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Zambia

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PREFACE

The UNCTAD Investment Policy Reviews are intended to help countries improve their investment policies and to familiarize governments and the international private sector with an individual country's investment environment. The reviews are considered at the UNCTAD Commission on Investment, Technology and Related Financial Issues.

The Investment Policy Review for Zambia was initiated at the request of the Government and was financed by the Government of Germany. The review was carried out through a fact-finding mission in May 2003. In preparing the review, UNCTAD received the full support and cooperation of the Ministry of Commerce, Trade and Industry, the designated cooperating agency, and other government ministries and agencies, including the Zambian Investment Centre. The mission also had the benefit of the views of the private sector, foreign and domestic, civil society, as well as the resident international community, particularly bilateral donors and development agencies.

This report was prepared by John Gara, Arvind Radhakrishna, Taffere Tesfachew, Shuvojit Banerjee, Lena Chia and Zbigniew Zimny under the direction of Khalil Hamdani. Erich Supper and Andrea Zazzarelli also provided inputs. Lang Dinh provided research assistance and Essie Saint-Clair provided production support.

It is hoped that the analysis and recommendations of this Review will contribute to an improvement of Zambia's investment policies, promote dialogue among stakeholders and catalyze investment in Zambia.

Geneva, July 2005

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ABBREVIATIONS

AGOA	Africa Growth and Opportunity Act
BIT	Bilateral investment treaty
CDC	Commonwealth Development Corporation
COMESA	Common Market for Eastern and Southern Africa
DTT	double taxation treaty
DRC	Democratic Republic of Congo
EBA	Everything But Arms
FDI	foreign direct investment
FTA	Free Trade Agreement
GDP	gross domestic product
GFCF	gross fixed capital formation
GNP	gross national product
GSTP	Global System of Trade Preferences among developing countries
ICSID	International Centre for Settlement of Investment Dispute
ICT	information and communications technology
IFC	International Finance Corporation
IMF	International Monetary Fund
IPA	Investment promotion agency
JV	joint venture
Kwh	kilowatt per hour
LDC	least developed country
LSE	Lusaka Stock Exchange
MIGA	Multilateral Investment Guarantee Agency
NAPSA	National Pension Scheme Authority
NORAD	Norwegian Agency for Development Cooperation
NRDC	National Resource Development College
PACRO	Patents and Companies Registration Office
PV Tax	present value tax
REER	real effective exchange rates
RSA	Republic of South Africa
SADC	Southern Africa Development Community
SMEs	small and medium-sized enterprises
TNC	transnational corporation
UK	United Kingdom
VAT	value added tax
WTO	World Trade Organization
WIR	World Investment Report
ZAMTEL	Zambia Telecom
ZAWA	Zambia Wildlife Authority
ZCCM	Zambia Consolidated Copper Mines
ZEGA	Zambia Export Growers' Association
ZESCO	Zambia Electricity Supply Corporation
ZIC	Zambia Investment Centre
ZNCB	Zambia National Commercial Bank
ZPA	Zambia Privatization Agency
ZSIC	Zambia State Insurance Corporation
$	United States dollar(s)

ZAMBIA

Zambia has been a republic since independence from the United Kingdom in 1964. It is landlocked and shares borders with eight countries. Lusaka is the capital and other main cities are Ndola and Kitwe in the Copperbelt, and Livingstone in Southern Province. Copper wealth has made Zambia one of Africa's highly urbanized countries. Multi-party parliamentary democracy has been in practice since 1991, with the legislature consisting of a 150 member National Assembly. The President is elected through direct vote. . The country obtains 75% of its export earnings from mining, mainly copper and cobalt. The country is notable in the region for its social and political stability. Governments since 1991 have enacted comprehensive market liberalization policies

Main economic and social indicators

Indicator	2000	2001	2002	2003
Population (million)	9.9	10.1	10.2	10.4
GDP at market prices (billion of current dollars)	3.2	3.6	3.7	4.3
Annual GDP growth (per cent)	3.6	4.9	3.3	5.1
Inflation (per cent)	26.0	21.4	22.2	21.4
GDP per capita (dollars)	317.1	349.5	352.4	413.2
GDP by sector (per cent):				
Agriculture	22.3	22.1	22.2	19.3
Industry	25.3	25.6	26.1	29.7
of which : 1) Manufacturing	11.4	11.1	11.6	11.3
2) Mining [a]	4.1	3.9	3.5	7.8
Services	52.4	52.3	51.7	51.1
FDI inflows (millions of dollars)	122.0	72.0	82.0	100.0
Total exports (fob) (US$ millions)	746.0	887.0	920.0	1'137.0
Copper as per cent of total exports	56.8	57.1	55.4	57.5
Exports of goods and services (per cent of GDP)	21.1	27.1	28.6	30.6
Imports of goods and services (per cent of GDP)	31.4	37.3	42.0	41.8
Gross capital formation (per cent of GDP)	18.7	20.0	17.4	16.0
Population living below the national poverty line (%), 1987-2000	72.9	72.9	72.9	72.9
Human development rank [b]	153.0	153.0	163 [c]	..
Adult illiteracy rate (per cent of people aged 15 and above)	21.8	21.0	20.1	..

Sources: UNCTAD, FDI/TNC Database. World Bank; World Development Indicators 2003 and 2004; UNDP, Human Development report 2002, 2003 and 2004.

Notes: 2003 data are preliminary estimates.

[a] Total countries ranked : 173

[b] Total countries ranked : 175

[c] Economist Intelligence Unit, Country Profile 2004

INTRODUCTION

Zambia has many attributes to attract investment. It is a mining economy with decades of experiences in mining-related activities. The quality of its mineral resources is equivalent, if not better, than those found in successful mining economies. Recent export trends, mainly spearheaded by FDI, also demonstrate the great potential and scope that exist in Zambia for deepening investment in non-traditional export sectors such as vegetables and flowers and non-copper mining. The prospects for investment in higher value added activities in mining, services and agriculture is also immense. Zambia has also underutilized rural resources, including unspoiled wilderness areas for tourism, which, if properly exploited, could help attract investment as large as, if not larger than, other countries in the region. Export potential are also enhanced by regional trading arrangements and privileged market access opportunities granted by developed countries.

With the opening up of the Zambian economy in the 1990s, FDI inflow has increased considerably reaching up to US$200 million in some years. This was largely due to the implementation of an ambitious privatization programme (1994-2001) and also due to Greenfield investments in the agricultural sector, in particular horticulture and floriculture production. The immediate challenge for Zambia will be to increase and sustain FDI inflows beyond privatization opportunities, which are still considerable, and to reap greater benefits from FDI.

The recent FDI inflow has contributed to the much-needed diversification of the economic base and exports. There is also some evidence to indicate that it has contributed to skill and technology transfer. But the assessment of this report is that given its resource potential, Zambia is under-performing and should have done better in attracting FDI. Based on Zambia's recent record and the level of foreign investment moving into other countries in the region, this report estimates that Zambia should be able to attract on average about US$ 300 million a year.

The key message of this report is that Zambia can realize this potential but will need to work hard on bringing its investment policy framework, macroeconomic policies, infrastructure and the costs of doing business to levels that are competitive regionally and globally. At the same time, concerted efforts must be made to strengthen Zambia's human resources and local enterprises to enhance the qualitative impact of FDI on the economy. Investment promotion and facilitation services should also be brought up to international standards. Many of the recommendations made in this report will help the country move in these directions. The report is divided as follows:

Chapter I highlights that FDI has been responsive to Zambia's liberalization policies in the 1990s but in general the performance of the country in attracting foreign investment has less impressive than other comparator countries in the region. The chapter also maps out the pattern of FDI flows, its origin, sectoral and geographical distribution and its impact on the economy.

Chapter II reviews Zambia investment policy and regulatory framework and provides recommendations that help improve the framework. It shows that although Zambia has put in place a liberal investment framework in the last decade, at the operational level, many impediments remain and the lack of coherence in government policies creates obstacles for

investors. Issuance of work and residence permits, labour severance payments and land acquisitions issues are generally weak spots, which should be quickly tackled.

Chapter III identifies the investment potential and constraints in Zambia. It shows that Zambia's potential still derives mainly from its varied resource base and special market access opportunities. Thus, the appropriate strategy is to attract investment that helps to exploit the country's rich resource base and expand export capacity by taking advantage privileged market access opportunities. This means addressing the severe infrastructural constraints and stabilizing macro-economic fundamentals such as interest rates, exchange rate and inflation, which are essential fo enhancing Zambia's investment prospects. The chapter highlights priority actions aimed at making the operational environment conducive for both domestic and foreign investment, and enhancing spillover effects, so far minimal, from FDI to local enterprises.

Chapter IV summarizes main conclusions and recommendations.

I. FOREIGN DIRECT INVESTMENT IN ZAMBIA: TRENDS AND IMPACT

Resource-seeking FDI since pre-independence helped propel Zambia to become a major world producer and exporter of copper. During the decades of the planned economy (the 1970s and the first part of the 1980s), the role of FDI greatly diminished, but it started increasing again during the 1990s, as Zambia's shifted toward a market economy. FDI attracted by privatization has helped to revitalize the ailing copper industry and to diversify production into non-traditional industries. With the privatization programme stalling, FDI inflows have declined, forcing Zambia again to rely more on domestic savings for capital formation, income generation and employment creation. But domestic savings are low, too low to fund desirable investment. The challenge for Zambia is to attract greater FDI, not only through the privatization programme but also greenfield projects (including through sequential, expansionary investments by existing investors). Zambia is well positioned to succeed. Copper prices have recently increased to unprecedented levels and are likely to stay at a higher level, at least for some time, due to increasing demand from growing economies like China. Moreover, Zambia has significant unexploited FDI potential in non-copper mining industries, manufacturing, services and agriculture. Since 2003, growth has picked up, inflation has been falling and significant debt reduction is quite likely, all promising a better investment climate.

A. Economic backdrop

Over the past three decades, Zambia has experienced extreme reversal of fortune, declining from the position of a middle-income country to a least-developed country (LDC). In 2000, per capita income was around 60 per cent of that in the late 1960s. The long-term decline and/or stagnation of copper prices from the mid-1970s onwards until very recently (only in 2004 prices increased significantly), coupled with inadequate investment in new capacities and technology, deteriorating infrastructure and policy failures, dealt a blow to the economy from which it has still to recover: in 2000, copper output was 256,000 tons, only one-third of the output level in 1969. The country's problems were exacerbated by increasingly large amounts of borrowing from international and domestic sources. Zambia went through three decades of nearly stagnant growth with GDP per capita consistently declining.

Since 1991 the country has been engaged in a comprehensive economic liberalization programme, including among others lifting of price controls, removing foreign exchange restrictions and freeing exchange rate, reducing and simplifying tariffs and removing restrictive policies and administrative measures that hindered the activities of the private sector including FDI. The transformation from a centrally planned to an open, market-based economy has been facilitated by a number of internal and external factors. Among them is an extensive privatization programme, a cornerstone of the reform agenda, which helped to increase the role of the private sector, in particular FDI, in the economy. External factors included, in particular, rising external debt and a decline in budget support grants by donors, and, until very recently, a continuously low copper price.

