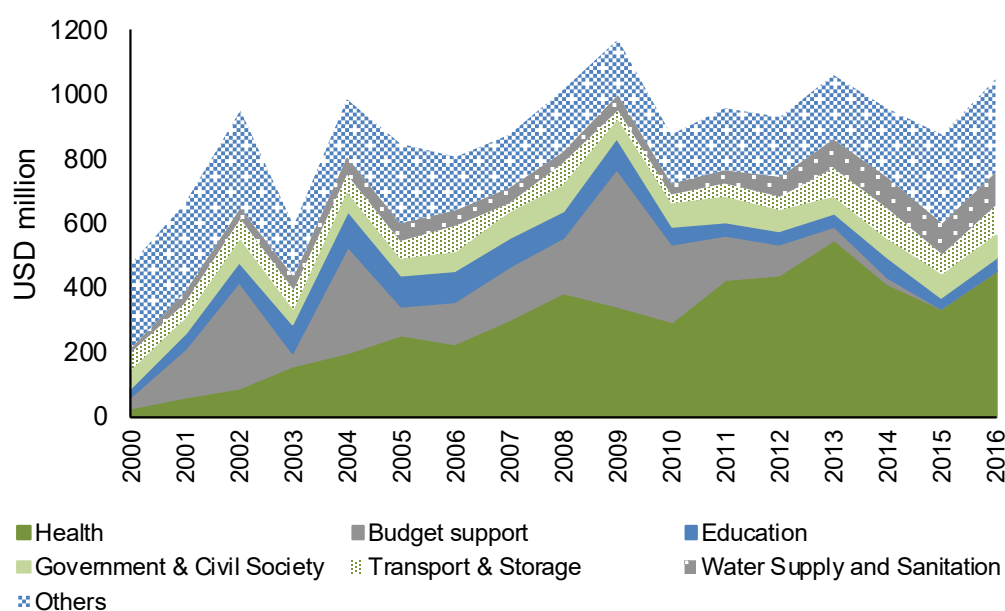
DAC providers have moved away from a focus on budget support to supporting specific programmes, especially in the health sector. Despite increases in allocation to economic and production sectors, their share in overall ODA is still quite limited.

General budget support, which was introduced in the early 2000s, has decreased from 18.0% in 2000 to 0.4% in 2016, reflecting a general trend among CPs, who grew less enthusiastic about this aid modality. In the Zambian context, in particular, economic growth and increased domestic revenues had reduced the macro-economic importance of budget support, and had made the modality less attractive. For DAC CPs, the instrument had lost its leverage effect, and for the Zambian government it made too many requirements compared to the amount of funding it provided. (Kemp and Lobbrecht, 2016^[43])

The share of ODA allocated to the social sector has increased from 44.9% in 2000 to 62.5% in 2016. Within the social sector, the focus has shifted from funding directed to the government and civil society, which received 27.9% of social sector ODA in 2000 but only 9.2% in 2016, to population and reproductive health policies and programmes, where 10.9% of social sector support was allocated in 2000 and 46.3% in 2016. This was particularly due to efforts to combat HIV Aid including by the Global Fund.

Even excluding the Global Fund, the concentration of ODA on health is pronounced. Total support to health makes up 38.7% of ODA between 2012 and 2016, excluding the Global Fund reduces this share to 33.7% of all ODA.

Figure 1.13. Official development assistance is largely and increasingly allocated towards health



Note: USD million in constant 2016 terms

Source: OECD (2018^[33]), Creditor Reporting System, <https://stats.oecd.org/Index.aspx?DataSetCode=crs1>

ODA to economic sectors has increased from 8.9% to 22.6%. However, support to economic sectors is not evenly spread out. Most of the increase is due to energy-related assistance which has picked up since 2014. A number of large-scale operations most notably from the World Bank driving the overall shift in allocations.

Mapping the contributions of DAC co-operating partners to the SDGs they target, which can reveal more about the underlying motivations and objectives of development assistance reinforces the earlier observation that health is the biggest priority. Other priority SDGs seem to be Goal 7 “Affordable and clean energy” as well as Goal 9 “Industry Innovation and Infrastructure”. It is notable that despite high poverty and inequality rates, hunger and poverty eradication (Goals 1 and 2) are not among the most prioritised goals. The same is true of education (Goal 4).

Figure 1.14. Health is the biggest priority for DAC providers, followed by energy, industry innovation, infrastructure

2016

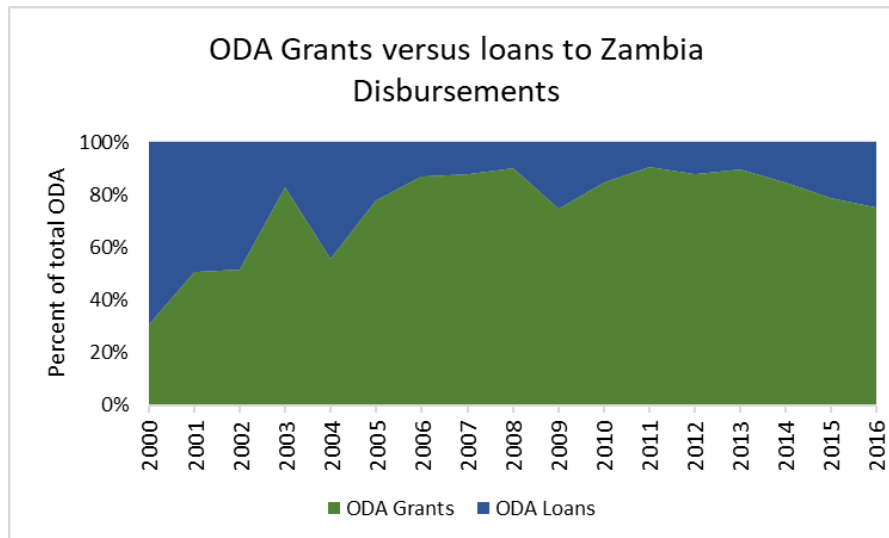


Notes: Preliminary results

Source: OECD (2018^[33]), Creditor Reporting System, <https://stats.oecd.org/Index.aspx?DataSetCode=crl>

The most common form of ODA financing is grants, but the share of loans has increased since Zambia's reclassification to LMIC status in 2011. After making up only 30%-50% of ODA in the early 2000s, grants became the predominant form of ODA financing around and after the completion of the HIPC initiative. Yet, in recent years, and especially after Zambia's reclassification to an LMIC, the portion of loans is increasing again. This is reflecting the greater amounts of ODA provided by multilateral providers such as the World Bank, who are more specialised in lending.

Figure 1.15. The share of loans in ODA is increasing reflecting the greater role of multilateral providers



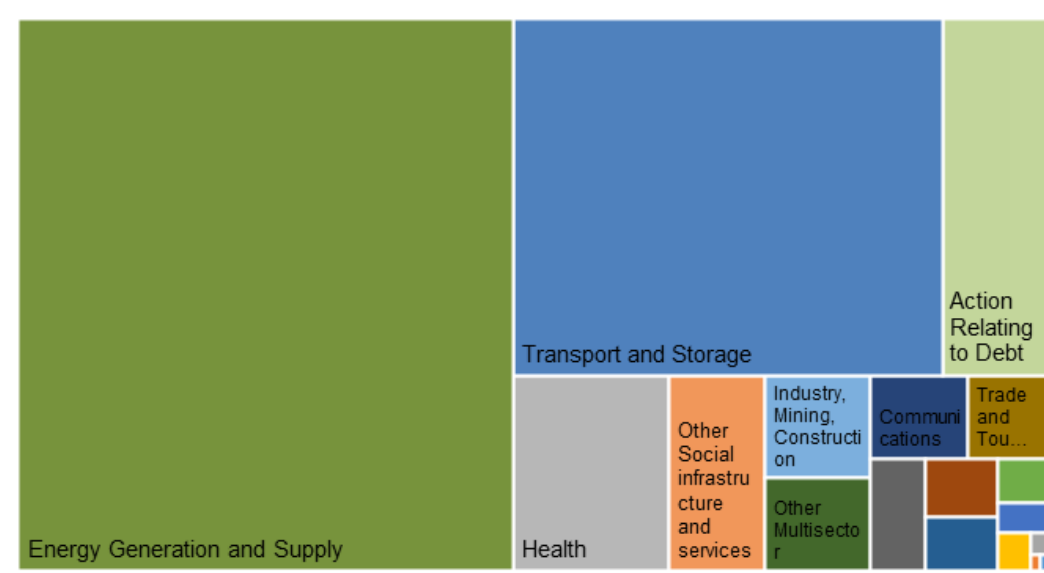
Source: OECD (2018^[33]), Creditor Reporting System, <https://stats.oecd.org/Index.aspx?DataSetCode=crs1>

Starting in the 2000s non-DAC providers have substantially grown in influence, but differences in perspectives and approaches make it challenging to co-ordinate among CPs. This is for example the case with China. Traditionally flows from China used to be small compared to aid from traditional providers. However, this situation changed in the 2000s. From 2000 to 2014, approximately 95 Chinese official development finance projects have been identified in Zambia through various media reports (AidData, 2017^[44]). By one estimate, financing from China grew from USD 14 million (in constant 2014 USD) in 2000 to USD 555 million in 2014 (AidData, 2017^[44]).

Most of the financing was provided in the form of loans and went to a range of sectors including agricultural initiatives, infrastructure developmental projects, public buildings including the Government Complex. However, the bulk targeted the energy and the transport and storage sectors.

Figure 16: Chinese development finance, USD current

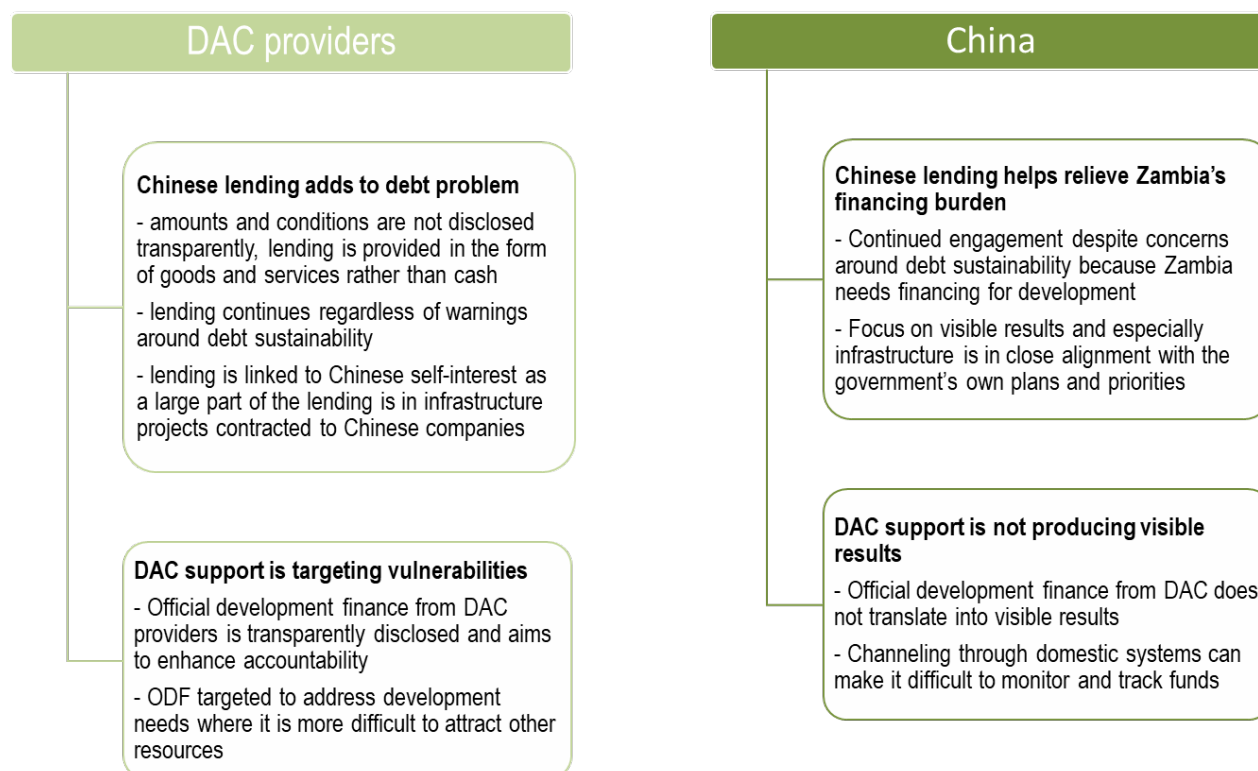
Sum of flows 2000-2014



Source: AidData, (2017^[44]), "Global Chinese Official Finance Dataset", <http://aiddata.org/data/chinese-global-official-finance-dataset>

China participates in co-ordination meetings with the government and other providers including from the DAC. Recently, China and Japan have signed an agreement to jointly finance a series of initiatives in Africa, which will collectively amount to USD 18 bn. However, a difference in perspectives and approaches hinders a closer co-operation and dialogue.

Figure 1.17. The Blame Game – Co-operating partners have different perceptions that need to be reconciled



Source: Authors' presentation

Political will and greater involvement of non-DAC providers such as China will be critical to yielding greater effectiveness of aid.

Zambia was an early adopter of the Aid Effectiveness Agenda. As one of the 50 aid recipient countries and 22 development partners that endorsed the Paris Declaration on Aid Effectiveness in 2005, Zambia pioneered various initiatives, including one of the first Sector-Wide Approaches (SWaP) and basket funding mechanisms. Zambia's government developed its own aid policy and strategy, which was developed in 2005. In response, co-operating partners introduced a joint assistance strategy in 2007 and a formalized division of labour among themselves. (Beuran, Raballand and Revilla, 2011^[45])

An evaluation of donor operations in Zambia across various programmatic sectors, however, reveals mixed results. Most aid-funded projects have been relatively or very successful in terms of their immediate outputs (e.g. schools are built, roads are rehabilitated, access to social services is improved), but results have been much more limited regarding service delivery and the achievement of broader development objectives (e.g. improving educational attainment, reducing rural poverty) (Beuran, Raballand and Revilla, 2011^[45]).

Weak governance is quoted as the key factor constraining the effectiveness of development finance (Beuran, Raballand and Revilla, 2011^[45]). As the relative importance of DAC providers is waning in face of the sheer amounts of financing and number of projects supported by others, their influence in

encouraging better governance system is getting weaker. Going forward, better alignment with China and other non-DAC players will be critical to ensuring greater effectiveness.