As a result, the macroeconomic environment, a pillar of a sound investment climate, deteriorated in the first half of the 1990s. During 1990-1995 GDP was falling –0.2% annually and GDP per capita –2.5% annually. Between early 1992 and the end of 1993, hyperinflation set in, and prices rose by 200%. However, towards the end of the 1990s, Zambia made significant progress in achieving growth and macroeconomic stabilization. In 2004, inflation was down to 18% (the lowest level since years but still too high for a sound investment climate), the GDP growth turned positive during 1995-2000 (2.1% per year), accelerating to 3.7% per annum between 1999 and 2002 and to nearly 5% during 2003-2004, with good prospects for a similar rate of growth in 2005. Copper production started increasing and a doubling of maize harvest and booming international tourism also contributed to a strong growth.

Reforms on liberalization, privatization and improvements in the investment framework, together with a political stability and a relatively low crime rate among the countries of the region, have put Zambia again within the purview of foreign investors. They have contributed to increased flows of FDI, albeit concentrated in the copper industry and associated with the privatization programme. The copper industry will most likely continue to attract FDI for a few more years. However, sustained inflows at higher levels, contributing to economic diversification, require not only a continuation of good macroeconomic performance but also deepening and broadening of reforms, further improvements in the investment framework as well as in policies to open up new opportunities for FDI, particularly with respect to the development of human resources, and infrastructure and the domestic private sector.

B. FDI trends

1. FDI size and growth

As a mining-based economy, before and after independence in 1964, Zambia relied on FDI for capital, technical inputs and managerial know-how. But the role of FDI was reduced dramatically after the nationalization of major private businesses, including large foreign-owned mining companies, in the early 1970s. Consequently, there was a huge divestment of around $300 million in 1970, followed by stagnation in FDI inflows during the 1970s and most of the 1980s (Figure I.1).[1] Average FDI inflows during this period hovered around $40 million (with another divestment of $38 million in 1981). At the beginning of the 1990s, when economic reforms began, over 80 per cent of companies in Zambia were State-owned, ranging from mines, utilities and financial services to hotels and supermarkets.

[1] From 1994 FDI inflows into Zambia are estimates by Zambia Investment Centre (ZIC), based on purchases of state-owned companies and investment pledges by foreign investors, as well as large expenditures of foreign companies on mining exploration. As regards pledges, ZIC applies an implementation rate of 65% to estimate actual investment. Zambia stopped collecting FDI inflows data in the balance of payments in the early 1990s, when exchange controls were abolished.

Box 1.1 Macroeconomic Policy Climate

Zambia's macroeconomic policy has shown signs of improvements recently. Nevertheless, it still needs further consolidating. Throughout the 1990s and into the 21st century, government finances have been under tremendous pressure, fuelling inflation, high interest rates and exchange rate volatility. Internal and external debt escalated. By 1998 an overall fiscal deficit reached 8% of GDP and after falling in 1999, increased again to 7-8% level in 2000-2001 (partly as a result of massive maize purchases to cover shortfall in production and because of drought). Government borrowing from local banks to finance the gap has crowded out private investment through sheer volume of lending and an increase in interest rates. For example, between the end of 1998 and the end of 2001, interest rates (on 91-day treasury bills) increased from 33% to over 50%, pushing the lending rate of commercial banks to almost 53%. Since then the interest rate went down to some 13% in 2004, but the lending rate at 38 % remains too high for local and foreign investors, many of them SMEs. Budget deficit remains also high, 6.6% in 2003, raising questions about policy stability.

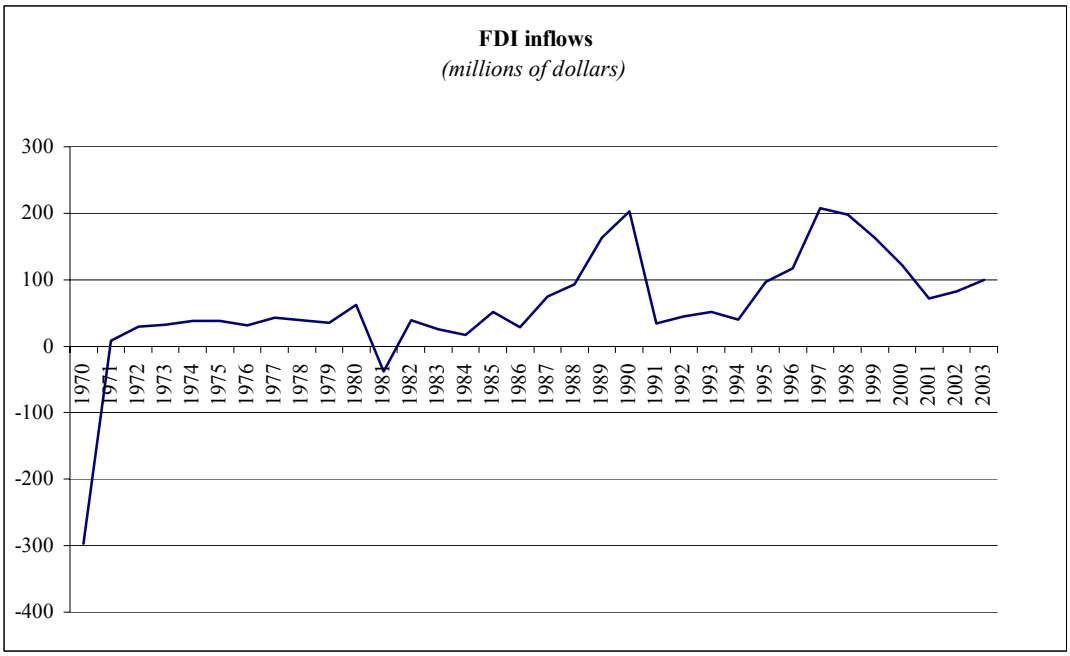
Macroeconomic policy has been affected by the fact that Zambia is a highly indebted country, with total stock of external debt in excess of US$ 6.5 billion, or 150% of GDP in 2003. The predominance of non-private loans enables Zambia to seek cancellations and rescheduling through the enhanced HIPC Initiative and bilateral agreements with Paris Club creditors. Since December 2000, Zambia has acceded to the Initiative (POINT f , HIPC Completion point was reached in 2005 –to reformulate…check) which requires it to meet conditions including further fiscal consolidation, successful implementation of poverty reduction strategy and the completion of the privatization programme. Zambia achieved the Completion Point in July 2005. This augurs well for Zambia, as this will enable it to receive the full assistance under the Initiative, estimated at US$ 3.8 billion. Since it acceded to the Initiative, the burden of external debt service was reduced, on average, to US$ 160m per annum. Failure to reduce the total stock of external debt and the debt service burden through the Initiative could hamper the country's efforts to attain further economic development. Export diversification, in particular, could be encouraged by stimulating domestic investment and attracting the types of FDI contributing to this objective. Debt service payments reduce the domestic resources available for investment. Progress towards completion point has been delayed because of Zambia's failure to meet performance criteria set by the IMF. However, during 2004, Zambia has succeeded in reducing government borrowing. If this trend continues and the country shows strong performance in the implementation of the poverty reduction strategy, it is envisaged that a completion point could be reached at the time of the second review under the Poverty Reduction and Growth Facility (PRGF) arrangement in early 2005.[a/]

[a/] IMF, Press Release No. 04/268, December 16, 2004.

Since reforms first began in the late 1980s, FDI inflow has been considerably higher than during the previous two decades, peaking to $200 million in 1990. But during 1991-1995, FDI inflows were modest, averaging $54 million per year. In the latter half of the decade, stimulus came from the privatization programme, which began in 1992 and accelerated from 1996 onwards. Between 1995 and 2000, average FDI inflows increased to $161 million. With major privatizations completed in 2000 (notably that of Zambia

Consolidated Copper Mines, ZCCM) and no new large privatizations in sight, flows decreased to $85 million per year during 2001-2003, but still were much higher than in the first half of the 1990s (figure I.1 and table I.1).

Figure I.1. FDI inflows into Zambia, 1970 - 2003
(millions of dollars)



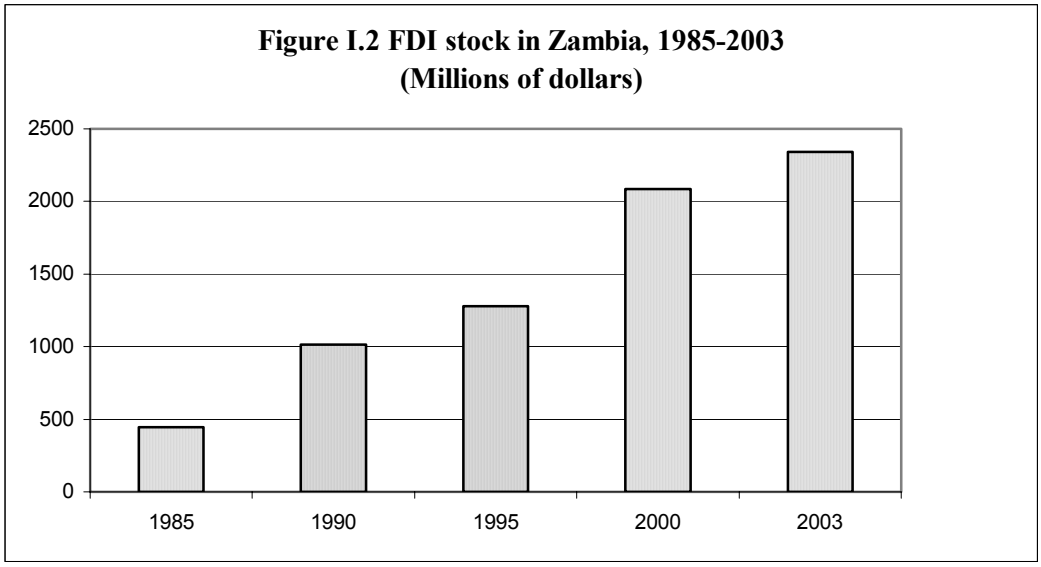
Source: UNCTAD FDI/TNC database.

FDI inflows are likely to increase after 2003 due to strong FDI-related growth in the mining sector, stimulated by rapidly growing international demand for copper, which led to the increase of the copper price by 80% between 2002 and July 2004 (from $1560 per metric ton to $2816).[2] Two large new mines are set to open during 2005-2006 (the Kansanshi mine by First Quantum Minerals from Canada and the Lumwana mine by Equinox Minerals from Australia). Others are rehabilitated by new foreign owners after a period of decline: notably the Ramcoz mine which was closed in 2000 (leaving Luanshya miners for two years without pay or termination benefits and provoking deep resentment about the privatization programme); and Konkola Copper Mines (KCM), the largest Zambia's producer, which went through a period of uncertainty, after Anglo-American, a global South African mining TNC, which acquired a 65% stake of KCM in 2000, withdrew from Zambia in 2002.[3] Consequently, copper production is projected to increase to 500,000 tonnes in 2006.

Increasing FDI flows have resulted in more than doubling of FDI stock between 1990 and 2003, to $2.3 billion (figure I.2), giving Zambia quite a prominent position in terms of the size of the stock relative to GDP, as compared to selected African countries, some of them larger than Zambia (table I.1).

[2] IMF, *International Financial Statistics*, September 2004, p. 1080.
[3] The Economist Intelligence Unit, *Zambia. Country Profile 2004*; and *Zambia. Country Report. Zambia at a glance: 2005-06*, November 2004.

Figure I.2. FDI stock in Zambia, 1985 - 2003
(millions of dollars)



Source: UNCTAD FDI/TNC database

However, in terms of average annual absolute FDI inflows over two sub-periods from 1996 to 2003, Zambia compared less favourably with other LDCs namely, Mozambique, Uganda and the United Republic of Tanzania. These countries attracted significantly higher flows throughout the sub-periods considered (table I.1), while Zambia saw a decline in the performance of FDI flows between 2001-2003. The better performance of these neighbouring countries is due to efforts made to improve their investment climate, stemming from the successful implementation of comprehensive economic reforms. Moreover, most of the FDI into Mozambique and United Republic of Tanzania were greenfield investments in the mining sector, notably in minerals, whereas the first wave of mining FDI in Zambia was related to sale of existing assets. But this is changing, as new mines are opened by foreign investors and new foreign owners of the existing mines are undertaking expansionary post-privatization investment.

2. Distribution by sector and industry

Systematic data on FDI inflows by sector, industry or country of origin are not available.[4] On the whole, FDI is concentrated in the mining sector, both in terms of stocks and flows since the mid-1990s. It is estimated that the mining sector attracted more than half of the FDI inflows during this period. Many large foreign mining companies have entered Zambia during the past decade for production and exploration of copper and other minerals such as cobalt. They included TNCs like Avmin (Australia), America Mineral (USA), Metorex (South Africa), First Quantum (Canada) and, more recently, Equinox Minerals (Australia), J&W Investments (Switzerland), which acquired the closed Ramcoz mine, and

[4] As mentioned earlier, Zambia does not even collect data on actual FDI inflows. Therefore the picture of FDI is based on information concerning large projects in the mining sector, privatization-related FDI projects, and projects approved by ZIC.

Table I.1 Comparative FDI performance of Zambia with selected countries, 1986-2003

(Dollars and percentage)

Country	ABSOLUTE PERFORMANCE					RELATIVE PERFORMANCE													
	FDI inflows per year				FDI Stock	FDI inflows												FDI Stock	
	Millions of dollars				Dollars	Per capita (Dollars)				Per $1000 GDP (Dollars)				As per cent of GFCF				Per capita (Dollars)	Per Cent GDP
	Average (1986-1990)	Average (1991-1995)	Average (1996-2000)	Average (2001-2003)	2003	Average (1986-1990)	Average (1991-1995)	Average (1996-2000)	Average (2001-2003)	Average (1986-1990)	Average (1991-1995)	Average (1996-2000)	Average (2001-2003)	Average (1986-1990)	Average (1991-1995)	Average (1996-2000)	Average (2001-2003)	2003	2003
Zambia	**112.5**	**53.7**	**161.4**	**84.6**	**2'341.4**	**14.5**	**6.1**	**16.3**	**7.8**	**35.5**	**16.0**	**47.9**	**21.7**	**37.4**	**10.3**	**23.6**	**13.4**	**211.0**	**55.2**
Botswana	72.4	-48.2	72.3	173.9	1'080.1	62.2	-36.1	48.4	111.2	31.1	-11.9	14.3	31.3	15.5	-4.5	6.0	14.2	687.6	14.6
Ghana	8.8	101.4	127.8	94.9	1'746.4	0.6	6.1	6.9	4.7	1.6	17.4	18.8	14.9	1.3	8.1	8.5	7.4	84.7	23.2
Lesotho	11.7	19.2	30.1	32.4	427.1	7.1	10.6	15.3	15.6	22.7	22.8	33.0	37.0	4.9	3.9	6.5	9.0	204.2	38.0
Mozambique	5.0	32.0	178.5	249.1	1'841.6	0.4	2.1	10.1	13.1	2.1	14.9	46.9	65.1	0.7	7.2	22.1	27.9	95.3	42.6
Namibia	7.3	109.0	99.2	210.0	1'175.5	5.5	72.4	58.6	116.4	3.2	35.4	28.6	69.2	2.0	18.9	13.8	30.4	635.7	39.1
South Africa	-72.7	376.5	1'517.3	2'769.3	30'373.1	-2.1	9.5	36.2	63.1	-0.8	2.6	10.8	23.7	-0.4	1.7	6.7	16.2	681.9	18.5
Uganda	-0.6	54.2	200.9	253.8	2'042.2	0.0	2.8	9.1	10.2	-0.2	12.5	33.0	43.1	-0.2	7.0	18.2	20.5	79.8	32.9
United Republic of Tanzania	0.3	46.4	260.4	318.5	2'582.5	0.0	1.5	7.7	8.7	0.1	9.0	31.6	33.8	0.1	4.4	19.8	20.1	68.5	26.8
Southern African Development Community - SADAC	283.2	1'121.8	3'718.2	5'873.5	57'777.4	1.9	6.5	19.1	28.0	2.2	6.1	19.7	32.3	1.2	3.6	11.1	20.2	267.1	25.2
SADAC without South Africa	355.9	745.2	2'200.8	3'104.2	27'404.3	3.2	5.6	14.3	18.6	8.3	16.0	42.7	49.1	-0.4	1.7	6.7	16.2	159.6	42.1
Least developed countries (LDCs)	634.1	1'517.2	3'918.8	6'524.0	56'820.6	1.4	2.8	6.1	9.3	4.5	8.8	20.1	32.5	2.0	5.8	10.7	18.3	78.9	24.5

Source : UNCTAD, FDI/TNC database (WIR04)

Vedanta Resources (United Kingdom), which acquired Konkola Copper Mines, the country's largest producer of copper, from which Anglo-American withdrew in 2002.

The second largest sector for FDI is the services sector, more specifically in banking, communications and tourism. There are six international banks operating in Zambia, including Barclays, Standard Chartered, Stanbic and Citibank. FDI in telecommunications services is more recent and concentrated in mobile telephony, with licences granted to Telecel (French) and Celtel (The Netherlands). The tourism industry began to attract foreign investors in recent years, especially in the development of game parks, which cover one-third of Zambia's territory, and the establishment of tourism sites in the Victoria Falls area. The latter saw the opening of the Sun International resort in 2001 built at a cost estimated at $45.6 million on 46 hectares. Foreign investors are also present in the country's three big international hotel chains, namely Intercontinental Hotels, Taj Group and Holiday Inn, which were acquired through privatization.

In recent years, agriculture has been attracting FDI directed mainly at the production of fruits, floricultural and horticultural products, cotton, maize, tobacco and sugar. Foreign investors' involvement in this sector range from such large companies as Illovo, medium-sized foreign companieslike Enviroflor (joint venture with Netherlandsand individual farmers from Zimbabwe.

The involvement of FDI in manufacturing is linked mainly to the production of inputs for the mining sector and food and beverages for the domestic market. There is also some FDI in the production of cotton yarn and engineering and copper-based products for the regional market. For example, Phelps Dodge Cable and Wire Company of the United States, which took over the formerly state-owned firm, Zamefa in 1996, is one of the biggest manufacturers of copper rods, copper wire and power cables in Southern Africa. It exports 90% of its output, most of it (65%) to South Africa. Other key foreign investors in manufacturing include African Explosives, South African Breweries, Parmalat and Lonrho Africa. China is also emerging as an important foreign investor in Zambia.

3. Types of FDI

Recent FDI to Zambia has been boosted by the acquisitions of existing assets by foreign investors under the government's privatization programme, under which 257 of 280 enterprises in the Zambia Privatization Agency's books have been privatized to both foreign and local investors. The programme started in 1992, concerning initially smaller companies, and accelerated from 1996 and 1997 onwards, when assets of ZCCM, including not only copper mines but also power and cobalt plants, were gradually put on sale, culminating with the sale of the largest copper company in 2000 (table I.2). Privatizations with foreign participation greater than $5 million accounted for 38 per cent of FDI in the years 1997-2000, the period which had seen the highest inflows during the last ten years.

Of 254 privatized projects by the end of 2002, foreign buyers accounted for a minority (33%) of the total number of projects. However, in value terms, foreign investors dominated the privatization programme, although mainly through joint ventures with local investors, which accounted for 83 per cent of the total value of privatization transactions, while foreign purchases of entire enterprises accounted for only 12 per cent.[5] The total value of privatization

[5] Source: World Bank, "Zambia Privatization Review: Facts, Assessment and Lessons", December 5, 2002.

receipts amounted to around $450 million, thus indicating the small size of many projects. Foreign investors were involved mainly in the purchase of a number of larger mining, energy, manufacturing and agro-business companies (table I.2). The largest participation has come through the purchase of government mining holdings. The main foreign investors purchasing privatized assets came from the UK and South Africa. Some of these investors, such as CDC, Lonrho and Anglo-American have already had a long-standing presence in Zambia and were expanding their shareholdings in these companies.[6]

Table I.2. Profile of major privatizations with foreign participation, as of 31 March 2003

Name of the acquired enterprise	Date privatized	Buyer	Foreign participation ($ million)[a]	% share
Mining				
ZCCM Luanshya/Baluba complex	Jun'97	Binani Inds (UK & India)	35	85
ZCCM Chibuluma Mine	Sep'97	Metorex (RSA), Miranda Mines (RSA), Crew Devt Corp (Can) & Genbel (Aust)	18	85
ZCCM Power Division [	Nov'97	National Grid Co (UK) & Midlands Power Intl (UK)	50	80
ZCCM Chambishi Copper Mine	Jun'98	China Non-Ferrous Metal Inds Corp (PRC) [/b]	20	85
ZCCM Chambishi Cobalt Plant	Sep'98	Avmin (RSA)	50	90
ZCCM Nkana Mine, Concentrator & Cobalt Plant, & Mufulira Division	Feb'00	First Quantum Minerals (Can) and Glencore Intl (Switz) [/c]	43	90
ZCCM Nchanga Division, Konkola Division, Chingola Refractory Ore Dumps & Nampundwe Pyrite Mine	Mar'00	Anglo American Corp (RSA), IFC & CDC (UK) [/b]	30	80
Subtotal			*246*	
Manufacturing				
Chilanga Cement	Jun'94	CDC (UK)	5.4	26
Zambia Breweries Central Division	Aug'94	Zamanglo (RSA- owned by Anglo American Corp and Indol Intl.)	14	100
Northern Breweries	Jul'96	Lonrho (UK)	9	100
Subtotal			*28.4*	
Agriculture				
Zambia Sugar Company	Jul'94	Tate & Lyle (UK) and CDC (UK)	37	70
Mukumpu Ipumbu Farm & Mukumpu Kampemba Ranch	Dec'95	CDC (UK)	7	100
Lusaka & Gwembe cotton	Jan'96	Lonrho Zambia (UK)	6	100