1.2.3. Private investment has a narrow focus

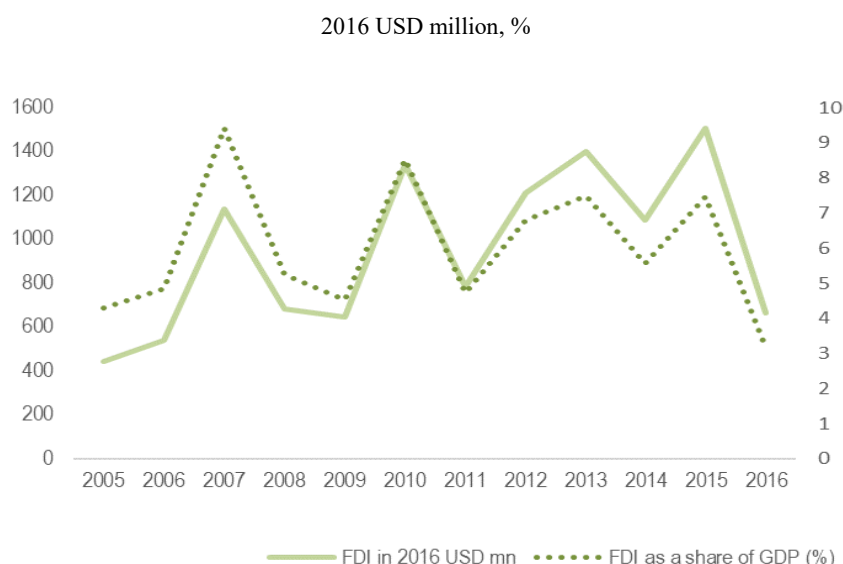
Private investment plays a key role in transition finance. Private investment is driven primarily by business decisions, which may not automatically be linked to sustainable development. Nevertheless, private investment is of critical importance in raising enough financing to achieve the SDGs.

Taking into account that private investment provides the largest external financing source in developing countries, the OECD's Global Outlook on Financing for Sustainable Development (2018^[42]) highlights that aligning even a fraction of the flows towards the SDGs could have a significant development impact. However, to strengthen the role of FDI within development finance, more focus should be placed on its quality to assess and eventually improve its development footprint.

Driven by favourable global conditions, private investment in the form of FDI has been significant, but recently flows are declining.

The two years where FDI peaked and amounted to close to 10% of GDP were 2007 (FDI/GDP: 9.4%) after implementation of the HIPC and MDRI initiatives and 2010 (FDI/GDP: 8.5%), where global macroeconomic conditions were especially favourable for investments in developing countries. The average annual growth rate for FDI from 2000 to 2016 was 13.5%, compared to 0.5% for ODA (excluding debt relief).

Figure 1.18. FDI flows have seen a sharp decline in 2016



Source: IMF (2017^[35]), "Balance of Payments" (database), <http://www.imf.org/external/datamapper/datasets/BOP>

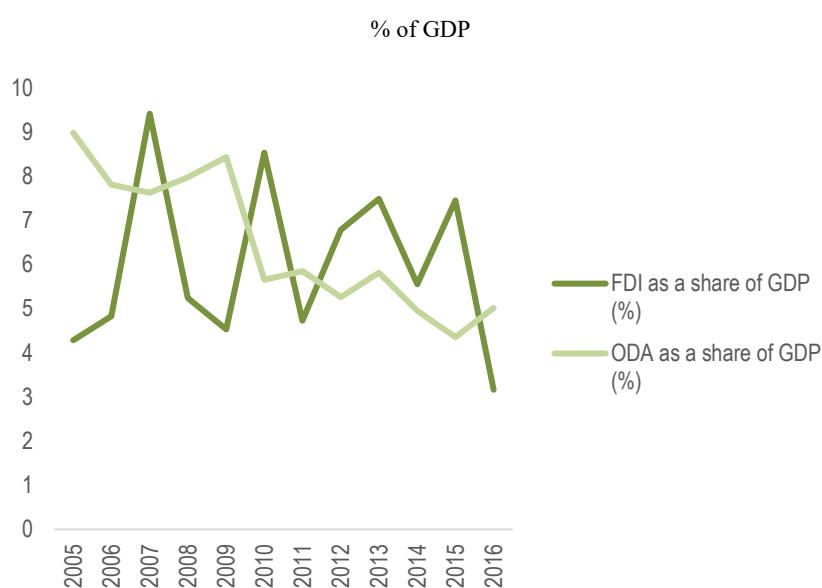
The Zambian government launched an initiative to liberalise investment regimes and privatise state-owned assets to encourage FDI. As a result, FDI inflows hit an all-time high of USD 1.5 billion (in

2016 constant dollar terms). However, the situation was reversed in 2016, when FDI inflows fell to the post-crisis levels of below USD 700 million. This fall may result from macroeconomic instabilities, such as high inflation and power outages throughout 2015. Uncertainties related to the mining tax regime are also said to have motivated this trend (UNCTAD, 2016^[46]). This decline is also in line with a broader trend across developing countries, who on average registered a 11% fall in FDI in 2016 (OECD, 2018^[42]).

Overall, FDI cannot be said to have replaced the role of ODA. Net FDI inflows have been on average smaller than ODA and more volatile. FDI is also heavily concentrated in the mining sector.

Since the reclassification of Zambia to LMIC status, FDI has been greater than official development assistance from DAC providers. However, over the period of 2005-2015, FDI has been less important than ODA on average. The average share of net FDI over GDP during the time has been 6%, compared to 6.5% for ODA. Moreover, FDI has been much more volatile than ODA, which is also manifest in the higher standard deviation of the growth rate at 55.9% compared to 14.7%.

Figure 1.19. In terms of GDP, FDI has recently declined from previously high levels



Source: OECD (2018^[33]), “Creditor Reporting System” (database), <https://stats.oecd.org/Index.aspx?DataSetCode=crs1>; IMF (2017^[35]), “Balance of Payments” (database), <http://www.imf.org/external/datamapper/datasets/BOP>

FDI has a narrow sectoral focus. According to one estimate, over 70% of the FDI stock is in the mining sector (Bank of Zambia, 2017^[6]). The investor base also demonstrates high levels of concentration, with the top five investor countries making up more than 70% of FDI stock. Among main investors are Canada, UK, Switzerland, China and South Africa (IMF, 2018^[47]).

1.2.4. Domestic Resources are not growing quickly enough

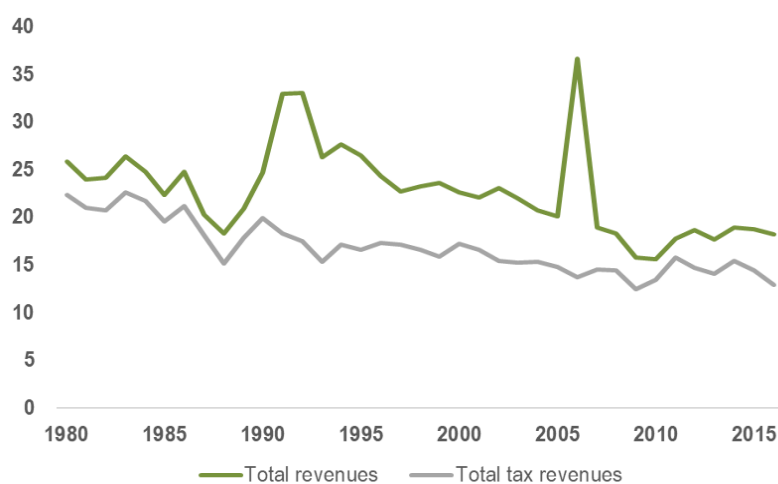
Domestic revenue is critical for a country's transition finance to generate fiscal space for increased investment and to ensure gradual phase-out of ODF. Among all income groups, tax-revenues represent the largest single source of financing for development (OECD, 2018^[42]). The role of domestic revenue is also stressed by the Addis Ababa Action Agenda (AAAA) recalling that country's themselves hold the primary responsibility for its economic and social development. Undoubtedly, an increase in domestic revenue lifts a country's opportunities to finance its investments in a self-sustained manner. Given this importance, co-operating partners can support countries to build necessary capacities to develop public finance management and domestic resource mobilisation.

Domestic resource mobilisation in Zambia did not keep up with growth in expenditures.

While Zambian tax revenue was above 20% of GDP in the early 1980s but the ratio decreased. This decline was mainly due to the decreasing mining revenues in the 1980s and 1990s and weak tax administration. In 2016, total tax revenue was at 12.93% with average tax revenue amounting to 15.6% over the past decade (2006-2016).

Public revenues including non-tax revenues such as mining royalties have been relatively stagnant in the 2000s, but in more recent years, there has been an increase from 15.6% of GDP in 2010 to 18.2% in 2016. This reflects increases in mining output and improvements in the tax compliance of mining companies (World Bank, 2016^[49]). However, the pace of this increase did not match that of growth in public expenditures (World Bank, 2016^[49]).

Figure 1.20. Domestic public revenues have been relatively stagnant



Source: ICTD/UNU-WIDER (2018^[48]), Government Revenue Dataset, <https://www.wider.unu.edu/project/government-revenue-dataset>

Initially, generous tax incentives have made it difficult to generate domestic revenues from the mining sector, and efforts to remedy the situation have led to high volatility in the tax regime.

The contribution of the mining sector to domestic revenues is perceived to be small. Due to tax incentives and generous concessions on development agreements in the mining sector, Zambia's public revenues did not benefit largely from the increase in copper production throughout the 2000s. The contribution of mining taxes for the 1998-2011 period averaged 4.4% (Lundstøl, Raballand and Nyirongo, 2013^[49]).

In response to increasing concerns over the low tax intake, the government implemented a series of tax reforms to increase revenues by imposing a revenue-based windfall tax, higher royalties, increased company tax and a variable profit tax. As a result, the contribution of the mining sector to government revenues increased after 2007/8 to over 18% in 2011 (Lundstøl, Raballand and Nyirongo, 2013^[49]). However, the downside of these measures was that they reduced tax certainty. The tax regime was changed nine times, of which the last three occurred throughout 2016/2017.

In light of the budgetary pressures that are due to the high costs of debt servicing, the government is continuing to emphasise domestic resource mobilisation. However, there are some concerns the lack of tax predictability will deter investors. For example, the recent proposal to introduce the sales tax to replace the VAT tax, which was included in the 2019 Budget Speech by the Ministry of Finance, arose scepticism about the policy direction of the government with regard to private companies. The objective of the policy change was to enhance domestic public revenue mobilisation by foregoing VAT refunds to manufacturers and exporters including mining companies.

Zambia's reliance on mining exposes it to high risks of tax avoidance and evasion, putting pressures on stressed administrative capacities.

Zambia's high reliance on mining poses an additional challenge in terms of tax administration, as the extractive sector is highly exposed to tax evasion.

Zambian tax administration is currently not using the tax transparency tools to fight against tax evasion. Zambia is currently not using Exchange of Information (EOI) and there is no infrastructure (dedicated unit, guidelines, trained staff etc.) in place, which allows the Zambia Revenue Authority (ZRA) to use EOI during its tax audits. A joint ATAF/Global Forum technical assistance mission on exchange of information took place in 2018 to help assist Zambia with EOI.

However, Zambia has demonstrated its willingness to tackle tax evasion and avoidance with some recent improvements.

Zambia has recently joined the BEPS Inclusive Framework and new transfer pricing regulations were published in April 2018, strengthening and clarifying existing transfer pricing rules. In November 2018 the ZRA published its Transfer Pricing Practice Note setting out the ZRA's interpretation of Zambia's transfer pricing rules. Together these provide Zambian taxpayers with much greater clarity on how to comply with Zambia's transfer pricing rules. Alongside this Zambia has benefitted from assistance under Tax Inspectors Without Borders (TIWB) which has been helping build the capacity of auditors to effectively apply the transfer pricing rules.

Moreover, Zambia has implemented some mechanisms to improve mining tax compliance with the support of the World Bank³ and bilateral CPs. ODA targeting domestic resource mobilisation amounted to USD 6.6mn in 2015, which is the first year where data for this category of donor support is available. Norway's Tax for Development Programme, which started in 2011, is a prominent and successful example. Experts from the Norwegian Tax Administration were sent to ZRA to support the planning and conducting of mining audits. However, the programme was phased out in 2018 with the exit of Norway as a co-operating partner, and the amounts of ODA for domestic resource mobilisation are expected to decrease as a result.

2. Benchmarking: How to compare Zambia's transition finance with other peer groups and countries?

A comparison of Zambia's financing mix with countries at both similar and different development stages allows to discuss Zambia's development finance in a broader transition context. In this spirit, the following section aims to identify how Zambia's financing mix is positioned in comparison to its peers, and seeks to provide best practice examples from other countries.

The key finds of the benchmarking exercise are:

- Although debt levels have increased across countries, **the pace of the increase has been especially rapid in Zambia**. Due to the high concentration of maturities and borrowing at variable interest rates, the implications on debt servicing costs has also been more severe.
- Official development finance is still important but **Zambia receives less than countries with similar vulnerabilities**.
- **Official development finance is concentrated in health**, possibly forgoing opportunities to accompany economic transition of the country.
- **Domestic public resources have not grown to the same extent as in some other countries**; increasing resources will be crucial to overcome a rising debt burden.
- **Remittances are lower** than for peer countries, **possibly leaving a financing gap in social sectors** due to lower spending by households.

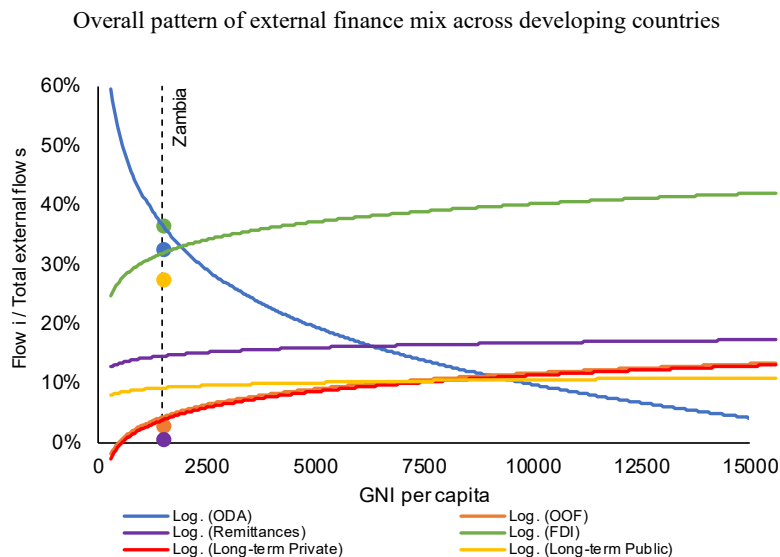
2.1. Zambia's hybrid status as both an LDC and LMIC is reflected in its financing mix

The subsequent analysis focuses on comparing countries with similar income levels in terms of the mix of financial resource they can access. While the concept of development is multi-dimensional, and a number of studies look beyond traditional measures of economic performance to better understand transition challenges⁴, income per capita remains an important indicator in terms of both growth and economic outcomes and countries' access to finance. A country's gross national income (GNI) is particularly important as it often affects the country's eligibility to access concessional public finance (ODA) and can be highly correlated with access to non-concessional sources of finance, including international financial markets (OECD, 2018_[42]).

Compared to other developing countries, Zambia has a high reliance on non-ODF resources, especially external non-concessional long-term debt. Zambia's share of public debt in the external financing mix is much higher than for other countries with similar income levels (Figure 2.1). This ultimately reflects Zambia's previous issuances of three Eurobonds in 2012 (USD 750 million), 2014 (USD 1 billion), and most recently in 2015 (USD 1.25 billion), and increased commercial debt from Chinese lenders.

Moreover, the country's share of ODA is slightly below the predicted value for its given income level while the share of FDI is higher.⁵ The share of remittances is far below the curve that represents the overall pattern observed across developing countries.

Figure 2.1. Zambia's external financing mix is over-reliant on long-term public debt

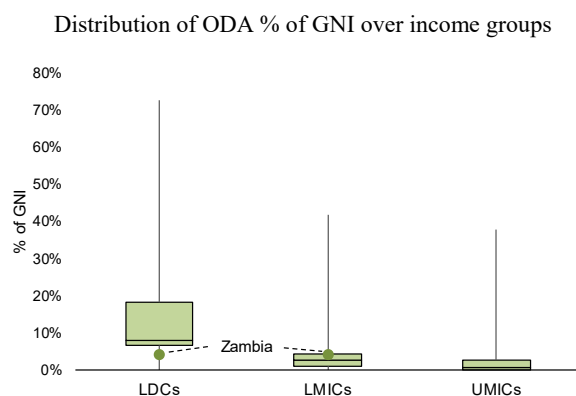


Note: The plotted lines represent predicted values at each GNI per capita level. The predicted values result from a logarithmic regression where the share of flow over total external flows is regressed on the logarithm of GNI per capita. The underlying values are average values for the years 2012-16.

Source: OECD (2018^[33]), Creditor Reporting System, <https://stats.oecd.org/Index.aspx?DataSetCode=crs1>

Considering the group of LMICs, Zambia receives slightly more than the median country. Within the group of Least Developed Countries (LDC's), in turn, Zambia is among the countries with the lowest share of ODA over GNI (Figure 2.2). This could suggest that the relatively low weight of ODA is not justified in light of the social and economic vulnerabilities that classify Zambia as an LDC.

Figure 2.2. Zambia's ODA receipts are located between LDCs and LMICs



Note: Income groups defined according to OECD DAC ODA recipient list.

Source: OECD (2018^[33]), Creditor Reporting System, <https://stats.oecd.org/Index.aspx?DataSetCode=crs1> for ODA; World Bank, (2018^[51]), "World Development Indicators" (database), <http://wdi.worldbank.org/tables> for GNI.

While this broad comparison sheds light on the wider context, a closer look using a more selective group of peer countries can provide more inputs to inform development partners' support for Zambia financing strategy.

2.2. A more specific look: Zambia in comparison to regional and structural peers

2.2.1. Who are Zambia's peers?

This section compares Zambia to two groups of countries, namely *regional* peers and *structural* peers. This exercise can shed light on both strengths and weaknesses of Zambia's financing mix. In consequence, it can provide information about financing mixes and targets that may be more desirable in order to achieve Zambia's development ambitions – while being feasible at the same time.

For regional peers, we identify countries that belong to the same (LMIC) or higher (UMIC) income category. All countries have an abundance in natural resources, which makes them more easily comparable to Zambia. LMIC countries in the regional peer group have a similar level of income to Zambia but do not belong to the group of least developed countries. The characteristics of the countries are summarised in Table 2.1 below:

Table 2.1. Zambia's regional peers

	Per capita GNI (USD)	Income category	Natural resource endowment	Human Asset Index	Economic Vulnerability Index	Concessional/non-concessional lending
Botswana	6,610	UMIC	Diamonds	79.0	45.5	IBRD
Ghana	1,380	LMIC	Gold/oil	69.9	33.7	IDA
Cameroon	1,200	LMIC	Oil	62.7	19.1	Blend
Republic of Congo	1,710	LMIC	Oil	66.0	31.8	Blend
Zambia	1,300	LMIC	Copper	58.6	40.5	Blend

Source: (IMF, 2012^[50]) for natural resource endowment; World Bank, (2018^[51]), “World Development Indicators” (database), <http://wdi.worldbank.org/tables>

The group of structural peers includes countries that, just like Zambia, rely on a high share of copper in their exports. Chile is at a much higher stage in terms of national income level and, thus, serves as an aspirational peer. Mongolia is in the same income category as Zambia (LMIC) although its human asset index is much higher. The last country is the Democratic Republic of Congo, which has recently overtaken Zambia as Africa's leading copper producer, but is at a lower stage of development in terms of the income category (LIC).

Table 2.2. Zambia's structural peers

Type the subtitle here. If you do not need a subtitle, please delete this line.

	GNI	Income category	Share of copper in exports (2012-2016)	Human Asset Index	Economic Vulnerability Index	WB Lending window
Chile	13,530	UMIC	44% - 52%	98.0	26.6	IBRD
Mongolia	3,550	LMIC	22% - 45%	91.7	39.0	Blend
DRC	420	LIC	38% - 56%	41.9	27.2	IDA
Zambia	1,300	LMIC	71% - 81%	58.6	40.5	Blend

Source: United Nations Committee for Development Policy Secretariat, Triennial review dataset 2000 – 2018, The Observatory of Economic Complexity, <https://atlas.media.mit.edu/en/>; World Bank for income classifications

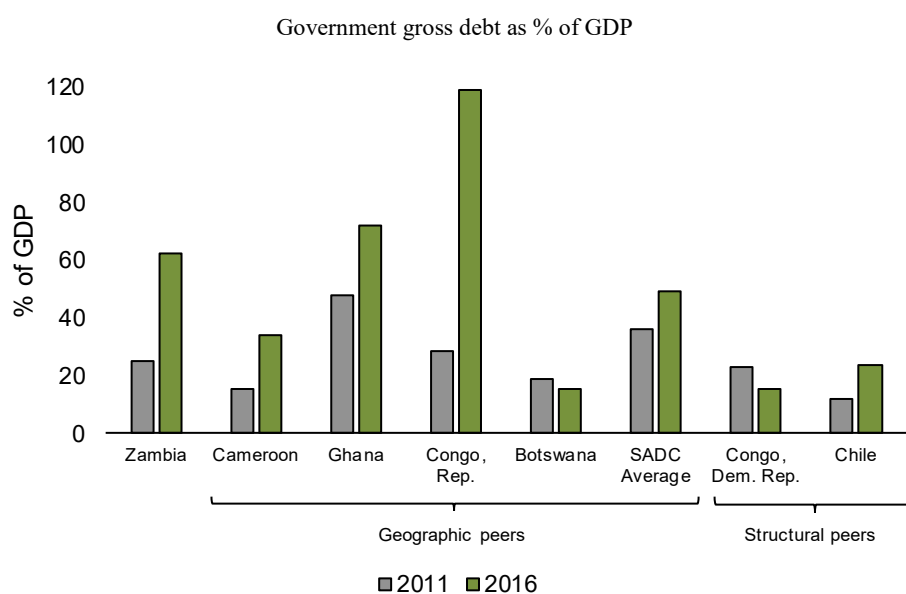
The following section will compare the development finance patterns of Zambia with those of peer countries. This will help to put into perspective the findings of the previously undertaken assessment, and can guide DAC and other development partners in supporting Zambia tap into a balanced and sustainable mix of financing resources to continue transition into higher stages of development. In line with the holistic approach called upon by the OECD (OECD, 2018_[42]), the following analysis will explore:

- rising debt levels among benchmarking countries,
- level, composition and sectoral allocation of development finance,
- characteristics of domestic revenue mobilisation,
- volumes and sectoral allocation of private investment
- inflows and use of remittances.

2.2.2. Rising debt levels across benchmarking countries put pressure on available financing resources

Debt levels have increased across countries, but generally not to the same extent as in Zambia. The assessment section above highlights that Zambia's debt levels have increased at an unsustainable pace since its classification as an LMIC in 2011. Broadening the picture, it becomes evident that debt levels have also risen in a number of peer countries since then.

However, the increase has been steeper in Zambia than in other countries (Figure 2.2). For example, government debt has tripled in Zambia while the increase has been much smaller in other countries. In Botswana and the Democratic Republic of Congo's (DRC), government debt levels have even declined. In case of the latter, the DRC received substantial debt relief in 2010 and 2011 by the IMF and World Bank under the HIPC and MDRI initiatives; followed by sound fiscal policies and favourable exchange rate developments (IMF, 2015_[51]). The only country for which government debt has increased even more than in Zambia is the Republic of Congo. Here, government debt has grown from 23.8% of GDP in 2011 to 114.6% of GDP in 2016.⁶

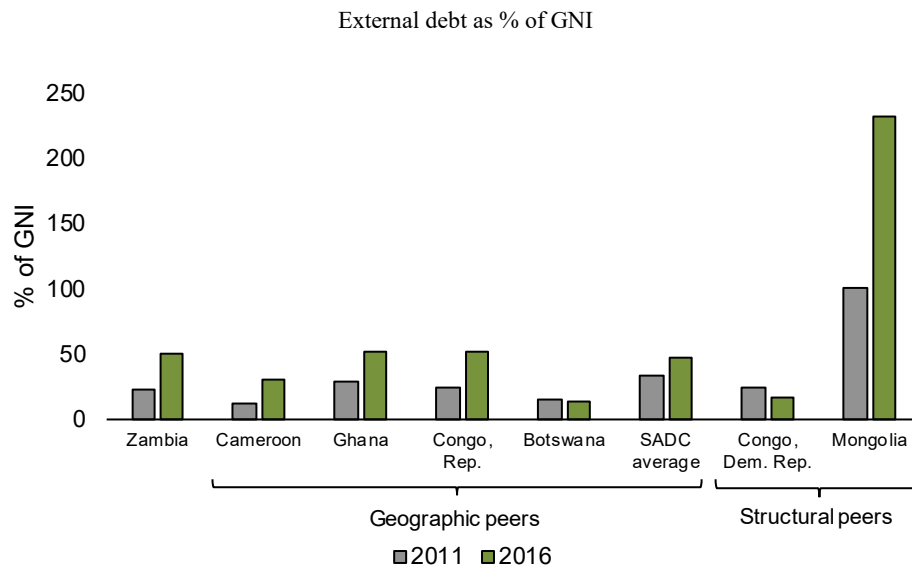
Figure 2.3. Government gross debt increased across most benchmarking countries

Note: No data on Mongolia in respective data source

Source: IMF (2018^[52]), World Economic Outlook, <https://www.imf.org/external/pubs/ft/weo/2018/02/weodata/index.aspx>

Similar to the developments in general government debt, external debt has increased substantially since 2011. In Zambia, the ratio of external borrowing to GNI more than doubled between 2011 and 2016. The only country, for which the increase was more pronounced, was Mongolia, where the debt ratio increased from 100.6% of GNI to 231.9% of GNI in 2016 (further see Box 2.1).

Figure 2.4. External debt more than doubled in Zambia but volumes are substantially below those in Mongolia



Note: No data on Chile

Source: World Bank (2018^[5]), “World Development Indicators”, <http://wdi.worldbank.org/tables>

Box 2.1. Mongolia’s recent experience with public debt is comparable to Zambia

Mongolia, largely relying on its mineral exports, was hit strongly by commodity prices falling from 2011 onwards. Additionally, FDI dropped in 2015 when the second-phase of the Oyu Tolgoi (OT) mine was delayed over an investor dispute (IMF 2017) and was at USD -398.88 million in 2016. A loosening of macroeconomic policy aimed to counteract the negative external shocks led to an increase in public debt levels. In 2016, fiscal deficit rose up to 17% of GDP (IMF 2017). Highlighting Mongolia’s exposure to global commodity markets and the impacts on its economic performance, growth in 2016 was down at 1%, down from almost 8 percent in 2014.

Over the past years, Mongolia has experienced major increases in its public levels. External debt stocks amounted to 285.5% of GNI in 2017, or USD 28.19 billion, up from 89.7% in 2010. Interest payments on external debt have seen a record high in 2017 being at USD 940.88 million, up from USD 94.99 million in 2010. In the meantime, foreign reserves have decreased 4.8% of total external debt in 2016 but stood at 10.1% in 2017. The share of concessional debt of total external debt decreased to 11.9% in 2017, down from its peak at 90.2% in 2006 and 29.9% in 2010. Likewise, the share of multilateral debt in total external debt decreased from its peak at 57.1% in 2006 to 5.8% in 2017.