[6] African Development Bank, "Privatization of Public Enterprises in Zambia: An Evaluation of the Policies, Procedures and Experiences" Economic Research Papers No.35.

ginneries				
Subtotal			*50*	
Tourism				
Intercontinental Hotel, Lusaka	Mar'98	Marasa Holdings (Uganda)	9	100
Intercontinental Hotel, Livingstone	Mar'98	Sun Intl (South Africa)	7	100
Subtotal			*16*	
TOTAL			**340.4**	

Source: Zambia Privatization Agency, Status Report March 2003
Notes: [a] Privatization values of greater than $5 million
[b] Purchase allows extra conditional/deferred cash of $60 million
[c] Value of cash at close of $20 million and $23 million deferred

With regard to greenfield investments, there has been significant FDI in mining and exploration of new copper deposits and in agriculture. First Quantum of Australia is developing a mine in Kansanshi, north-west of the traditional deposits in the Copperbelt, and Equinox Resources of Australia is exploring new deposits in the same area in Lumwana, as mentioned earlier. In agriculture, new investment has come through the purchase of land for large-scale farms by Zimbabweans, especially in tobacco and maize. ZIC records 61 farmers as having entered between 2002 and October 2004, with investments estimated at $51 million. The Sun Resort International Hotel was one recent success in attracting greenfield investment, supporting the government's objective to develop the Victoria Falls area as a prime tourist destination.

4. Countries of origin

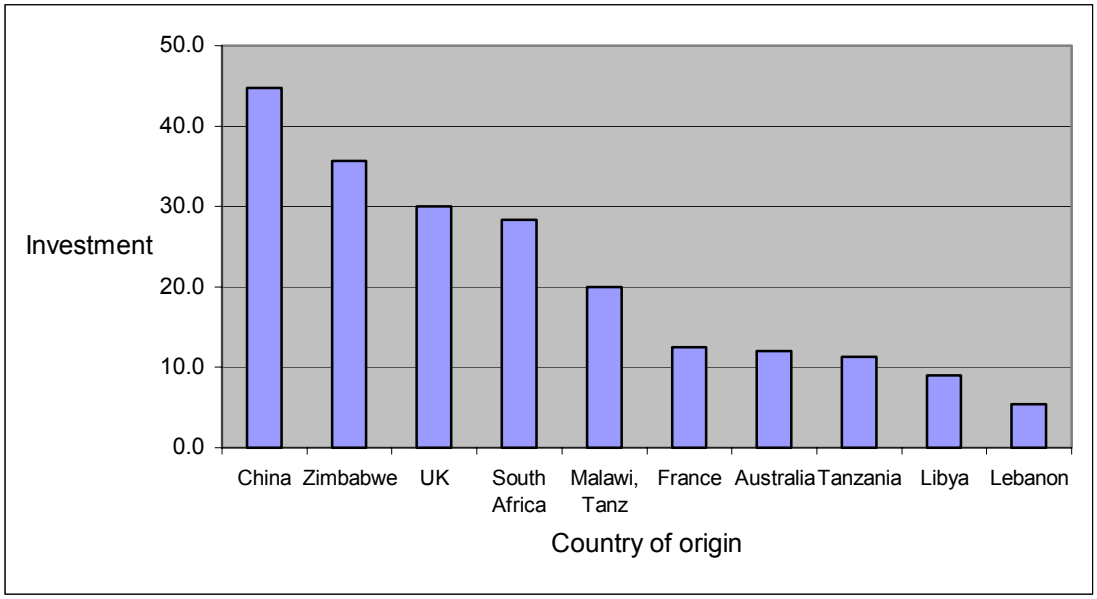
Companies from the United Kingdom and South Africa have been traditionally the main foreign investors in Zambia. In recent years sources of FDI have diversified and include other developed and developing countries. Data on investment approvals in the years 2000-2002 provide some insight into these countries (Figure I.3). Amongst developing country investors, Chinese investors are playing a prominent role, primarily in the manufacturing and construction sectors. Regional investment has come recently from Zimbabwe, mainly to the agriculture and tourism sectors, partly caused by push factors related to the source country's difficult business climate. Apart from mining, British interest is evident in the tourism, services, and manufacturing sectors. South African investors have displayed most interest in recent years in services, particularly in tourism, retail trade and banking.

C. Impact of FDI

In the past decade, renewed FDI inflow to Zambia has contributed to increased inflows of capital, technology, and knowledge, which have helped to develop new mines and rehabilitate existing ones. As a result, in the early 1990s, the production and exports of copper have increased, achieving the level not seen in Zambia for decades. FDI has also contributed, albeit modestly, to the diversification of exports into new products and modernizing services,

notably telecommunication and tourism services. However, it is of concern that FDI has not been able to provide a sufficient level of other benefits to the local economy in terms of the

Figure I.3. Investment approvals by country of origin, 2000 - 2002
(millions of dollars)



Source: Zambia Investment Centre

development of linkages with the domestic enterprise sector, which is an essential condition for sustained transfer of skills and technological capability.

1. Technology and skills

FDI has helped to some degree in improving skills in the domestic economy but it has done little to upgrade local technology levels. Many, if not most, formerly state-owned firms, acquired by foreign investors have been technologically upgraded, but technology transfer to local industry has been limited due largely to low domestic absorptive capability. Thus, Zambia has not been able to reap much benefit from technology transfer to the mining sector, which is a highly capital-intensive sector utilizing specialized technology.

However, FDI has made a greater impact in the transfer of skills and knowledge in the *horticulture and tourism sectors*. In horticulture, foreign investors have introduced new varieties of flowers, and vegetables, and taught local farmers the use of new pest control methods and irrigation. At the managerial level, Zambian employees have been promoted to management roles with expatriates occupying only the most senior positions. Local supervisors are being trained in quality control, important especially for the fruits, flowers and vegetables export business. Workers are provided with ongoing training programmes to improve on skills learnt in specialized agricultural colleges. The industry is providing support to its key technical staff to continually keep up with knowledge on developments in agricultural science (Box I.2). The Natural Resource Development College/Zambia Export Growers' Association (NRDC/ZEGA) Training Trust has also been set up by exporters – most of them foreign firms - in partnership with the Government of Zambia. Through this Trust, the Zambia Export Growers' Association and the Government educate farmers on the

safe use of agricultural chemicals, how to work with pesticides and herbicides, personal and consumer safety. There is particular emphasis on environmental and social aspects of production.

The entry of a number of international hotel groups brought with it an increase in service and quality in hotel management. The Intercontinental Hotels, Holiday Inn, and the Taj Group took over going concerns in Lusaka through the privatization programme. Employees have been retrained since the takeover and are now performing at international standards. All the international hotels have in place continual staff training programmes. Staff were also introduced to modern reservations systems and marketing techniques. Employees, who are already in many cases graduates of government tourism training institutes, benefit from the upgrading of practical skills.

Box I.2. Promoting sustainable knowledge and skills

Enviroflor Ltd. a Dutch-Zambian joint venture engaged in growing roses for export was established in 1995. The present Dutch management bought over a share of the business previously held by the Dutch development agency. The company acquired 106 hectares of land. Enviroflor grows mainly medium-sized roses, which are exported to the Netherlands and sold through auction to global markets. The company exports over 18 million of roses per year and growth is estimated at around 10 to 15 per cent per annum.

Enviroflor's operations also include community development to improve overall social welfare for the local community. The company has 200 employees and part of its equity capital is invested in the community. It has built a school with classes from Grades 1 to 7, with capacity for 400 children. The school is frequented both by workers' offspring and some 100 children from the wider community. Financing is drawn from the company, the Twatasha Community Trust, the Ministry of Education, the Netherlands Embassy and other Dutch sources. The company has an onsite shop run by the workers' families whose profits contribute to the Twatasha Community Trust. The company premises also contain a clinic for children and a crèche for smaller children. There is an ongoing housing construction project to build 100 houses by the end of 2004 to be used by the company's employees.

The rose growing industry is capital intensive and needs well-developed skills, especially technical skills in maintaining optimal conditions for rose growing, in grading and sorting roses for exports, and in overall quality control. To promote the long term sustainability of the industry Enviroflor provides training to its local managers who go to the Netherlands for 2 to 5 weeks of training at an agricultural college, and visit the rose auction houses there to gain comparative knowledge of rose quality. Enviroflor was also closely involved, along with other foreign export growers, in setting up the Natural Resource Development College (NRDC)/Zambian Export Growers Association (ZEGA) Training Institute. The institute provides a three-year horticultural training programme and turned out its first batch of graduates in 2002.

Source: Investor interview.

2. Employment and linkages

FDI was historically important in providing employment in mining and related industries, but the overall direct impact was not large because of the low labour intensity of mining. In 2002, fewer than ten percent of formal sector workers were employed in mining. However, there are spillovers and indirect employment creation for suppliers of goods and services to the mining sector.

Privatization-linked FDI in mining has been initially associated with a negative impact on employment as new foreign owners have rationalized operations. One mine was even closed, creating a huge stir among affected miners and overall concerns about privatization. Paid overall employment in mining declined from over 52,000 in 1995 to 35,000 in 2002. But with post-privatization and greenfield FDI taking off, it started rapidly increasing, reaching 54,000 in 2003. There has also been greenfield FDI in other industries, providing employment opportunities. These industries are labour-intensive and include tourism, horticulture, and the growing of sugar, coffee and tobacco. Jobs in the tourism sector, for example, doubled from 5,909 in 1995 to 11,892 in 2000.[7] By the end of 2003, it had reached 16,000.[8]

Linkages of foreign affiliates with local companies are limited. The mining industry is linked to some support sectors that provide maintenance and basic machinery. In the case of machinery however the supporting companies are also often foreign affiliates who only have a marketing presence in Zambia, importing their products from abroad. Agriculture has provided more links with local producers, such as in the cotton and horticulture sectors. Linkages have been established with the local population through the use of outgrower schemes where cotton and flower supply arrangements are entered into with small individual farmers (see Box I.3). Dunavant, a US TNC, buys approximately 57 per cent of the national cotton crop, and has 100,000 outgrowers with holdings averaging 1.2 – 1.4 hectares. It has also just had another scheme approved which will access an additional 40,000 outgrowers over 20,000 hectares.[9]

3. Export diversification

In recent years, FDI has been instrumental in spearheading the growth of non-traditional export products (non-metals) and contribute to a more diversified export composition. Zambia's exports in the 1980s and up to mid-1990s were dominated by copper and other minerals, (comprising non-ferrous waste and scrap, silver, lead, platinum, cobalt and zinc). All minerals together accounted for around 75 % of total exports in the 1980s.[10]; while cotton and tobacco made up another 12 % (figure I.3).