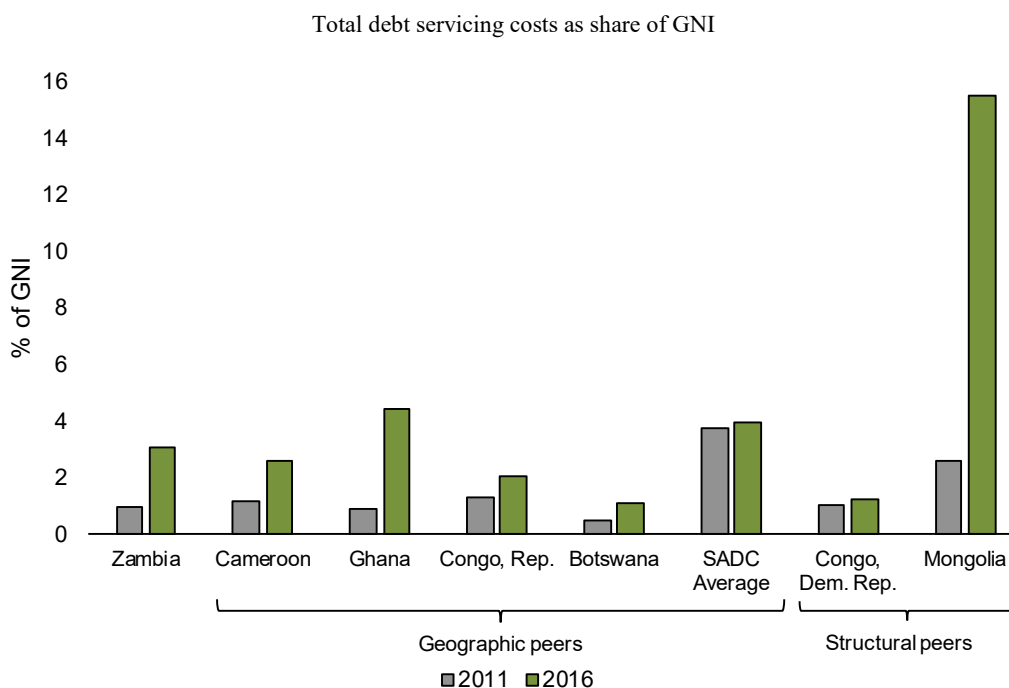
In 2017, co-operating partners agreed on supporting Mongolia’s economic reform with a financing package summing up to USD 5.5 billion. These partners included the IMF, the Asian Development Bank, the World Bank, Japan, and Korea. Since then, Mongolia experienced strong economic growth. In 2017, the economy grew by 5.1% and has further accelerated to more than 6 percent in the first three quarters of 2018 (IMF 2018). In 2017

and 2018, monthly primary balance has been positive thanks to royalties and corporate income tax building on strong mineral exports – after having been negative throughout 2015 and 2016 (IMF 2018).

For 2019, the Mongolian authorities have proposed a budget including a primary surplus of 1% of GDP (IMF 2018). Growth projections by the IMF are expected to remain high due to strong coal exports and improved credit support.

More alarming than debt levels themselves, is the surge in debt servicing costs. Since 2011, total debt servicing costs have increased in all benchmarking countries shown in Figure 2.5. Between 2009 and 2017, the share of domestic revenue allocated towards meeting debt obligations has risen from 9% to 25% in Zambia (World Bank, 2017^[39]). This is particularly due to the high concentration of maturities and the depreciation of the national currency. Average interest payments on new external debt commitments have risen in Zambia since its LIC graduation (from 1.34% in 2011 to 3.16% in 2016) whereas average interests among SADC members declined from 2.08% in 2011 to 1.40% in 2016.⁷ Regarding Zambia’s issuance of Eurobonds, the coupon rate had increased with each bond.

Figure 2.5. Debt service costs have increased across benchmarking countries



Note: No data on Chile within source

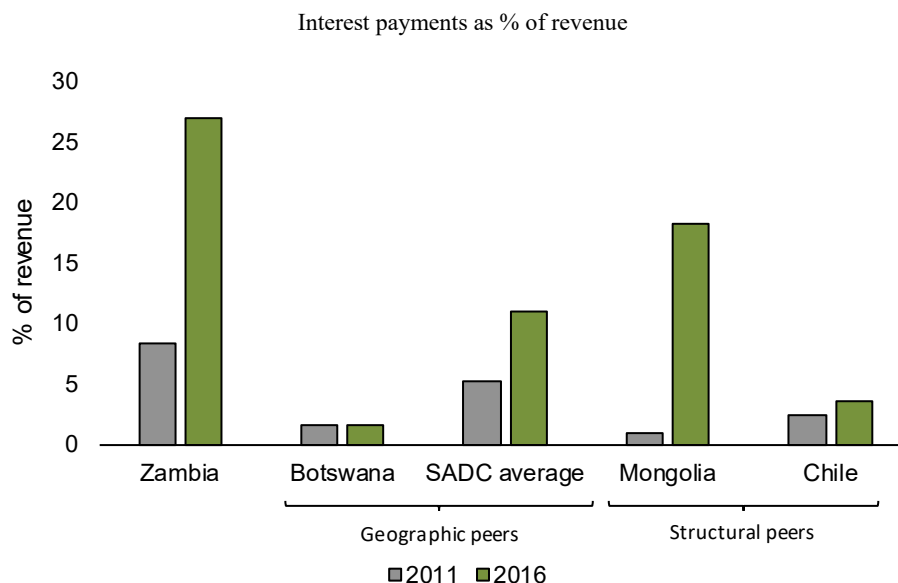
Source: World Bank (2018^[5]), World Development Indicators, <http://wdi.worldbank.org/tables>

Rising debt levels and debt servicing costs put strain on the countries’ ability to finance development projects. As debt levels have increased and terms worsened, Zambia spends larger fractions of their revenue on debt servicing including interest payments (Figure 2.6). This trend is also observed for Chile, Mongolia and the SADC members as a

whole. With increasing shares of revenue going to debt servicing, fiscal space for spending on infrastructure, production and social sectors becomes more limited.

The trend in rising debt cost and lower domestic revenue available for other expenditure, reveals a critical relationship between rising debt and development finance. While government spending is constrained by rising debt obligations, resources and investment allocated towards focus areas of Zambia's national development plan become more limited. Additionally, access to non-concessional lending will become less available as Zambia transitions further along the development continuum, possibly leading to a continued increase in debt service costs. Therefore, DAC providers continue to play an important role in Zambia's ongoing development progress. Their support should be aligned to fill financing gaps in sectors most in need while incorporating the rising debt burden into their own lending conditions.

Figure 2.6. The share of Zambia's revenue going to interest payments has substantially increased



Note: Data on other benchmarking countries more limited.

Source: World Bank (2018^[5]), World Development Indicators, <http://wdi.worldbank.org/tables>

2.2.3. Official development finance is still important but may not be sufficient

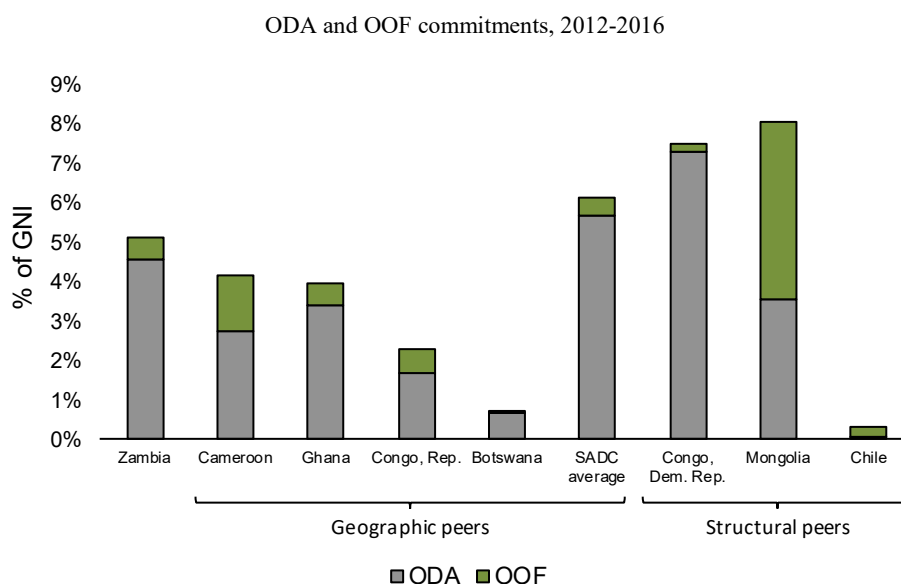
Zambia has a relatively high reliance on official development finance compared to its aspirational peers but receives less than countries with similar vulnerabilities.

Between 2012 and 2016, Zambia received ODF commitments summing up to 5.1% of GNI. This is similar to the share of FDI over GNI (5.9% respectively), and is higher than for most peers that belong to the LMIC or UMIC category (Figure 2.7). In light of the increasing debt burden, this suggests that official development finance can still play a considerable role in the financing strategy of Zambia. Nevertheless, Zambia received

slightly less ODF in terms of its GNI level than the SADC average (6.1%), which reflects the fact that nine of the 16 SADC countries are LDCs. Somewhat unsurprisingly, ODF is also significantly more important for the Democratic Republic of Congo, which is one of the SADC countries and has a by far lower GNI than Zambia.

More remarkable is the fact that Mongolia, despite a higher income level, receives substantially larger shares of official development finance than Zambia. Most notably, this is mainly due to OOF commitments amounting to 4.5% of GNI between 2012 and 2016 that are largely allocated towards the mining sector. The need for an unusually large amount of official development finance can be explained by Mongolia's debt-ridden financing situation explored in Box 2.1 and the country's high economic vulnerability in the face of its high reliance on mining. Figure 2.7 also emphasises the different development stages of Botswana and Chile who are both considerably less reliant on ODF when measured as share of GNI.

Figure 2.7. Official development finance relative to GNI signals differences between Zambia and its peers Botswana and Chile



Source: OECD (2018^[33]), Creditor Reporting System, <https://stats.oecd.org/Index.aspx?DataSetCode=crs1> for ODA and OOF; World Bank (2018^[5]), World Development Indicators, <http://wdi.worldbank.org/tables> for GNI.

Official development finance in Zambia is more tilted towards the health sector than is the case for most of its peers.

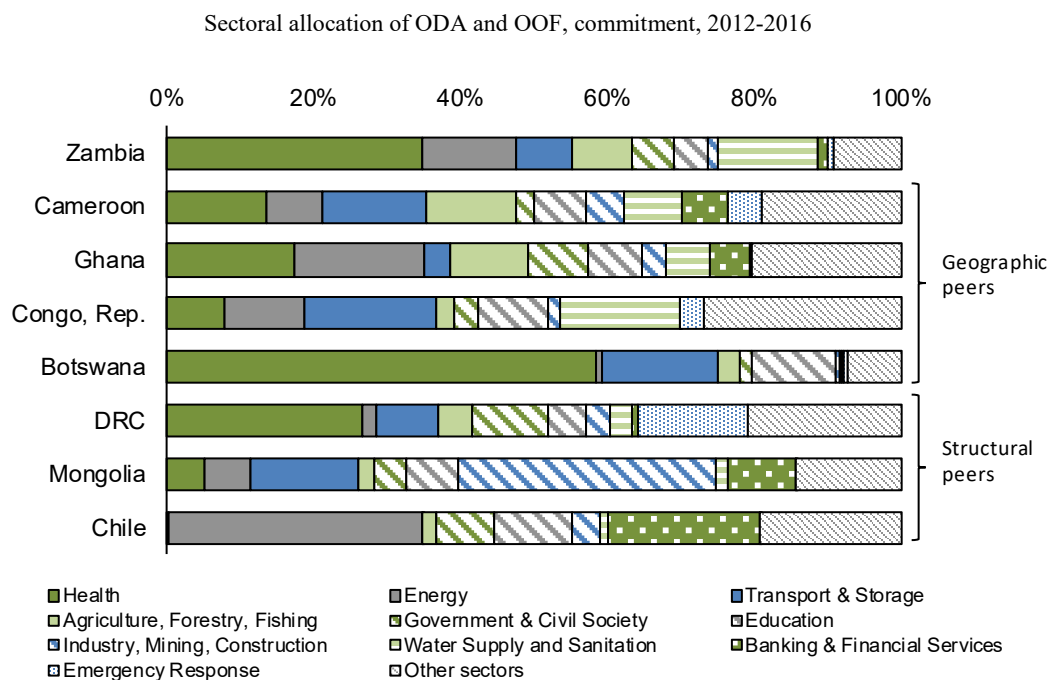
As highlighted in the assessment section, Zambia receives the largest ODF flows in the health sector. This is also true for Botswana but as indicated in Figure 2.7, ODF in terms of GNI is much smaller in Botswana. Moreover, the high concentration towards health in Zambia stands in contrast with regional peers like Cameroon, Ghana, and the Republic of Congo whose ODF is more balanced across different sectors. With large amounts of ODF allocated to the health sector, Zambia presents a counterexample to the recent OECD

finding that countries are prone to experience financing gaps in social sectors as they transition along the development continuum (**Box 2.2**).

However, in Zambia's the focus on health can have a downside as well. For example, it could explain why the importance of ODF in Zambia is perceived to be lower than it actually is. Although the share of total ODF of GNI is still sizable, the presence of DAC development partners and their resources is rather limited in areas that are prioritised in the government's development agenda (see Box 1.2 on National Development Plan) and that are strategically important for the country's continued transition towards increased economic progress and diversification.

Looking at Zambia's structural peers sheds more light on this observation: ODF in the structural peers is more directed towards infrastructure and production sectors, which are strategically important for continued economic upgrading and transition. Chile's ODF receipts in recent years are largely targeted towards energy as well as the banking and financial sector (34.5% and 20.4% of total ODF commitments between 2012-2016). In Mongolia, the largest share of ODF went towards the mining sector (35.1%), as further explored in Box 2.3, and the second largest destination was transport and storage (14.6%). Projects included the construction of railways to transport mining outputs for further processing and exports. Conversely, the industry, mining and construction sector accounted for only 1.3% of ODF commitment in Zambia between 2012 and 2016; the transport and storage sector accounted for 7.6%.

Figure 2.8. ODF in Zambia is concentrated towards health



Note: Sectors with largest allocation chosen; other sectors aggregated into 'other sectors'. The bars for each country follow the order of the legend from left to right.

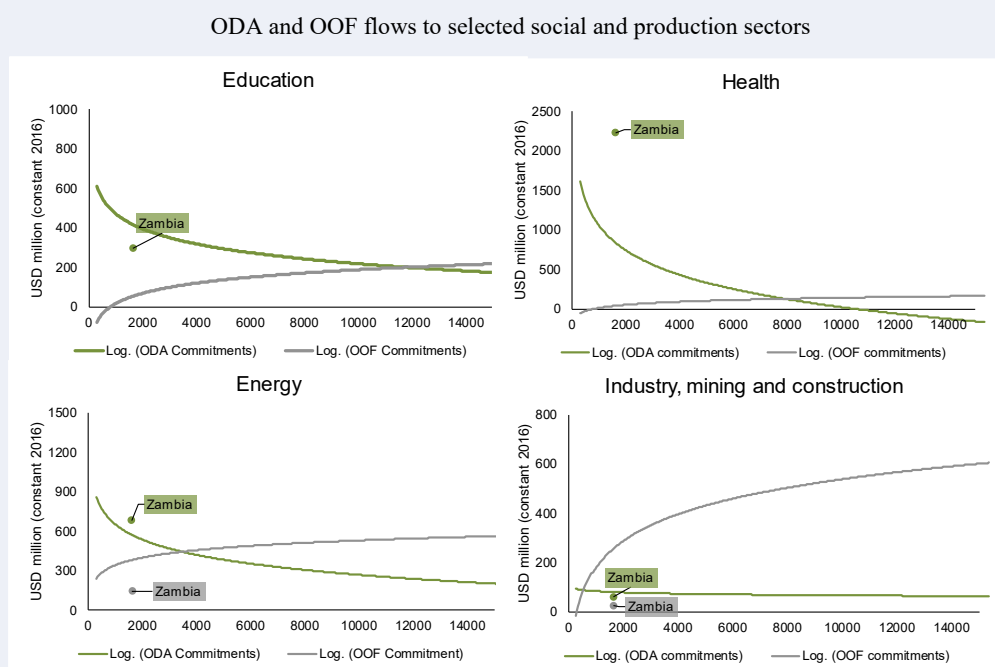
Source: OECD (2018_[33]), Creditor Reporting System, <https://stats.oecd.org/Index.aspx?DataSetCode=crs1>

Box 2.2. Transition finance gaps and their implications for Zambia

Building capacity in the health sector is important to prevent financing gaps in social sectors as Zambia transitions.

OECD research (OECD, Forthcoming^[2]) has found that social sectors are prone to financing gaps (underfunding) as countries progress in the development continuum. That is, production and infrastructure sectors are found to be more likely to attract ODF (in the form of OOF) at higher income levels than social sectors such as health and education. Consequently, measures should be taken to ensure that ODF spent on health at earlier development stages is building the necessary capacity and prerequisites to equip Zambia for a potential future phase out of ODF. Similarly, the findings call upon better co-ordination and alignment between the country's financing needs and its donor support as Zambia transitions.

Figure 2.9. Financing gaps are more likely to appear in social sectors



Source: OECD (2018^[33]), Creditor Reporting System, <https://stats.oecd.org/Index.aspx?DataSetCode=crs1> for ODA and OOF; World Bank (2018^[5]), World Development Indicators, <http://wdi.worldbank.org/tables> for GNI.

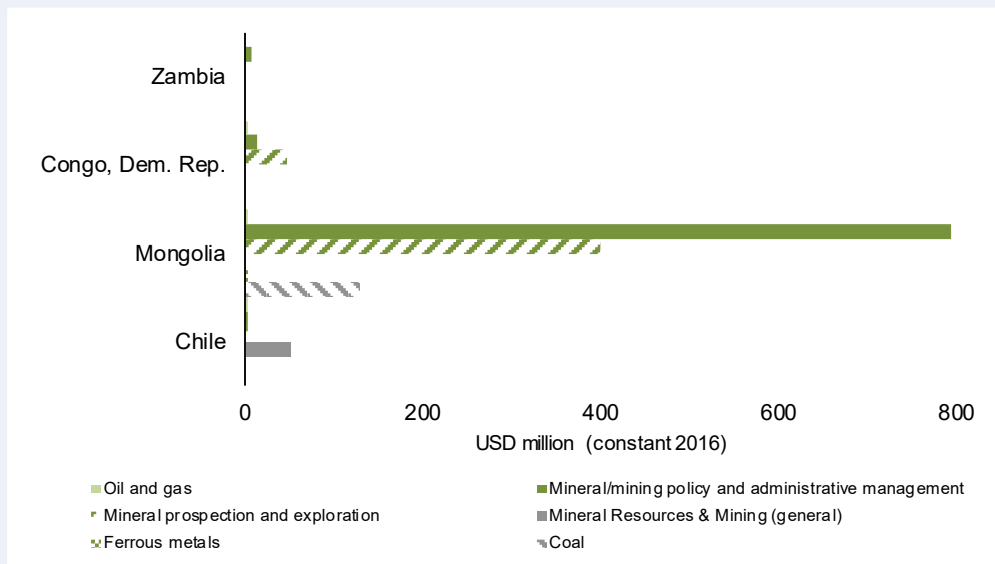
Box 2.3. What DAC CPs do to support the mining sector in Zambia's peer countries

Looking at the breakdown of ODF to mining amplifies the major gap across structural peers in terms of mining sector ODF receipts (Figure 2.11). Mongolia outnumbers the other countries by landslides; between 2012 and 2016 a total of USD 792.9 million was committed to mineral policy and administrative management, and an additional amount of

USD 399.7 million allocated towards mineral prospecting and exploration. Zambia, on the contrary, received only USD 7.2 million towards the former category.

Figure 2.10. Mongolia's ODF receipts in mining outnumber its peers

Breakdown of ODF to mining sector by purpose codes

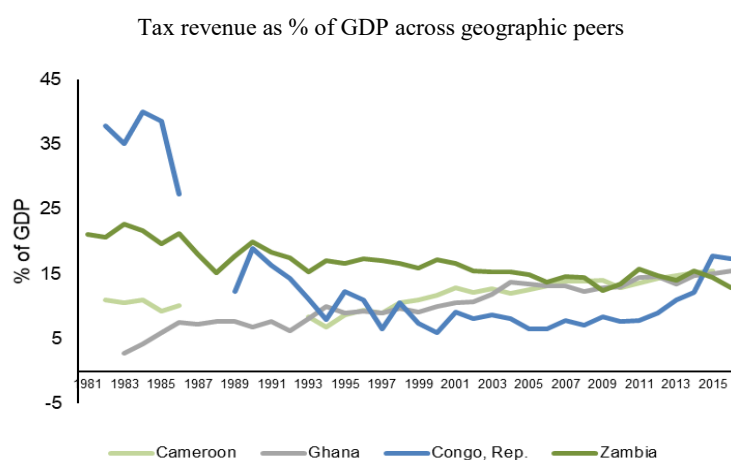


Source: OECD (2018^[33]), Creditor Reporting System, <https://stats.oecd.org/Index.aspx?DataSetCode=crs1>

The largest donor in Mongolia's mining sector is the European Bank for Reconstruction and Development (USD 880.9 million), followed by the International Finance Corporation (USD 398.2 million). The EBRD began its operations in Mongolia in 2006 and it aims to support Mongolia transition to a full market economy (EBRD). Further, it states to be the largest foreign investor within the country. The EBRD also highlights the contribution of copper exports and mining-related investment on Mongolia's current growth dynamics. That said, the EBRD also engages in other activities in Mongolia (e.g. cashmere industry), seeking to support the economic diversification of the country.

2.2.4. Domestic public resources are below expectations

Zambia's tax revenues have not grown to the same extent as in peer countries. The assessment part highlights that Zambia's tax revenue has been relatively slow (Section 1.2.4). This stands in contrast to developments by its geographic peers who experienced greater dynamics in recent years. Lately, Zambia's tax-to-GDP ratio is similar to those of the Republic of Congo, Ghana, and Cameroon. However, these countries have increased their revenues recently after having had a lower tax intake than Zambia before.

Figure 2.11. Zambia's tax revenue is relatively stagnant

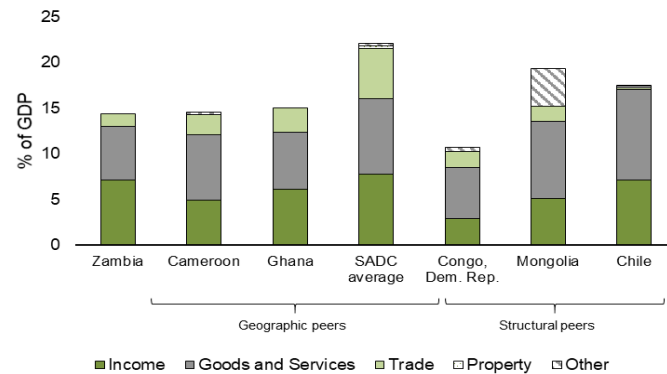
Notes: Botswana is not included in the group of peers for the benchmarking exercise regarding domestic public resources. A clear comparison with Botswana with regard to their public revenues is difficult because of significant discrepancies in the ICTD/UNU-WIDER data with ones in the Africa Revenue Statistics <https://stats.oecd.org/index.aspx?DataSetCode=REV>.

Source: ICTD/UNU-WIDER (2018^[48]), Government Revenue Dataset, <https://www.wider.unu.edu/project/government-revenue-dataset>

Zambia's tax revenue from goods and services and from trade is lower than that of most benchmarking countries. In contrast to tax revenue in its benchmarking peers, Zambia's tax mix is more reliant on income taxes. Especially, revenues from the taxation of goods and services in recent years are smaller than in benchmarking countries. This reflects Zambia's difficulties in administering its VAT, and the high levels of reimbursements it owes to manufacturers and exporters.

Reflecting Zambia's liberal trade regime, Zambia's revenue from trade (export and import) taxes⁸ is considerably lower in comparison with those in Cameroon, Ghana, and the overall SADC average who have higher intake primarily through import taxes.

Figure 2.12. Zambia relies more on income taxes than others and less on taxes from goods and services and services

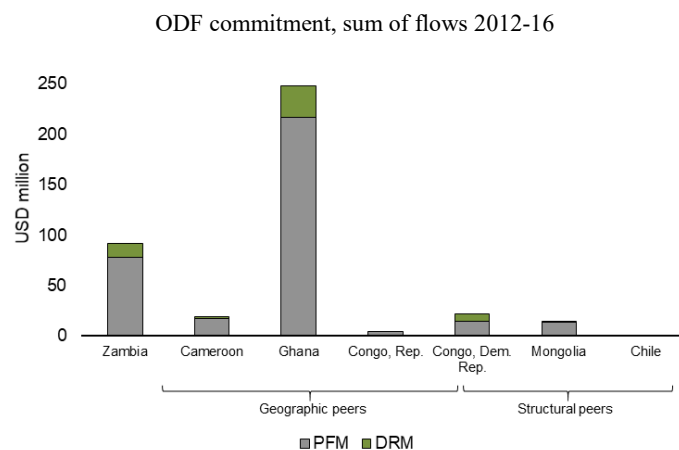


Notes: Botswana is not included in the group of peers for the benchmarking exercise regarding domestic public resources. A clear comparison with Botswana with regard to their public revenues is difficult because of significant discrepancies in the ICTD/UNU-WIDER data with ones in the Africa Revenue Statistics <https://stats.oecd.org/index.aspx?DataSetCode=REV>.

Source: ICTD/UNU-WIDER (2018^[48]), Government Revenue Dataset, <https://www.wider.unu.edu/project/government-revenue-dataset>

Donor support to public finance management (PFM) and domestic resource mobilisation (DRM) has been relatively high in Zambia but needs to continue. Donor support to public finance management and domestic revenue mobilisation is important to foster fiscal capacity and achieve independence of official development finance in the mid-term. As Figure 2.13 indicates, Zambia received relatively high amounts that are only exceeded by flows to Ghana. Projects in Zambia are largely funded by the IDA with an ODA loan commitment in 2012 (2016) amounting to USD 13.59 (19.68) million to public finance management. Further support was mostly provided by Germany and the United Kingdom.

Figure 2.13. Donor support to public finance management and domestic resource mobilisation is relatively large in Zambia



Note: ODF to public finance management refers to flows captured by the purpose code 15111, flows with purpose code 15114 refer to domestic resource mobilisation support.

Source: OECD (2018^[33]), Creditor Reporting System, <https://stats.oecd.org/Index.aspx?DataSetCode=crs1>

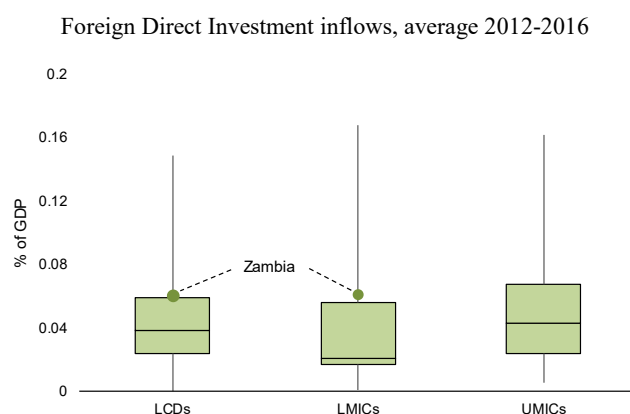
Palpable results in PFM and DRM require long-term support. CPs who have invested in PFM and DRM have noted visible improvements in the technical competence of officials. However, to see results in the form of more domestic revenue intake and more efficient and effective use of public finances involve greater systemic processes at the political level, which require a long-term perspective and persistence.

With the phase-out of Norway’s successful tax for development programme in Zambia, active measures from other CPs have to be taken to ensure that Zambia continues to see the relatively high levels of support for DRM and PFM.

2.2.5. Private investment is an important source of financing but is heavily concentrated

Compared to LDCs and LMICs, Zambia receives relatively high amounts of FDI. Figure 2.14 illustrates that Zambia is among the top quartile of FDI recipients when expressed as share of GNI among both LDCs and LMICs. Based on this high share of FDI inflows, private investments plays a substantial role in Zambia’s development finance mix. Given this importance, the qualitative contribution of private investment to Zambia’s development targets and achievement of the SDGs should be assessed more thoroughly.