[7] Ministry of Tourism as reported in the Zambia Poverty Reduction Strategy Paper, 2000.

[8] A statement by the Zambian Minister of Tourism, Environment and Natural Resources during the launching of Visit Zambia 2005 campaign on 8 November 2004. See, a report by Patrick Kayukwa in Zam-World (www.zamworld.com/Tourism).

[9] An Assessment of Trends in the Zambia Agriculture Sector, The IDL Group, December 2002.

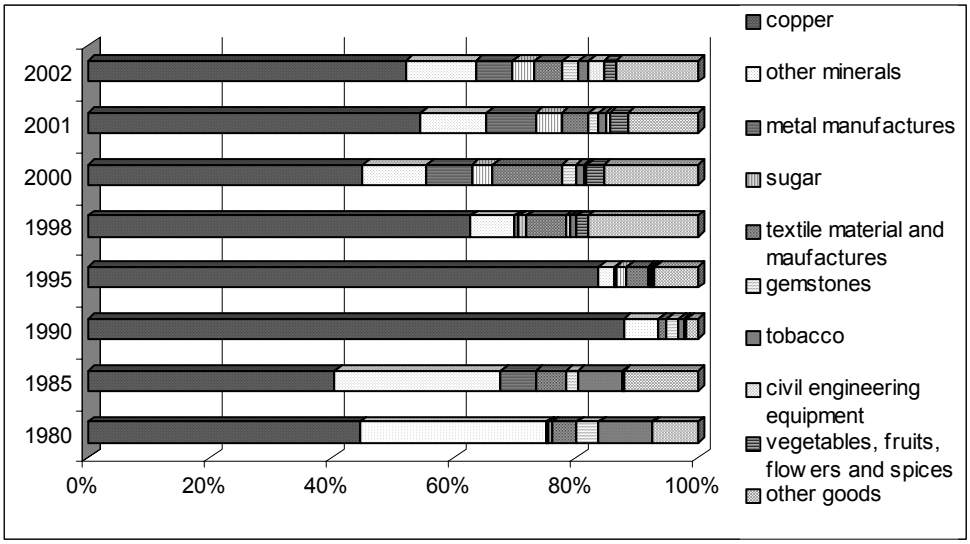
[10] Copper's share stayed above 80% in 1990 and 1995, because of lower export performance of the other export products which were affected by the poor macroeconomic climate (particularly inflation).This is reflected in the real effective exchange rate which shows a strong appreciation almost at the same time as the lowest level in exports (in 1986).Copper, being priced internationally, is more resilient to the prevailing domestic economic climate confronted by a loss in competitiveness.

Box I.3. Exports and linkages in agriculture

Agriflora, which until its recent crisis was wholly owned by Trans-Zambizi Investments of Zimbabwe/South Africa, is Zambia's largest commercial horticulture exporter. It produces a variety of cut roses, fresh fruits and vegetables mainly for export to the UK and other EU countries. The company was established in 1994 and began exporting to the EU in 1998. Its annual turnover is approximately $30 million with exports of nearly 200 tonnes weekly.

Other than its direct contribution to employment through its 8000 employees, the company's has created linkages with local businesses. The company formed, in conjunction with the Cooperative League of the USA, 12 small farmer cooperatives with a total membership of 500 families. The cooperatives entered into a partnership with Agriflora to produce vegetables for export. At full implementation of the first phase of this project, the number of participating small farmers in Zambia is expected to increase to around 900. The outgrowers are expected to produce 9,300 metric tons of exportable produce—mainly snow peas, baby corn, fine beans, mangetout, and okra - with a cost and freight value of $37.1 million a year. At maturity, this alliance is expected to generate revenue of $2.6 million annually for the farmers from fresh vegetable production and export. It is estimated that a farmer with one hectare under cultivation after three years will have net earnings of $2,800 a year, up from an average annual income of $250 on one-quarter hectare of land.
Agriflora assists its suppliers through the service of an agronomic team that visits farms on a weekly basis giving advice and direction in all aspects of production. Thus local farmers benefit through gaining technological knowledge on crop care and understanding of quality and standards. They have also been able to gain access to markets for their products.
Source: Investor interview and articles. The interview for this study was conducted before the recent collapse of Agriflora following the discovery of serious financial irregularities in the company and the decision by its creditors to place Agriflora under receivership.

Figure I.3. Composition of Zambia's exports, (per cent) 1980 to 2002



Source: UNCTAD COMTRADE

Diversity in Zambia's export composition was somewhat present in 1980 but mainly concentrated in raw materials and higher value added products were virtually absent until the late 1990s. The situation is changing thanks to slowly improving economic conditions, reforms and the role of FDI. Products like sugar; cotton and other textiles; vegetables, fruits and cut flowers, displayed strong growth. Their total aggregated exports rose from about $32.4 million in 1990 to $ 174.4 million in 2002. Many of these non-traditional exports have grown from a low base since the liberalization programme began. Cut flowers exports which averaged $138,000 in the period 1980 to 1985, reached nearly $10 million in 2001. Sugar exports amounting to $200,000 in 1990 reached a peak of $43 million in 2001. Likewise, exports of fresh vegetables and fruits, which averaged less than $1million in 1980 rose to $16 million in 2001, and falling to $8 million in 2002, a trend that reflects the fluctuating performance of agricultural products due to climatic factors. An important shift has occurred from the 1980s when fresh fruits accounted for the bulk of the exports in the fresh fruits and vegetables category, while in the 1990s fresh vegetables started to play a predominant role (Table I.3).

Table I.3. Export Composition (millions of dollars)

YEAR	1980	1985	1990	1995	1998	2000	2001	2002
Copper	582.3	317.5	522.4	884.0	647.4	300.5	537.8	483.9
Other minerals	399.3	213.9	33.8	26.6	75.3	69.1	106.5	106.8
Metal manufactures	2.5	44.1	0.7	2.9	6.3	49.2	78.0	56.3
Sugar	8.8	0.3	0.2	18.3	13.6	23.1	43.0	34.7
Cotton, other textile	54.1	38.2	7.6	36.4	65.7	75.0	42.9	42.4
Gemstones	46.5	16.0	11.4	5.4	8.9	15.1	17.2	23.3
Tobacco	113.2	57.0	4.8	1.7	8.3	9.5	10.6	15.6
Civil engineering equipment	0.0	0.2	0.0	0.8	2.4	2.8	6.7	23.4
Vegetables, fruits,	1.9	2.2	3.4	4.3	17.8	18.2	29.2	17.7
Flowers and spices	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other goods	96.8	94.8	10.5	74.5	186.6	103.0	112.8	125.4
Total exports	1'305.4	784.0	594.8	1'055.0	1'032.3	665.6	984.6	929.5

Source:Comtrade

More impressively, is the increase in the composition of higher value added products in the post-liberalization period. Metal manufactures (mainly base metals, including copper waste and scrap) saw a dramatic increase, largely due to FDI rising from $700,000 in 1990 to a high of $78 million in 2001, and accounting for 8 % of total exports The composition of the export category, cotton and other textiles manufactures saw a dramatic change. In the 1980s it consisted substantively of ginned cotton, and as of the late 1990s, exports included a wide range of manufactures, namely, textile yarn, men and women non-knit outwear, outer and under knitted garments, textile clothing accessories and various textile articles. Zambian Mulungushi Garments, a joint venture with China, was behind the garments manufactures. In 2000 the sector recorded an unprecedented expansion with a ten-fold increase from 1990 to 2000, and exports reached $75 million. In the subsequent two years, exports fell but the level was high at around $43 million. The production of gemstones revived in the late 1990s with several foreign SMEs operators, and exports doubled from $11 milllion in 1990 to $23

million in 2002.[11] Export revenues from tourism are estimated to have risen from $35 million in 1990 to $91 million in 2000. FDI, among others, through the opening of two luxury hotels in the region of Victoria Falls, was instrumental in stimulating tourism growth, as was the rehabilitation Livingstone airport.

The special access to international markets has enhanced export opportunities and enabled diversification into non-traditional exports. Zambia is a member of the regional organizations of South African Development Community (SADC) and of the Common Market for Eastern and Southern Africa (COMESA), and it also enjoys privileged market access granted to LDCs by developed countries.[12] Chilanga Cement, for example, has capitalized on Zambia's regional comparative advantage to sell to the region (see Box I.4).

Box I.4. Tapping export opportunities in the region

Chilanga Cement was the first company privatized in Zambia under the liberalization programme of the 1990s. A majority stake was first sold to the Commonwealth Development Corporation (CDC) in 1994. CDC sold its share to the French investor, Lafarge, one of the world's largest cement producers, in 2000. Chilanga Cement is quoted on the Lusaka Stock Exchange (LSE), with around 15 per cent of its shares listed. It is one of the LSE's largest companies, with a market capitalization of around $12.5 million.

The company has significant linkages to domestic companies: for example, it is a major client of Zambia Railways and of the largest domestic colliery, Maamba Collieries, the biggest employer in Southern Province. Lafarge has invested $8-10 million in improving the efficiency and reliability of the two cement plants in Chilanga and Ndola and reduced operating and financial costs . As a result, in 2001, profits grew by 250% (in Kwacha terms).

Apart from maintaining 80% share of the domestic market, the company also exports a significant share of its production regionally - 23% in 2002. Exports are divided fairly evenly between the United Republic of Tanzania (31%), Malawi (21%), Burundi (25%), and the Democratic Republic of Congo (23%). Zambia's principal competitor in this industry is South Africa, and Zimbabwe availing of a parallel exchange rate. Cement exports from Zambia grew nearly six-fold from 1990-2001. Zambia has a total cost advantage compared to South Africa in selling to these regional markets due to the smaller distances involved, compensating for Zambia's higher operating costs. Chilanga's main export focus is on the Democratic Republic of Congo, due to the distance advantage of its plant in Ndola.

Source: Investor interview.

The current non-traditional exports developed during the decade are at their infancy and they grew despite difficult economic conditions. The examples given in this section demonstrate the potential of Zambia and the role played by FDI, which can be both further

[11] A recent World Bank study shows that the official export figures represent only a small proportion of the actual level of gemstone exports from Zambia. It is claimed that a more accurate figure would be around $50m. Other suggestions put the figure at $100m. The reasons for this discrepancy is largely because the sector is prone to illegal mining and trading activities, particularly in the absence of a clear government policy towards gemstone mining. World Bank (2003), op. cit p.33

[12] Horticulture and floriculture exports have benefited from the preferential access to the EU market. Sugar is exported to the EU utilizing quota under the EU Everything But Arms (EBA) Initiative and to the region using the duty-free access to COMESA markets.

enhanced with appropriate economic and investment policy, taking advantage of markets to which Zambia has privileged access (chapter III).