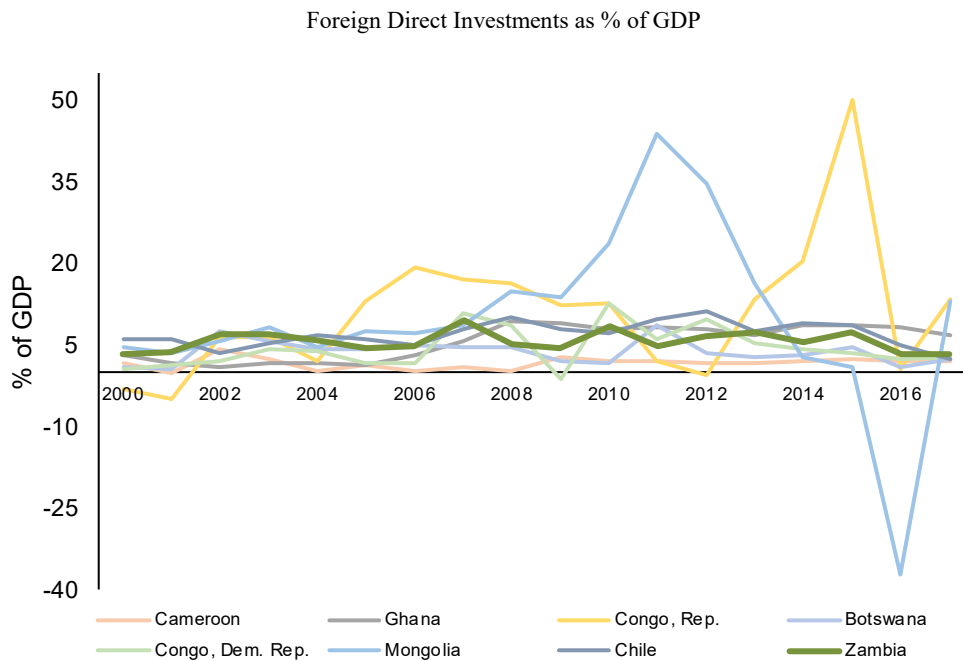
Figure 2.14. Zambia belongs to the top quartile in terms of FDI receipts among both LDCs and LMICs



Note: For visibility, two outliers of the LDCs category are not shown. These are Liberia with FDI inflow of 57.3% and Mozambique with 32.9% respectively.

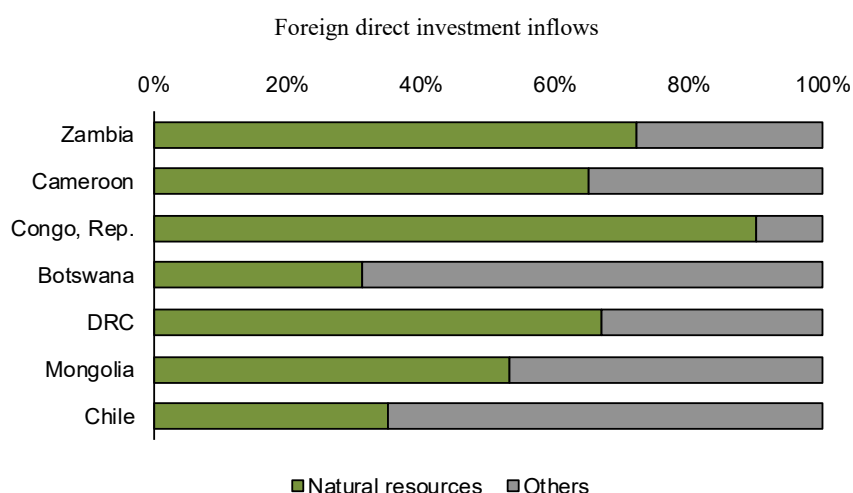
Source: World Bank World Development Indicators

In Zambia, FDI inflows have been relative stable compared to peer countries. Across benchmarking countries, FDI has been volatile and primarily targeted mining and other minerals. Foreign direct investment inflows have seen substantial variation over the past years with largest spikes observable in Mongolia and the Republic of Congo (Figure 2.15)⁹. As consequence of funds transferred “through intracompany loans by foreign MNEs in the mining industry” (UNCTAD, 2018_[53]), FDI inflows have stood at a negative record in 2016. With metal prices having stabilized in 2017, inflows turned positive again and FDI in Mongolia is believed to further grow as the Oyu Tolgoi mine expands. Flows to Zambia varied between 3.1% of GDP (2016) and 9.4% of GDP (2007) since the 2000s.

Figure 2.15. FDI in Zambia has proven relatively stable over time

Source: World Bank (2018^[5]), World Development Indicators, <http://wdi.worldbank.org/tables>

Although data on the sectoral allocation of FDI is more limited, it suggests that investments in resource-intensive countries largely went towards mining and other minerals. In Zambia, an estimated 72% of FDI went into mining and quarrying between 2015 and 2016. Around two-thirds were allocated towards mining in the DRC since 2010 (ANAPI, 2016^[54]). Data available for Chile and Mongolia suggests that numbers are somewhat below that. In 2014, FDI to mining accounted for 41% of total FDI in Mongolia with another 12% flowing towards refinery (KPMG, 2016^[55]). In Chile, mining FDI made up 35% closely followed by the financial and insurance sector with 33% in 2016 (Central Bank of Chile, 2018^[56]).

Figure 2.16. FDI largely targets natural resource sectors

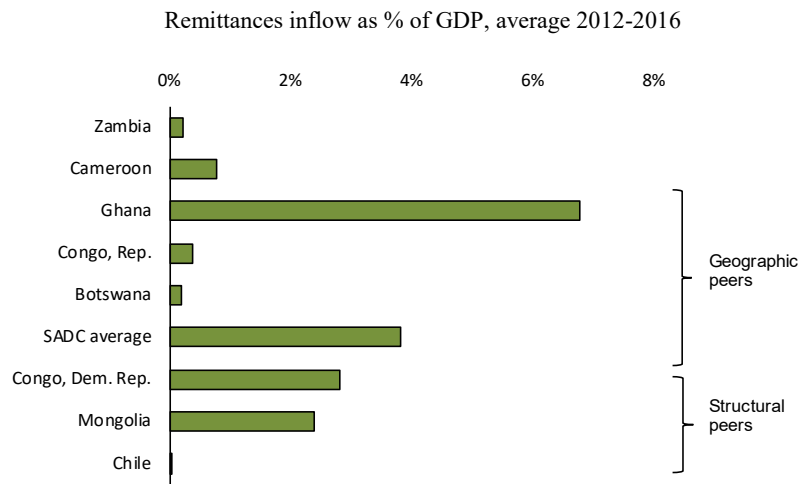
Note: Ghana not shown since division in natural resources and others not possible with given sector distribution. Flows in Zambia include mining and quarrying sector and refer to flows in 2015 and 2016; Cameroon represents coal, oil, natural gas and minerals between 2003 and June 2016; Republic of Congo contains oil and timber but data source remains limited in quality; Botswana flows include mining in 2011; Democratic Republic of Congo is sum of flows between 2010 and 2016 and includes mining; Mongolia includes mining and refinery and values are from 2014; Chile values refer 2016 and include the mining sector.

Source: Bank of Zambia (2017^[6]) for Zambia; ANAPI (2016^[54]) for DR Congo; Bank of Botswana (2012^[57]) for Botswana; WESGRO (2017^[58]) for Cameroon; Export.gov (2017^[59]) for Republic of Congo; Central Bank of Chile (2018^[56]) for Chile; KPMG (2016^[55]) for Mongolia.

2.2.6. Remittances are very low possibly leading to a financing gap in social sectors

Given its small diaspora, Zambia's remittance inflows are small. Figure 2.17 shows how the inflow of remittances varies across countries. While Ghana had an inflow that amounted to almost 7.47% of GDP in 2017, Zambia's level stood at 0.36% in 2017. This, however, is no surprise given that only a small fraction of the population lives outside the country ([WB 2007](#)).

While the low remittance inflow does not necessarily need to be a concern, it stands in contrast to many other developing countries where remittance flows exceed the amount of ODF. In fact, remittances can provide an important contribution to household spending of the poor (e.g. on daily commodities, education and health) – support that remains absent in Zambia.

Figure 2.17. Remittance inflow to Zambia is small

Source: World Bank (2018^[5]), World Development Indicators, <http://wdi.worldbank.org/tables>

3. Counselling: Recommendations for the DAC and its partners: Promoting mixed transition finance strategies

Zambia's development ambitions that are formulated in the 7th National Development Plan will require tapping into all available sources of development finance. While closing the gap between financing needs and available resources, the Government of Zambia needs to ensure that social and economic vulnerabilities are sufficiently addressed. To achieve continued economic growth alongside with socioeconomic progress requires a combination of measures along the following two dimensions.

1. Co-operative approach: Zambia needs to build resilience against possible transition setback through good governance and social safety nets. Development partners can accompany these efforts by supporting debt restructuring and management, as well as enhancing the quality of public investment, while ensuring that ODA contributes to strengthening domestic capacities in health and education systems to avoid socioeconomic risks.

2. Competitive approach: In parallel, Zambia has to continue efforts to generate self-sustained financing including through domestic public revenues. Development partners are encouraged step-up support to enhance the competitiveness of the private sector for greater economic diversification, which can lead to foreign and domestic investment but also more public revenues.

3.1. The Co-operative Approach: Managing debt while investing in socio-economic progress

3.1.1. Overcoming the risk of debt distress

The precarious debt situation that Zambia is currently facing is a key symptom of the bumpy transition the country has undergone so far, and managing it well is crucial to ensuring that the country continues on its trajectory towards sustainable development.

Coinciding with the country's reclassification as a lower middle-income country, Zambia gained access to debt capital markets and an abundance of lending on commercial terms. But Zambia's government was not equipped with the necessary capacities and institutional mechanisms in place to manage the widened range of financing options. As a consequence, debt was accumulated without transparent accounting mechanisms, and therefore was difficult to oversee and manage. At the same time, using those debt proceeds efficiently was challenging in the absence of sound public financial management, especially public investment management systems and procurement mechanisms.

Overcoming the debt situation is critical to allowing Zambia to continue economic growth and socioeconomic progress. By failing to address the debt problem, Zambia also risks losing access to other sources of finance, having to resort to increasingly unfavourable conditions. Negotiations with the IMF over an aid programme are on hold due to concerns over the country's debt management situation, while Germany has halted a loan approval process, which could bring much-needed resources at concessional terms.

Solutions: A three-pronged approach

Increase co-operation among co-operating partners. Zambia will need to consolidate debt management efforts through administrative co-ordination and more rigorous fiscal discipline. A more comprehensive and transparent debt governance framework is needed to facilitate the monitoring of total public sector debt levels including from line ministries and SOEs in a transparent manner. This will require a strong determination to overcome political economy obstacles to effective reform.

As argued throughout this study, the debt problem in Zambia has to be seen in the wider context of transition finance challenges, which are not specific to Zambia. The OECD and DAC can support efforts to accompany and smoothen this transition. Multilateral guidelines and best practices for sustainable lending need to be developed in co-operation with other international organisations and within the context of international processes such as the G20, noting that ensuring the participation of non-DAC and non-Paris Club creditors will be challenging but essential to the viability of these efforts.

Increase technical assistance on debt management. Zambian government officials have voiced great interest in technical assistance to strengthen debt management and negotiation skills to obtain more favourable terms for additional debt issuance but also for the restructuring of existing debt. The United Kingdom has initiated discussions on a programme to involve financial experts from the City of London to provide training in debt management and negotiation of terms for a potential restructuring.

Increase support for governance reforms. In addition to better managing debt, more attention has to be paid to ensure that the financing raised is spent in an effective and efficient way that enhances debt sustainability. Mechanisms have to be put in place to allow for the institutionalising value-for-money analysis and implementation. Transparent disclosure of public expenditures including procurement contracts, as well as accountability mechanisms such as regular public expenditure reviews need to be established.

Some development partners are already providing valuable support in this area, but greater engagement is needed. Germany provides assistance to build capacities in public financial management through GIZ, and has seen an increasing level of competence in professional staff. Broader engagement of the donor community is recommended to highlight the importance of the quality of public financial management at the political level.

Box 3.1. Managing Debt, what can the OECD do?

Based on the varied in-house experience and convening power, the OECD can provide institutionalised and targeted technical assistance for debt negotiation.

Why do developing countries need assistance in debt negotiation?

With rising debt levels, countries moving along the development continuum switch from concessional debt to non-concessional one and contract loans with new providers. Governments are however not always prepared to face the challenges posed by these new investors. In fact, **new investors usually enter the market with very attractive financial terms**, offering package and multipurpose projects, and are “less demanding in terms of procurement, resettlements or environmental concerns” (Estache, 2010_[60]). These packages might however **not deliver the necessary quality**: Foster and Briceno found that the developing world might be able to save up to 8.2% of total infrastructure development costs by reforming procurement rules to promote competition more effectively.

The G20 called “**debtors and creditors to work together to prevent and resolve unsustainable debt situations**” (G20, 2017_[61]) It sketched the way forward by pushing for “*provision of the necessary technical assistance to debtor countries [...] to enhance their debt management capacities, while ensuring recipient countries take ownership over building their debt management capacities [...] especially for the poorest countries that lack the technical capacity to face such a legal challenge.*” (G20, 2017_[61]).

What can the OECD do?

To provide tangible solutions to the G20 recommendations on financing guidelines, we proposes to create a secretariat in collaboration with IMF and World Bank to support developing countries in negotiating and arranging financing packages.

The form of engagement can be modelled after the **Tax Inspectors Without Borders (TIWB)** programme, which is a joint UNDP – OECD initiative aiming to facilitate the transfer of tax audit knowledge and skills to developing country tax administrations using a **problem-specific and "learning by doing" approach**.

Experienced tax auditors are called by host countries to assist on current tax audits and international tax issues alongside local tax officials under a TIWB programme whereby they share their expertise and skills. TIWB was launched in 2015, with 28 ongoing programmes and 7 completed. TiWB has led to USD 414 million increased in tax revenues, with a **return of USD 1 invested for USD 100 gained**.

Building upon the success of the TIWB model, the **OECD can move towards a more project-specific and developing country-driven approach in debt-related technical assistance**, especially around assessing the terms and conditions of loans and their capacities to deal with possible consequences. The programme would draw on a network of experts in member countries specialised in Public-Private Partnerships, infrastructure financing, debt management, etc, who would be sent to the host countries on short-term missions to provide advisory support and capacity building.

Our proposal for a Debt SWAT team that will be sent upon the request of host countries is based on the following five recommendations:

- The process can be iterative meaning than the host country can request the OECD network of experts to assist on other infrastructure contracting projects
- Experts cannot substitute to the work of local administrations
- Gains should be measured at the termination of each mission
- The SWAT should be composed of a network of partner countries and international organisation that has extensive expertise in infrastructure financing

3.1.2. Targeting social vulnerabilities with scarce official development finance sources

In addition to the unstable financing situation, social vulnerabilities are still afflicting the country. Relatively high levels of national income mask the prevalence of poverty especially in rural areas and widening inequalities between rural and urban areas. The Government of Zambia makes efforts to bolster the health and education system. In health, for example, Zambia will for the first time implement the National Health Insurance, potentially putting the country on a path to universal coverage. However, the large portion of debt servicing costs risk diverting funds away from urgently needed public investments in socioeconomic progress.

Exit from DAC providers may have been too early. The exit of some DAC providers, motivated by the rapid economic growth in the 2000s and Zambia's tapping into international capital markets, have left a void in financing specifically targeted to address these vulnerabilities. In retrospect, the decision to leave or scale down financing to Zambia may have failed to take into account the lack of Zambia's resilience to persisting social and economic vulnerabilities. Some DAC providers even left without engaging in prior consultation to co-ordinate their phase-out with others. Hence, they left a void that could not be filled with other resources.

The objective of OECD's ongoing work on transition finance, of which this pilot study is a part, is to develop a Transition Finance Toolkit for Co-operating Partners to inform their strategies for development co-operation with countries in transition. This will include guidelines on how to anticipate and manage phase-out and exit from countries, moving on to other forms of partnerships in better response to countries' needs.

DAC providers still have an important gap to fill. Given Zambia's position in the development continuum, domestic public revenues should be the primary source for social expenditures. However, domestic resource mobilisation does not match the pace of economic growth. Among the reasons are the large and growing size of the informal sector, and weaknesses in tax administration. Social sectors are the first to be affected by pressures on the budget. In the 2019 budget, for example, planned expenditures related to social protection decreased by 24% in real terms and social cash transfers by 10% compared to the previous year. (World Bank, 2018^[26])

Other official providers such as China and India entered or expanded their presence in Zambia's financing landscape. However, these providers usually do not focus on social sectors such as health and education, although a portion of the assistance has been used to build hospitals. As a result, the few DAC providers who stayed continue to play a key role in the financing of socioeconomic progress, while their shrinking number and financing means translate into an increased burden for each individual provider.

Increase presence in other sectors besides health. As mentioned before, although the relative share of their assistance to GNI is quite sizable, the influence of DAC providers is perceived to be low both on the providers' and on the Zambian government's side. One reason for this can be the high level of concentration on one single sector, namely health, which is not only due to the support from highly specialised actors such as the Global Fund who provide targeted assistance in tackling specific health issues.

For CPs who have mandates and resources that go beyond health, co-ordinated action is needed to increase their presence in other areas with similarly pressing needs. One area where DAC partners can increase their presence is education. Support for education to build a skilled workforce is key to tackling Zambia's

social and economic vulnerabilities. Given higher levels of youth unemployment and low levels of educational attainment¹⁰, the need for more financing for education is immense. Ironically, a relatively low share (4.6% between 2012 and 2016) of overall assistance from DAC providers is allocated to education. In response to this need, Ireland's new Mission Strategy (2018-22), includes a focus on increasing access to skills and education (especially for women and youth) exploring interlinkages to economic sectors including trade promotion and promoting market linkages and value chains in the food sector.

Tapping into domestic resources

Building resilience in the face of ODA phase-out requires strong domestic systems to make financing self-sustainable in the long-term. Zambia, backed by DAC partners, has made efforts to strengthen domestic systems in the health sector.

Encourage the mobilisation of domestic resources. For example, with support from Japan, Zambia is planning to introduce a national health insurance scheme to achieve universal health coverage by tapping into domestic resources for health sector financing. To overcome obstacles such as the large informal sector, Zambia was encouraged to benchmark Thailand and Rwanda, which have succeeded in implementing national health insurance in a comparable low-and-middle-income country context.

It should be noted that while efforts to capture revenues from the informal sector are necessary to ensure greater availability of domestic resources to finance sustainable development, careful attention has to be paid to the effects this can have on the poor in the country. The high levels of poverty and inequality in the country should be factored in the support of domestic resource mobilisation.

Engage private sector actors. In the same vein, efforts are underway to mobilise private sector participation and to expand domestic production along the full range of the health value chain. For example, a series of private hospitals have been opened in Lusaka, and pharmaceutical companies such as NRB Group are making investments in the special economic zones. While exploiting the potential of the private sector in the health sector, however, safeguards have to be put into place to ensure that equitable and affordable health services serve to mitigate the negative effects of growing inequalities in Zambia.

Innovative approaches to make more with less

Some providers have introduced new instruments and financing approaches in Zambia to mobilise private finance for development. Among LDCs, Zambia is one of the largest beneficiaries of private capital mobilised through blended finance transactions. In 2012-2015, over USD 500 million of private capital was mobilised, placing the country only behind Angola and Senegal. (UNCDF, 2018_[62])

Blend resources to bring in the private sector. For example, the Scaling Solar program of the World Bank Group, brings together different instruments and services including technical assistance (e.g. on procurement process), loans and payment guarantees to support a series of solar power projects. The support package enticed great interest from private sector participants who offered to provide electricity at the lowest tariff in Sub-Saharan Africa at the time.

Utilise ICT for greater reach. The use of information technology can be an effective tool to equip and empower domestic systems. The ZRA has introduced an electronic tax payment system, which helped capture some parts of the informal sector and enhance domestic revenues. But lack of resources make it difficult to invest in the system upgrading that is needed to build on the current success.

ICT can also be effective in reaching rural areas for the provision of health and education services. For example, Virtual Doctors Services, a UK charity foundation has partnered with the Ministry of Health to provide virtual diagnostic services to health workers in the rural parts of the country connecting them to a panel of medical experts in the UK.

3.1.3. Strengthening governance for self-sustainable financing for development

The challenges Zambia is facing are symptomatic of the transition that many countries are undergoing as they move along the development continuum. With growing levels of national income and greater access to financing options, the ambitions for sustainable development are rising. However, implementation capacities are still lagging behind, while the ability of co-operating partners to fill gaps is increasingly constrained.

With greater availability of financing and a wider range of options, the ambitions of the government for development have been expanding. However, the capacities and institutional mechanisms to realise the vast scale of ambitions are not necessarily in place.

The government has embarked on an ambitious development agenda, which was formulated in a highly sophisticated and well-elaborated National Development Plan and various National Strategies. However, as acknowledged in the 7NDP, the lack of implementation capacity prevents these plans to be effectively executed. Another key constraint is the mismatch between the financing strategy and the national development strategy. The lack of predictability of budgetary releases was diagnosed as one of the factors impeding the success of the 6NDP, and budgeting forecasts for the current national development plan already predict a financing shortfall of 10%, despite aggressive plans to raise domestic public resources. Corruption levels are at least perceived to be rising, hampering the effective and efficient allocation of resources.

DAC providers have lost influence. At the same time, there is a mismatch between the financing gaps of the country and the resources, which official providers can supply to meet those needs. Traditional official providers have exited or downsized their operations in the country, with the ones left behind having less collective leverage in accompanying the transition and supporting the development agenda. The financing these providers can offer is very limited compared to the needs of the country and the resources that are made available by other providers. The waning influence can result in frustration about the lack of results and even less engagement.

Still, there is need to persist in supporting domestic systems. One response can be to tighten control over the funds that are deployed by DAC providers. The phasing out of budget support, although a general trend among CPs and across recipient countries, is said to have been only fitting in the context of Zambia. However, ring-fencing funds and close intervention come at the risk of bypassing domestic systems, which would exacerbate the problem of weak domestic institutions.

DAC CPs have a comparative advantage in the transfer of soft skills. Instead, CPs should persist in the role of strengthening institutional and technical capacities for the execution and tracking of funds, for example in the form of requirements for the detailed budget reporting. This is especially important because the transfer of soft skills and technical capacities is one of the areas, where DAC CPs retain a strong comparative advantage compared to others. Interviews with government officials have revealed a need and willingness to receive capacity building support in the areas of debt management and contract negotiation,

for example. Some CPs already provide valuable support to strengthen public finance institutions, and there is need to continue and build on these efforts.

Empower civil society. The role of civil society is important in this context. Some DAC providers cooperate with local NGOs and think tanks to enhance public scrutiny and accountability. Civil society organisations have been formerly involved in the consultations regarding the 7th National Development Plan. This form of engagement can be further built on with regard to monitoring and tracking the implementation of the NDP.

Co-ordinate among like-minded partners. In the face of their declining influence, co-ordination among like-minded partners is important to ensure the consistency and coherence of efforts. Existing platforms for co-ordination among CPs and with the government are already well utilised in Zambia. But DAC partners can also team up with each other to identify new forms of leverage and partnership with Zambia. For example, European CPs can use their voice to shape trade negotiations with the EU and reflect development concerns. Moreover, co-ordination is especially required regarding the announcements to cease operations in the country and preparations of the phase-out. Consultations with other CPs can help smoothen the impact of the decision and allow for a well-handled exit.

3.2. The Competitive Approach: Making the most of domestic resources while promoting the diversification of the economy

3.2.1. Improve the enabling environment and investment climate

Zambia has recently moved up ranks from 98th to 85th in the World Bank's Ease of Doing Business Survey 2018. (World Bank, 2017_[63]) Despite this improvement, investors count the lack of policy consistency and predictability among factors holding back the country's potential as a major investment destination in SSA.

Frequent changes in laws, among them the recently announced introduction of the sales tax to replace the VAT tax often seem motivated by the financing situation of the government. Currently, overcoming the debt situation is an overriding priority, which leaves only little room for initiatives to attract foreign investment and foster private sector development.

This is mirrored in the institutional set-up of government organisations. For example, the Zambia Development Agency (ZDA), which is a semi-autonomous body under the Ministry of Trade, Commerce and Industry responsible for trade and investment promotion, lacks the resources and institutional leverage to push through reforms that may be in conflict with the immediate securing of financing means.

In addition, lack of trust and awareness about the potential social contributions of the private sector hamper the relationship between government and especially foreign investors. The government is considering a land reform, which will limit land ownership of foreigners from 99-year leases to 25 years, which can have negative effects on foreign investment in the agricultural sector.

It is notable that the Government already addresses this concern in the National Development Plan. By including the creation of a conducive governance environment as one of its five pillars, the 7NDP aims to improve policy certainty, transparency and accountability. By engaging the private sector in stakeholder consultations in preparation of the 7NDP, also, the government is showing some readiness towards dialogue.

DAC CPs can facilitate dialogue with investors. DAC CPs can support these efforts by elevating and mainstreaming policy dialogue with the private sector in the development assistance programs. The EU's

business association, the Zambia-EU Business Club, for example, serves as a platform for discussion between the Zambian government and European investors. As more CPs are teaming up with private sector institutions to lap their resources, they can also play a role as mediators and facilitators between the government and private investors.

Partner with CSR programmes. As part of a phase-out strategy when ending their engagement in Zambia, official providers can also consider approaching private companies to partner with and possibly hand over their programmes and projects that may fit their CSR programmes.

Box 3.2. What is happening on the CSR front in Zambia?

Manja Pamodzi project - ‘hands-together’ - an initiative co-funded by Zambian Breweries and Millennium Challenge Account – Zambia is helping clean up post-consumer packaging waste in Lusaka thereby improving sanitation and hygiene. The programme finally empowers people and creates more local jobs through collecting and recycling of uncollected waste. Since its establishment in 2015, the programme has made substantial contributions to community development. It has:

- Collected over 2, 500 tonnes of recyclable material.
- Empowered over 400 people, namely 399 collectors and 8 aggregators. Currently, women make up over 70 percent of total collectors.

In another CSR programme, Zambian Breweries has launched the Cassava Project to boost small-scale agriculture in the rural province of Luapula.

By developing a recipe for the cassava-based Eagle Lager, the company has found a way to create a local market for the widely grown but until now commercially unsuccessful crop. Due to the high water content of cassava, it was too costly to transport and export it, and most farmers used cassava only for home consumption.

Since the launch of the project in 2017, Zambian Breweries has bought over 5,000 tonnes of dried cassava chips. The number of cassava farmers involved in the production doubled from 2,000 to 4,100.

3.2.2. Increasing the mining sector’s contribution to sustainable development

One of the most pressing challenges for the country is to address economic vulnerabilities in the form of high copper dependence and the lack of local benefits it creates. The National Development Plan emphasises the need to develop upstream and downstream linkages in the mining sector for greater value creation in the domestic economy. Moreover, efforts are underway to enhance the tax administrative capacities to enhance domestic public revenues arising from the mining sector.

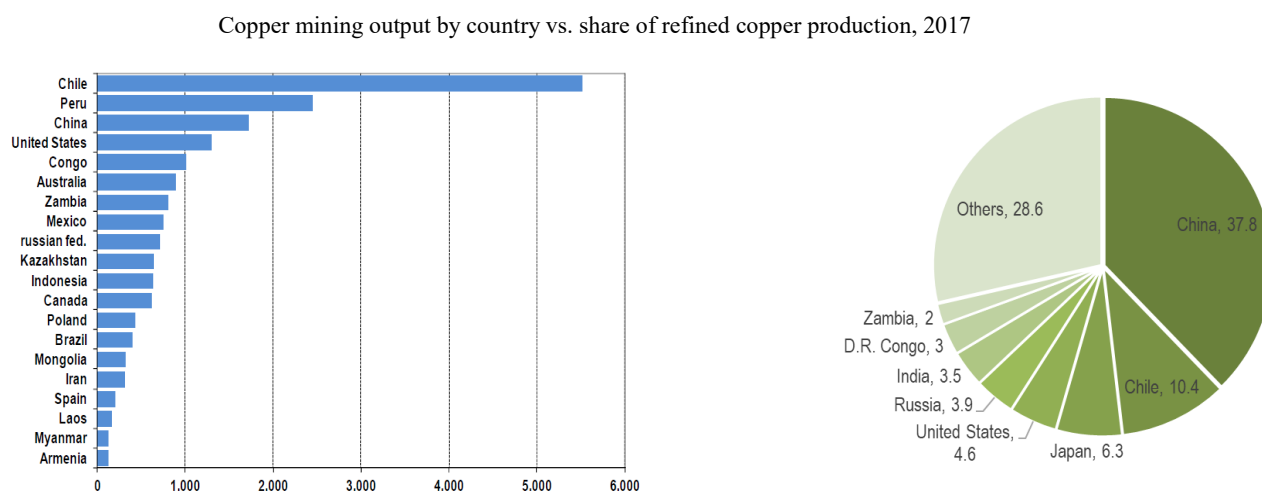
Capturing more value from the mining sector

There is scope for more downstream development in the mining sector. In 2017, the estimated output of copper mining is around 800,000 tonnes, making Zambia the seventh biggest producer in the world and the second biggest in Africa after the Republic of Congo. However, Zambia’s share in global refined copper

has remained at around 2% since 2000. This is despite the fact that Zambia has a total of four copper smelting operations, giving it the combined smelting capacity of 1.2 Mt of refined copper per year, which is the largest in Africa.