D. Assessment

With the transition to a market economy since the second half of 1980s and re-opening FDI has begun to play an important role in Zambia. FDI inflows accelerated in the second half of the 1990s, when the privatization programme, which started in the early 1990 was extended to include large State-owned mining enterprises. The average annual inflows reached a high of around $160 million during 1996-2000. Much of these investments were directed to the purchase of state-owned assets in the copper industry. However, Zambia has also attracted FDI into manufacturing, tourism and agriculture, but the projects were rather modest and did not create a major impact in terms the magnitude of flows.

Zambia can do much better in attracting FDI than during the first decade of reforms. It is a country with low political risk and relatively good governance, compared to other countries in Sub-Saharan Africa; it possesses considerable unexploited FDI potential in all sectors: mining (going much beyond copper), services, agriculture and manufacturing. This potential is enhanced by Zambia's preferential and/or privileged access to large international markets, resulting from its membership in regional groupings and privileges for LDCs in major developed countries. Moreover, Zambia has significant potential for the improvement of its investment climate. So far, Zambia has received increased FDI, capitalizing on its favourable natural resource base, opening it to privatization, improved investment framework, including incentives, and some investment promotion. But economic performance and macroeconomic fundamentals have been weak during most of the reform period (though both interest rates and inflation have been reduced significantly in recent years). Business costs are very high. In some aspects relating to infrastructure, among the highest in Africa, including transport costs, critical for a land-locked country. Physical infrastructure has not improved much. Red tape impediments still abound and the lack of coordination among government departments has created obstacles to effective FDI policies and investment promotion. [13]

The promising FDI performance of other neighbouring LDCs, such as Mozambique, the United Republic of Tanzania or Uganda (table I.1), can be taken as a reference for what Zambia should be able to achieve. Like Zambia, these countries started liberalizing their economies between the late 1980s and early 1990s. Two of them also possess deposits of one major world commodity, bauxite in the case of Mozambique, and gold in the case of the United Republic of Tanzania.[14] Zambia has not only copper, but many more minerals and, as mentioned above unexploited potential in other sectors. Mozambique has a GDP of a similar size to Zambia's and is much poorer than Zambia in terms of per capita GDP. Yet, from 1990 to 2003, these countries attracted much more FDI than Zambia: the United Republic of Tanzania - $2.5 billion in total inflows, Uganda - $2 billion and Mozambique $1.8 billion, compared to Zambia's $1.3 billion. Moreover, FDI inflows into these countries have continuously increased from sub-period to sub-period (1990-1995, 1991-2000, 2001-2003) while those into Zambia fell during 2001-2003 (table I.1).

[13] Since the completion of field work for this study , the Government has adopted a Private Sector Reform Programme, and concerted efforts are underway to tackle these impediments and to improve the investment environment.

[14] Mozambique was among the top ten FDI recipients in Africa in 2002. Apart from Tunisia and South Africa, the other seven countries are oil exporting countries (UNCTAD World Investment Report 2003).

FDI can also contribute more to developing the local economy. So far its impact has been limited to selected industries and products: copper, tourism, flowers and vegetables and a few manufacturing products. FDI has rehabilitated much of the copper industry and production, exports and employment are all growing again. It has also been instrumental in diversification of exports towards non-traditional products and services, notably tourism. Most of FDI in Zambia has been, in fact, export-oriented. FDI had initially a negative impact on overall employment, but this is changing with increasing greenfield investment in all sectors, including copper. There has been limited transfer of technology to, and establishment of linkages with, local firms. This has been due to difficult business climate, the lack of local technological capability, capacity building measures encompassing education and training, local enterprise development and the lack of support to innovation activities. Leaving major utilities such as telecommunications services out of privatization has also limited potential FDI impact on enhancing national competitiveness. With increasing FDI inflows, other impacts including on external resource inflows and overall investment will matter more for the entire economy.

Policy recommendations on improving the investment environment with a view to increasing FDI inflows and enhancing their positive impact on Zambia's economy are developed in Chapters II (dealing with the investment framework) and III (dealing with economic aspects of the investment climate and investment promotion).

II. THE INVESTMENT FRAMEWORK

Introduction

Although Zambia's framework regulating foreign direct investment (FDI) is rather liberal, there remain significant legal or administrative impediments to higher inflows. FDI is subject to the same regulations as domestic investment under the Investment Act of 1993, as amended in 1996. A rather heavy process of submission for an Investment Certificate with the Zambia Investment Center (ZIC) is required from foreign and domestic investors alike in order to avail of the incentives and protection provided under the Investment Act. While an Investment Certificate is optional for foreign investors, it has become a *de facto* necessity, including for subsequent dealings with other administrative requirements.

While the government is committed to private sector development and the role of FDI in the economy, it is likely that the amendments to the Investment Code proposed recently may add restrictions or make administrative procedures heavier. Some of the amendments come as a response to genuine concerns about the benefits of liberalization, but great attention must be paid not to needlessly discourage or impede higher flows of FDI.

A. Specific FDI measures

1. Entry and establishment

Zambia has an ostensibly open scheme for entry of foreign investors. There is no distinction under the Investment Act between foreign and domestic investors, which implies that no sectors or activities are off-limit for FDI. Investors, foreign or domestic, are not legally required to undergo a screening process. Those that wish to avail of the special rights and incentives offered by the Investment Act, however, must petition for an Investment Certificate delivered by the Zambia Investment Center (ZIC).

The application for an Investment Certificate (which is a legislative requirement) is rather burdensome and requires, among others, a very comprehensive business plan (analysis of industry, market, and competitors, marketing strategy, operational plan, production process, etc.), evidence of project finance and justification about the impact of the investment on Zambia's growth and development. Investment in certain sectors also requires prior authorizations from other parts of the administration, even though this applies both to foreign and domestic investors. Manufacturing enterprises need to obtain licenses from city, municipal or district councils, and investments in air and road transport, banking, telecommunication or tourism need authorizations from the relevant ministries.

Upon application, Investment Certificates are typically granted within thirty days and the screening appears routine and non-discriminatory. Applicants may also appeal investment board decisions in case of rejection.

Although the Investment Certificate is not legally required for FDI, most foreign investors regard it as practically mandatory for several reasons. Firstly, it seems to be a necessary step to succeed in passing through other bureaucratic procedures, including the recruitment of expatriate personnel. An Investment Certificate is also a condition to avail of

the special rights and incentives offered by the Investment Act. Most important among these are the possibility of acquiring land on a long-term tenure, guarantees on the repatriation of profits, dividends or sales proceeds and protection against or compensation for nationalization. Special tax incentives can also be secured for investment in certain sectors.

2. Treatment and protection of FDI

Zambia's Investment Act has no provisions specific to foreign investors on standards of treatment. Neither does it have any discriminatory clauses in that respect. The Act has provisions on the protection of foreign investor interests with respect to compulsory acquisition of property and the transfer of funds. Zambia has signed eight bilateral investment treaties (BITs) that address both treatment and protection issues.[15] Indeed, the Government should consider expanding its BITs network learning from best practices elsewhere with respect to treatment and protection issues.

a) Treatment Standards

Zambia's BITs accord the standards of fair and equitable treatment, national treatment and most favoured nation treatment to foreign investors (see Box II.1). Interestingly, typical developing countries' exceptions from national treatment, supported by arguments about encouraging local enterprise development, are not provided for in the Zambian BITs[16] Since the Investment Act makes no distinction between foreign and local investors, this is probably an indication that Zambia intends to harmonize its international treaties with its domestic legislation. At the same time, Zambia's BITs take account of its membership of various regional agreements under which it has committed to provide preferential treatment of investors from regional countries. Thus Zambia's BITs make an exception from these treatment standards of special advantages to nationals of third States by virtue of agreements establishing customs unions, economic unions, monetary unions or similar institutions.

b) Repatriation and convertibility rights

The Investment Act provides guarantees for rights of repatriation with respect to profits, debt service, fees, royalties and disinvestments proceeds. These guarantees only apply to foreign investors who have sought and obtained the investment licence. However, foreign investors without the licence are not particularly disadvantaged as in practice, there are no longer any foreign exchange restrictions in Zambia (see section B1. below).

[15] The eight countries are Belgium/Luxembourg, China, France, Germany, Ghana, Italy, Netherlands and Switzerland.
[16] During this Review, a number of local investors expressed the view that the liberalization process did not take into account support measures for Zambian investors. But none of them directly relate that to national treatment clauses in BITs.

Box II.1 Treatment standards in the BIT between Zambia and Netherlands

"Article 3: Protection of Investments

1) Each Contracting Party shall ensure fair and equitable treatment of the investments of nationals of the other Contracting Party and shall not impair, by unreasonable or discriminatory measures, the operation, management, maintenance, use, enjoyment or disposal thereof by those nationals. Each Contracting Party shall accord to such investments, full physical security and protection.

2) More particularly, each Contracting Party shall accord to such investments treatment which in any case shall not be less favourable than that accorded either to investments of its own nationals or to investments of nationals of any third state, whichever is more favourable to the national concerned.

3) Each Contracting Party shall observe any obligation it may have entered into with regard to investments of nationals of the other Contracting Party.

4) If the provisions of law of either Contracting Party or obligations under international law existing at present or established hereafter between the Contracting Parties in addition to the present Agreement contain a regulation, whether general or specific, entitling investments by nationals of the other Contracting Party to a treatment more favourable than is provided for by the present Agreement, such regulation shall, to the extent that it is more favourable, prevail over the present Agreement.

Article 4: Exception

If a Contracting Party has accorded special advantages to nationals of any third State by virtue of agreements establishing customs unions, economic unions, monetary unions or similar institutions, or on the basis of interim agreements leading to such unions or institutions, that Contracting Party shall not be obliged to accord such advantages as stated in Article 3, paragraph 2 to nationals of the other Contracting Party."

c) Expropriation

In the past, Zambia experimented with a significant nationalization policy that entailed extensive expropriation of foreign investment. Today, these policies have taken a complete about-turn. Zambia is a member of the Multilateral Investment Guarantee Agency (MIGA). That is a positive signal to foreign investors. Investments may only be expropriated by an Act of Parliament relating to the specific property. The Investment Act provides that compensation must be at market value. This is another positive signal for many investors. However, the method for determining market value is not spelt out (see Box II.2). That may leave some foreign investors still worried. Market value based methods include the going concern value, asset value (including declared tax value) and book value. To eliminate ambiguity, Zambia could specify the method of valuation. But it is also important to note that

once a specific method is indicated in the Code, it might be difficult to use other legitimate methods. To allay investor worries about ambiguity and still retain flexibility it is suggested that the Code simply requires that the market value of property shall be calculated in accordance with generally recognized principles of valuation

Box II.2. Clause on expropriation in the Zambia Investment Act

1) No property of any description shall be compulsorily acquired, and no interest in or right over property of any description of an investor shall be compulsorily acquired, except for public purposes under an Act of Parliament relating to the compulsory acquisition of property which provides for payment of compensation in respect thereof.