Moreover, Zambia is barely active in the fabrication of semi-finished copper or the manufacturing of finished copper goods, which are areas situated further down the value chain that the government aims to develop according to the 7NDP.

Figure 3.1. Zambia is a leading copper mining producer in the world but refined copper production leaves potential for growth



Source: International Copper Study Group, 2018

The upstream linkages to the domestic industry remain underexplored, and the government's efforts in this regard are yet at a preliminary stage. Under the 7NDP, emphasis has been put on local content development. The National Local Content Strategy, which was announced in September 2018, aims to promote to foster business linkages by requiring the use of at least 35% locally available inputs in industrial processes.

Increase technical assistance and capacity building in mining sector. The AfDB supports a comprehensive assessment of the supply chain, which will identify local sourcing opportunities. The government plans to formulate a strategy around the findings of the study, and donor support can target areas that will be pointed out. (Box 3.3)

However, there are risks in promoting local content. For example, government-mandated preference to use local inputs can raise costs for the extractive industries with knock-on effects for other industries. (Korinek and Ramdoo, 2017^[64]) In light of the preliminary stage of this exercise, there is a great need for support including from DAC CPs for capacity building and technical assistance.

Box 3.3. How can CPs support local sourcing in the mining industry

The example of IFC Business Edge capacity building program in Guinea and its impact

In 2006, IFC, in collaboration with Rio Tinto and Guinea Alumina Corporation (GAC), launched IFC Business Edge in Guinea. The lists below show some of the goods and services that have been specifically identified by the IFC as having a potential for local sourcing during the operation of the mining projects in Guinea. The project developed the capacity of local trainers in training local SMEs and helping them meet international mining companies standards. This project supplements the “Guinea Buy Local Program” which encompasses Rio Tinto’s local procurement policies, procedures and activities to meet its commitment to increase local sourcing in Guinea. A comprehensive database of local businesses (over 700 SMEs) that could become suppliers to mining companies was developed. Results and impact included, as of the end of 2012:

- Over \$9.1 million in new contracts between local businesses and international mining companies such as Rio Tinto, GAC and BHP.
- Over 700 new jobs created in local businesses as a part of the mining sector’s supply chain.
- Over 860 participants received training by four local firms, using IFC’s Business Edge training platform for SMEs.
- Over 100 local SMEs received individual coaching from IFC in financial management, marketing, and health and safety procedures.
- Over 100 local SMEs received training in business plan development and access to finance through a program jointly developed by IFC and BICIGUI, the local banking affiliate of BNP Paribas.
- A joint venture was established between a local SME and North Safety Products, a South African manufacturer for personal protective equipment and uniforms. This resulted from the collaboration with Rio Tinto Procurement and from an IFC study, which identified 50 manufacturers in South Africa as potential partners for transferring know-how to Guinea’s local supply chain.
- 25 IFC general information workshops for SMEs were attended by over 600 people, including 123 women.
- A new business and training centre for local SMEs was established by IFC and Rio Tinto in the city of Beyla. Similar centres are expected to be replicated along the port and rail corridor.

Source: IFC (2013), “Bridging the Gap Between Small Businesses and Mining Companies to Increase Local Impact in Guinea”, *IFC Solutions: SMEs Stories of Impact*.

Increasing compliance with corporate obligations

Due to generous tax incentives and subsidies in the past, as well as weak administrative capacities to raise revenues from mining companies, the contribution of the sector to domestic public revenues was low, at least initially, while expenditures related to subsidies to mining companies present a burden on the public budget (Hillig, 2016^[65]).

In general, reconsidering the provision of excessive tax incentives is in line with recommendations to apply a holistic view on maximising the impact of various sources of financing for sustainable development and consider the interlinkages among them (OECD, 2018_[42]). It has been advised to review tax incentives to attract investment, which are rarely the most important factors in the investment and location decisions of businesses (UNIDO, 2011_[66]).

However, attempts to capture more revenues have led to frequent changes in tax policy, and the current direction is towards higher rates and the removal of incentives. The National Budget for 2019 envisages to maximise the potential of domestic revenues for more fiscal sustainability in light of the debt situation. This translates into greater efforts to collect taxes including from the mining sector through the bolstering of administrative capacities and a strict tax regime.

ZRA's efforts combined a long-term OECD transfer pricing and BEPS capacity building programme working closely with the African Tax Administration Forum (ATAF), Norway and the World Bank Group to strengthen transfer pricing capacities has led to great improvements in the quality of transfer pricing audits including in the mining sector. This has led to increases in tax collected from transfer pricing audits and the introduction of new transfer pricing regulations and a Transfer Pricing Practice Note as described in section 1.2.3.

DAC support for domestic resources are key. The successful example of Zambia's co-operation with Norway reinforces the importance of support from DAC CPs in domestic resource mobilisation, which presents a key challenge in a country's transition from reliance on external sources to reliance on domestic resources.

Zambia eagerly seeks co-operation with multilateral and bilateral partners to tackle profit shifting. The country has joined the BEPS Inclusive Framework in December 2017, and has passed a new transfer pricing legislation in 2018. However, there are still some remaining areas to be addressed for full compliance with BEPS recommendations, in which the OECD and partner organisations have a critical role to play. As part of its exchange of information programme, ATAF provides technical assistance to Zambia for the fight against tax evasion through tax transparency and exchange of information (EOI). The findings of an initial assessment in April 2018 indicated that there is a great need for capacity building to use tax transparency tools.

Support CSR governance. Moreover, there is a sense that other contributions from mining companies, for example, in the form of Corporate Social Responsibility programmes and activities, are limited, especially in comparison with the once government-owned ZCCM (Zambia Consolidated Copper Mines) prior to its privatisation in 2000.

The ZCCM was responsible for building much of the social infrastructure in the Copperbelt including hospitals and schools. However, there are examples of mining companies building and revamping health facilities and schools. For example, First Quantum has set up Educare Services, a foundation that built six schools in the poverty-stricken North-Western Province, offering education to children from nursery up to grade 12, as well as a teachers training college. (Educare,(n.d.)_[67])

There is scope to expand the CSR efforts of the companies, in close alignment with the National Development Plan. The lack of a governance framework to guide, encourage and track CSR activities has been pointed out as one of the reasons mining companies are not more visibly contributing to local community development. Partnerships between the government and mining companies can benefit from the support and involvement of official providers and civil society who have experience in co-ordinating with the government in social sectors.

3.2.3. *Promoting private sector development for more economic diversification*

The key industries outlined in the 7NDP including agriculture and tourism hold great promise. However, there are only few success stories. To realise the potential of export industries, the government puts great emphasis on the need for more infrastructure investments to reduce logistics costs. These investments need to go hand in hand with improvements in the enabling environment for private sector development including support for SME financing.

Promoting the diversification of the economy

Support investment in agriculture. Zambia's agricultural sector has lots of potential that remains untapped. Despite an abundance of arable land and groundwater resources, as well as low population density, Zambia's agriculture sector contributes to only 9% of GDP. Employing over 50% of Zambia's workforce, agriculture is still mainly based on large-scale subsistence farming while agribusiness success stories such as Zambeef remain the exception. Yet, the World Bank predicts that agriculture and agro-processed products are among the industries most likely to be conducive to diversified export growth (Merotto, 2017_[12]).

DAC CPs have started to provide new and targeted support to the agribusiness sector in line with Zambia's 7NDP and the National Agricultural Policy 2016-2020. As part of the Zambia Agribusiness and Trade Project (2017-2022) the World Bank provides USD 40 million credit to strengthen market linkages and firm growth in agribusiness. The EU will provide EUR 87 million to support the sustainable commercialisation of Zambia's smallholder farmers, by easing their access to finance and providing technical assistance to promote investments in promising agriculture value chains. Both the World Bank's and the EU's programmes envisage the mobilisation of private sector resources, which will help to allow a scaling up of agricultural businesses and long-term sustainability of the financing to the sector.

Scale up support for tourism. Tourism is another industry with large but unrealised potential. In spite of the tourism assets it has such as the Victoria Falls and national parks, the number of tourists and their average length of stay lag behind that of regional peers. Although it is one of the priority sector outlined in the 7NDP, tourism receives only little support from DAC CPs. The EU, which supports the government's Tourism Master Plan provides most of the little official development assistance in the sector.

Investing in economic and financial sectors

Financing for infrastructure is already picking up. Infrastructure is crucial for private sector development. The government already puts great emphasis on the need for more investments in infrastructure for better transport and connectivity to regional markets, and a great part of the financing from non-DAC CPs are in roads and other infrastructure. The drive for infrastructure modernisation, however, is at odds with the need to curb down on debt financing to mitigate the risk of default.

Financing needs are also great in the energy sector, and official providers have started to increase their support. Power shortfalls especially as a result of the drought in 2015/16 have been recognised as critical bottlenecks for sustained economic growth and industrialisation. The World Bank provides support to increase solar power generation, which will help Zambia to move away from a high reliance on hydropower. In another project, AFD is investing in improvement of the energy grid and network to increasing access to electricity.

Increase support for better access to finance. Access to finance is a key constraint for domestic companies, especially as government borrowing is crowding out private borrowing from domestic debt markets. In recognition of the strategic importance of the financial sector, the Government launched the Zambia National Financial Sector Development Policy in November 2017 with an emphasis on financial inclusion including for rural areas and SMEs. Alongside the Financial Sector Development Policy, the Government has designed the National Financial Inclusion Strategy 2017-2022 which aims to increase overall financial inclusion from 59 to 80%.

There have been several initiatives to provide affordable finance to SMEs, who are the most affected by this constraint. Official providers have partnered with the Zambian government and financial institutions to support SME financing through guarantees and credit lines. For example, SIDA and USAID run a joint programme that issues guarantees for loans to SMEs, and the AfDB has provided lines of credit to banks in Zambia to lend to local SMEs. However, the share of ODA allocated to the financial and banking sector is still quite low in Zambia compared to both structural and regional peers, suggesting there is scope to do more in this area.

Strengthen regional trade. Being a landlocked country, regional trade with neighbouring countries can offer the potential for more diversified exports. Zambia is a member of the Common Market for Eastern and Southern Africa (COMESA) and Southern Africa Development Community (SADC). Trade with neighbouring countries, of which a large part is informal and unrecorded in official trade statistics, provides an important source of income for many households in Zambia (World Bank Group, 2014_[68]). The main products exported to SADC and COMESA member countries include non-copper products such as cereals, sugar, tobacco, etc. confirming that regional trade is important for trade diversification (World Bank Group, 2014_[68]).

Currently, donor support for these regional initiatives and trade remains quite limited, amounting to less than 1% of total ODA between 2012 and 2016.¹¹ Most of the support targets trade policy or trade facilitation and is provided by USAID and the EU.

Abbreviation	Full name
AfDB	African Development Bank
ATAF	African Tax Administration Forum
COMESA	Common Market for Eastern and Southern Africa
CP	Co-operating Partner
CSO	Civil Society Organisation
CSR	Corporate Social Responsibility
DAC	Donor Assistance Committee
EOI	Exchange of Information
EU	European Union
GDP	Gross Domestic Product
GNI	Gross National Income
HDI	Human Development Index
HIPC	Heavily Indebted Poor Countries
IMF	International Monetary Fund
LDC	Least Developed Country
LIC	Low-Income Country
LMIC	Lower Middle-Income Country
NDP	National Development Plan

ODA	Official Development Assistance
OECD	Organisation for Economic Co-operation and Development
OOF	Other Official Flows
SADC	Southern Africa Development Community
SDG	Sustainable Development Goal
SME	Small and Medium-Sized Enterprises
TIWB	Tax Inspectors Without Borders
UN	United Nations
UNDP	United Nations Development Programme
ZRA	Zambia Revenue Authority

¹ By comparison, the average tax-to-GDP ratio in 16 African countries covered in the OECD Revenue Statistics database was 19.1%.

² In Zambia, most official development finance is provided at concessional terms and therefore qualifies as official development assistance (ODA).) 74.12% ODA and 25.88% OOF in 2016.

³ For World Bank assistance in strengthening domestic resource mobilisation see <http://blogs.worldbank.org/governance/innovative-solutions-resource-mobilization-zambia>.

⁴ See for instance the significant work on “Development in transition” produced by the OECD Development Centre (available at <http://www.oecd.org/dev/development-in-transition.htm>).

⁵ Predicted value refers to the expected value based on a logarithmic regression of the respective flow type share on GNI per capita using underlying data from all ODA eligible developing countries.

⁶ In 2003, the Republic of Congo’s government debt peaked at 204.3% of GDP. Following major debt relief through the HIPC and MRDI initiatives, debt declined to from roughly 55% to 22.2% in 2010. In 2014, government debt was 47.6% of GDP and jumped to 97.1% of GDP in the following year. According to the IMF, debt largely increased as response of bilateral loan agreements with China (IMF 2015). Further, the decline in oil prices (terms of trade loss) and changes in debt valuation due to depreciation of the CFAF relative to the dollar contributed to the large debt increase.

⁷ Average interests rate most notably declined in Angola (from 7.8% in 2011 to 0.6% in 2016) and in Tanzania (from 2.1% in 2011 to 0.75% in 2016).

⁸ Trade taxes, as included in the used ICTD GRD data, refer to both import and export taxes. As stated in the data documentation, it may – in some cases – also include VAT collected at the border.

⁹ FDI inflows peaked at 43.9% of GDP in Mongolia in 2011 but were down at -37.1% of GDP in 2016. In the Republic of Congo, the largest value is observed at 50% of GDP in 2015.

¹⁰ According to UNICEF, the adult literacy rate in 2015 stood at 61.4%, compared to 71.3% in Cameroon, 83.6% in Zimbabwe and 85.1% in Botswana.

¹¹ This amount refers to ODA allocated to the sector classified as Trade Policies and Regulation.