2) Any compensation payable under this section shall be made promptly at the market value and shall be fully transferable at the applicable exchange rate in the currency in which the investment was originally made, without deductions for taxes, levies, and other duties except where those are due.

d) Dispute settlement

Zambia has a chequered history of investment disputes dating back to the period of nationalization. Of importance to foreign investors is that international arbitration is now a right for investors with an investment licence. The State recognizes international arbitration as binding. But Zambia is not a member of the International Centre for the Settlement of Investment Disputes (ICSID) and that could be a matter of concern to some foreign investors. Where a dispute is submitted to international arbitration, certain issues of enforcement may arise in practice. The arbitral tribunal will most likely not have the ultimate means of enforcement available to domestic courts. However, where ICSID arbitration is used, each State party to the ICSID Convention is required to enforce the resulting arbitral award in its territory by virtue of Article 54(1) of the Convention. Providing investors the comfort of knowing that enforcement of arbitral awards can be guaranteed through the ICSID mechanisms can be factor influencing decision on investment location. Moreover, rights to international arbitration granted by national legislation can always be removed by the same legislature. This is not the case with regard to obligations entered into by international treaty.

International arbitration may be a right, but it is important to note that foreign investors must first resort to Zambian dispute settlement mechanisms. The investment code provides for foreign investors to first resort to internal dispute settlement and, failing that, the parties may go to international arbitration. While the courts in Zambia are reasonably independent, enforcing contractual and property rights can be a difficult process and final court decisions can take a long time. This may cause concern to some foreign investors and even though this Report makes some recommendations for the reform of the commercial justice system (see Section B.7 below), Zambia should consider guaranteeing first resort to international arbitration in case of significant disputes such as expropriation.

B. General investment measures and conditions

This section reviews those areas of the policy and operational framework that affect all investors and form part of the investment climate that impacts upon FDI. As in other UNCTAD Investment Policy Reviews, attention is given here to those areas that are most problematic for foreign investors.

1. Foreign exchange control

Zambia abolished exchange control in 1994. Currently it limits over the counter cash conversion of kwacha into foreign currency to the equivalent of $7,500 for account holders and $5,000 for others. Foreign exchange is available at market determined rates. Foreign currency transactions are carried out by bureaux de change and high-street banks, both foreign and local.

2. Taxation

The Income Tax Act (Chapter 323 of the Laws of Zambia), the Customs and Excise Act (Chapter 322 of the Laws of Zambia) and the Value Added Tax Act (Chapter 331 of the Laws of Zambia) are the basic laws that cover Zambia's tax system.

Corporate income tax – The general corporate tax rate is 35 percent and lower preferential rates, including generous allowances are given to the sectors the Government wishes to promote. The agriculture sector enjoys a rate of 15 percent; successor mining companies to ZCCM pay a concessionary rate of 25 percent; rural enterprises are taxed based on a concessional formula (for each of the first five charge years, and reduced by an amount equal to one-seventh of that tax which would otherwise have been chargeable); and companies listed on the Lusaka Stock Exchange pay 33 percent to promote 'financial deepening'.[5] Banks, however, are taxed at 45 percent of their profits above 250 million kwacha.

A *value added tax* of 17.5 percent was introduced in 1995. The administration of the VAT was singled out by the business community to be problematic, in particular, delays in receiving refunds (can be up to one year), the large thresholds for making claims, a non-operative offset scheme, cumbersome forms, and a high incidence of audits following the submission of claims. Examples provided to the Review team indicate that most of these concerns were justified, and the Government needs to address them urgently.

Zambia uses fiscal incentives to quite a wide extent to attract investments into desired sectors, as can be seen from the various incentives granted.

Key incentives for the *agriculture sector* include:

- Dividends payable to farmers are tax exempt for the first 5 years of operation;
- 100 per cent tax allowance for outlay on land development, conservation and other costs;

[5] The rate had originally been brought down from 35 to 30 percent, but it was noted that few companies were registering on the Stock Exchange. The Revenue Authority felt that the tax incentive was not effective and there was unnecessary lost revenue; thus the tax was increased to 33 percent.

- Capital expenditure on farm improvements qualify for an allowance of 20 percent per annum for each of the first five years;
- Substantial rate of depreciation allowing farm machinery to be rapidly written off against tax;
- Agricultural production is zero rated for VAT;
- Duty on most agricultural inputs has been removed completely or reduced considerably.

For the *mining* sector the fiscal regime compared favourably with most countries in terms of royalties and taxes, and a number of financial incentives are also provided. However, negotiations with Anglo-American on the privatization of ZCCM have led to the proliferation of incentives. The levels have now been taken as a benchmark for other investors in this sector. Successor companies to ZCCM now enjoy the following reduced tax levels:

- A reduction of the mineral royalty tax from 2 percent to 0.6 percent;
- Copper and cobalt price participation fees are tax deductible;
- Excise on electricity is not charged (usual rate is 5 percent);
- Company tax rate is reduced to 25 percent (from 35 percent), and losses can be carried forward for a period of 20 years;
- Withholding tax on interest, dividends, royalties and management fees paid to shareholders and affiliates is exempted;
- Duty free importation of capital equipment and utility vehicles.

These incentives were granted to accelerate the privatization of the government owned mining companies at a time when there was an apparent lack of interests from potential buyers. While these concessions enhanced the attractiveness of the Zambian mining sector to foreign investors, ultimately, however, other factors (such as the copper price) still kept some investors away, as in the case of Anglo-American's decision to pull out of the privatization process.

To promote Livingstone in Zambia as another point of access for tourists visiting the world famous Victoria Falls, besides from Zimbabwe, incentives were granted for *hotel development.* Sun International from South Africa negotiated and obtained certain concessions for developing "ultra-modern" tourist facilities in the Livingstone district. The concessions given to Sun International in the 2000 Budget included the following:

- The new hotels were defined as "industrial buildings", thus qualifying for an industrial building allowance of 10 percent;
- The amount paid for existing property was treated as part of the construction cost, also qualifying for the industrial building allowance;
- The company was defined as a non-traditional exporter, and so attracted a lower corporate income tax rate;
- Partial relief from the casino levy was awarded.

In the following year (2001) some further concessions were extended to the tourist industry, in particular zero-rating their activities for VAT purposes, initially for a two-year period, and now extended for a further two years.

Box II.3 presents a comparison of Zambia's taxation of investment with the tax regime in other regional and leading African destinations for FDI. The comparison covers five sectors and does not include the mining sector. The methodology is explained in Annex 1. The following conclusions may be drawn with respect to the competitiveness of Zambia's taxation regime:

- The general system of taxation (excluding special incentives) places Zambia among the countries with the heaviest tax burden among comparator countries for all sectors.
- Generous incentives for the agriculture and manufacturing sectors reduce the tax burden under the incentives scheme to the lower levels among comparator countries.
- Sectors that do not benefit from generous special incentives schemes, however, remain heavily taxed when compared to other countries in the region.

Finally, in the area of taxation, it should be noted that Zambia has signed Double Taxation Treaties (DTTs) with a number of countries that are important to it as far as trade and investment is concerned. But it is notable that, apart from Japan and India, there are no other signatories from the Asian region, especially those countries which Zambia is keen to attract. The countries that Zambia has signed Double Taxation Agreements with are Botswana, Canada, Denmark, Finland, France, Germany, India, Ireland, Italy, Japan, Kenya, Netherlands, Norway, Romania, South Africa, Sweden, Switzerland, United Republic of Tanzania, Uganda, United Kingdom and the U.S. The Zambian Government should consider expanding its DTT network to other Asian countries from where it is aggressively seeking FDI.

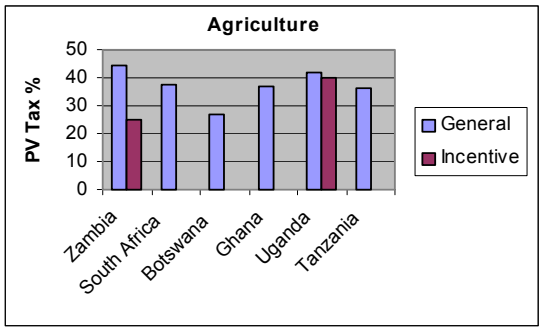
3. Employment

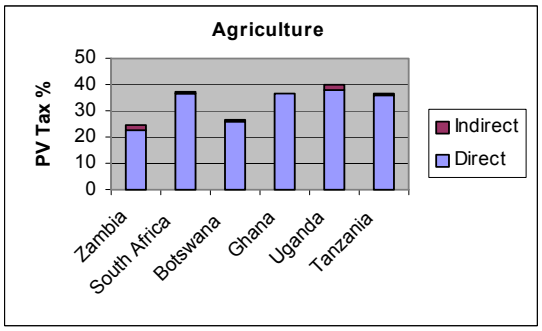
The Employment Act (Cap 268 of the Laws of Zambia) is Zambia's fundamental law in this area and provides for basic employment terms such as the minimum contractual age, establishment of employment contracts, settlement of disputes, appointment of labour officers.[17] It also provides for certain conditions of employment, such as ordinary leave, sick leave, maternity leave, redundancy and welfare of employees. Certain other legislation expound on some of these issues. The 1993 Industrial and Labour Relations Act (Cap 269 of the Laws of Zambia) is the legislation governing the rights and obligations of employers and employees. The Industrial and Labour Relations Act provides for the conduct of industrial relations, the establishment of workers' and employers' organizations, their registration and administration, settlement of disputes and consultative machinery. Zambia is a very "unionized" country.

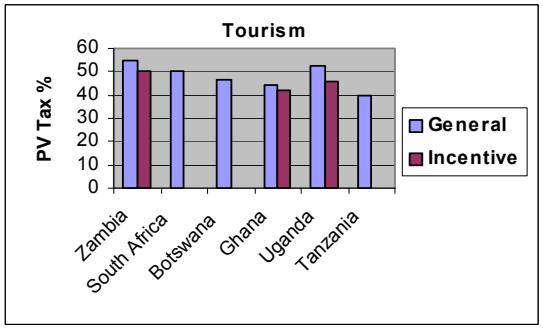
Wage policy is left to the market and wages are determined through collective bargaining. Once the parties have come to a consensus, the collective agreements are forwarded to the Minister for approval and registration. However, there are some types of work where workers are not represented by unions. The Minimum Wages and Conditions of Employment Act (Cap 276 of the Laws of Zambia) enables the Minister to determine minimum conditions of employment for categories of employees not effectively covered through collective bargaining. He does this through statutory instruments issued every two years. Such employees include general workers, clerks and drivers.

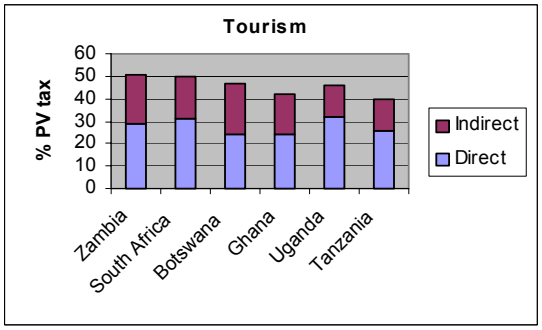
[17] Zambia's employment act is currently under review.

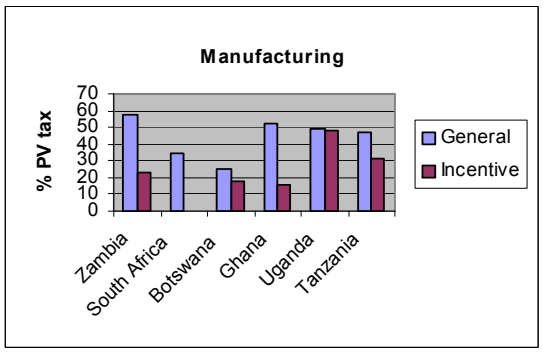
Box II.3 Comparative taxation of FDI in Zambia

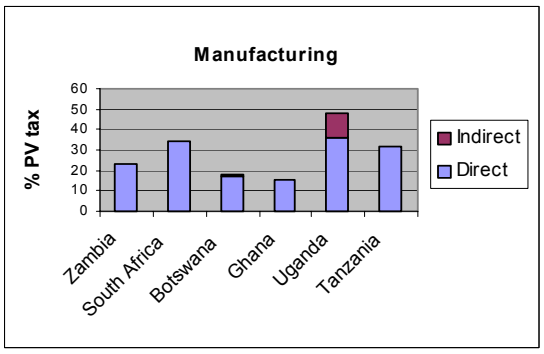


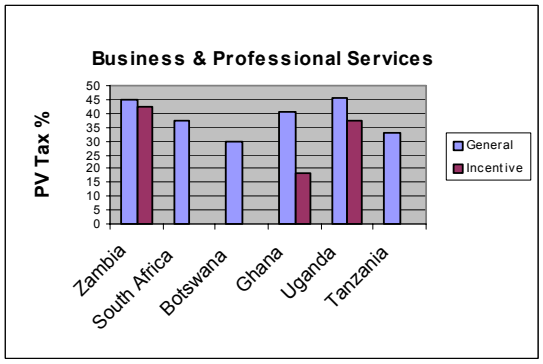


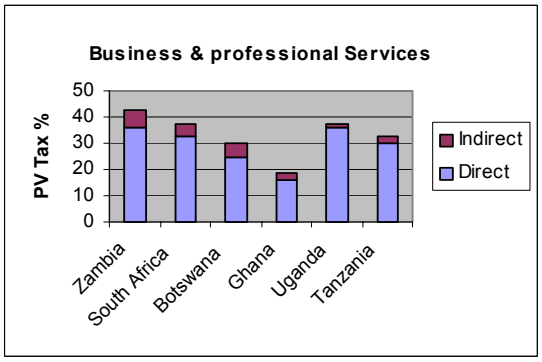


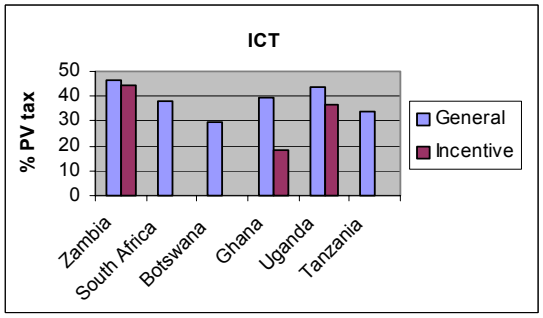


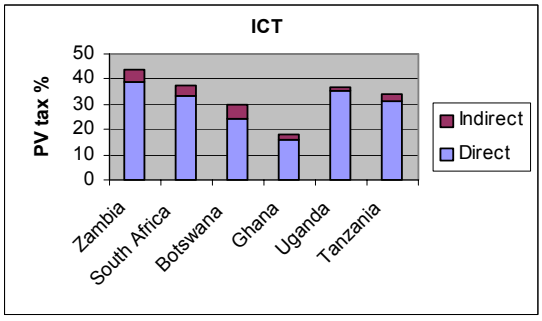












Investors in Zambia face two main problems in the general area of employment. The first is very frequent industrial action. Part of the cause for this is that many strikes are not carried out in accordance with the law and the collective bargaining agreements. The second problem relates to a legal requirement that on severance, an employee is entitled to a payment of 3 months basic pay for each completed year of continuous service. Moreover, employers also contribute to the national social security corporation (Napsa) for each of those employees. This matter needs to be reviewed. After all, it is encouraging many investors to opt for short-term contracts that do not give rise to these benefits. Unfortunately, such short-term contracts are not conducive to skills-transfer programmes. Table II.1 provides a comparative survey of statutory redundancy payments in selected countries. It indicates 3 months basic pay for each year of service is way above the average. It should also be noted that many countries actually leave the matter to negotiation between the parties.[18]

4. Non-citizen employment

The Investment Act of 1993, specifies that an investor who invests a minimum of $250,000 and who employs a minimum of ten persons is entitled to a self-employment permit or resident permit. In addition, and pending such conditions, ZIC stands to assist the investor to obtain work permit for up to five expatriate workers. It does not guarantee that permits will be granted, however, as this falls under the jurisdiction of the immigration authorities.

In practice, companies have had difficulties in securing their allotment. Although the procedures themselves appear straightforward, there is considerable dissatisfaction within the investor community about the issue of employment permits for expatriate workers and self-employment permits for individual investors. The Immigration Department has immense discretionary powers in granting work permits and often does not even bother to issue reasons for its decisions. This makes the process very uncertain and therefore also provides potential for corrupt practices. It is a matter that needs to be reviewed. Furthermore, in the recent past, it has become particularly difficult for investors to obtain work permits for foreign employees in certain professions, such as those in accounting and financial positions, as it was perceived that there are Zambians with these skills who could fill these jobs.

The issue of employment permits is a critical component of the process of establishing a business in the first place. It can make or unmake the initial decisions on where to invest. It can also be of utmost importance to certain types of investments during latter stages of operation. Consideration must therefore be given on how to address investor complaints while taking into account Government concerns about creating employment for Zambians.

In discussions with the Review team, a number of investors expressed the view that dealing with the Immigration Department is not easy for foreign investors. Many staff members of the Department do not seem to share the same liberal attitude to attracting foreign investors as their counterparts at the Investment Centre have. Thus the Review recommends that the Investment Centre's proposed changes should be accompanied by:

[18] E.g. Gambia, Ghana, Hungary, New Zealand, Singapore, USA, and Venezuela.

Table II.1 Comparative Survey of Statutory Redundancy Payments

Country	Statutory Redundancy Payment
Egypt	Half a month pay for first 5 years of service; 1 month for each subsequent year.
Ethiopia	30 days wages for first year of service, 40 days wages for subsequent years, with a maximum of 12 months wages.
Indonesia	One month pay per year of service, up to maximum of 5 months.
Kenya	Not less than 15 days of each completed year of service.
Lesotho	2 weeks wages for each year's service, after minimum of 1 year.
Malaysia	10 days wages for first year, 15 days wages for 2-5 years, 20 days for more than 5 years.
Mauritius	Generally 15 days wages for each year's service.
Mexico	Generally 6 months wages for first year of service, 20 days for each additional year.
Namibia	For workers with one or more years of service, 1 week wages for each completed year of service.
Philippines	1 month's wages per year of service.
South Africa	1 week's wages per year of service.
Spain	20 days per year, maximum 12 months wages.
Swaziland	10 days wages for each year's service above each year.
Tunisia	1 day per month of service, up to 3 months maximum.
United Kingdom	1 week's wages per year.

- A training programme on FDI policy for immigration officials;
- Clear guidelines for the approval of the employment permits for the foreign nationals to be employed in the managerial, technical and advisory positions; and,
- A policy statement on the implementation of a training and localization programme.

5. Land

The current Land Act came into force on September 23, 1995. Under the Act, all land is vested in the presidency on behalf of the people of Zambia and there are only two types of tenure: leasehold tenure for up to 99 years (and renewable for a further 99 years) and customary tenure (convertible to leasehold).

A non-Zambian can acquire land under the following conditions:

- if he/she is a permanent resident in Zambia;
- if it is a company registered under the Companies Act, with no less than 75 per cent Zambian shareholdings;
- if it is an investor licenced under the Investment Act or any other law permitting investment in Zambia;
- in exceptional cases, by presidential consent in writing even if the above conditions are not met.

Other than the above, a foreign investor may also acquire land under a short-term tenancy of not more than five years or under a concession or right granted under the National Parks and Wildlife Act.

The purchase of land that already has clear title does not seem to be complicated. It requires the Commissioner of Lands to issue a "State Consent" that the land may be sold. This can usually be granted within a few days. If there is no response within 45 days of application, the consent is deemed to be granted. .

Acquiring traditional land has been described by foreign investors as time-consuming, costly and uncertain. Yet traditional land constitutes the majority of land in Zambia. Particular problems raised are high fees, which are set statutorily in some cases; extended approval periods and a lack of clear criteria for decision making during the application procedures; and limited capacity in Zambia for survey of titles.

This Review recommends that the Government consider the following:

- Develop and implement a specific land registration programme targeted at foreign investors who wish to invest in traditional land areas. This effort should initially target areas in agriculture and tourism identified to be suitable for investments. The Review noted that as part of its agricultural market liberalization policy, the Government has already identified the land tenure system as a priority area for reform;

- Use commercially operated industrial zones as a short to medium-term means of providing access to serviced industrial and commercial land. Over the longer term, it will be necessary to address the underlying policy issues, given the importance of land acquisition and of an open market in land for economic growth;

- Review the fees structure for land registration/acquisition;

- Allocate adequate resources, both financial and human, for the Survey of Titles Department.

6. Competition policy

Competition policy in Zambia is governed by the Competition and Fair Trading Act. It came into force on 15 February, 1995 and is enforced by the Zambia Competition Commission. The Act deals with anti-competitive practices and the abuse of market power. It also deals with consumer welfare and protection issues.

Since its inception in 1997, the Zambia Competition Commission has significantly impacted FDI through the authorization process of mergers and acquisitions. There is a mandatory requirement under Section 8 of the said Competition and Fair Trading Act that all mergers and acquisitions have to be authorized by the Commission before they can be completed. Although most foreign investors view obtaining investment licences from the Zambia Investment Centre as the critical entrance issue, it seems the current competition policy framework does not allow for the entry into the Zambian market through a merger, a takeover, joint venture or other acquisitions of control without formal authorization from the Commission.

The merger control regulations in Zambia, however, does not seem to discourage the flow of FDI into the country. Indeed, the Competition Commission claims that through its policies, it ensures that players entering the market do not meet structural entry barriers such as highly concentrated industries and exclusive dealing contracts with major distributors that could limit market access. At the same time, the Commission also ensures that foreign entrants do not engage in regional or global cartels of market allocation and price fixing with other international players, which have the effect of foreclosing entry to particular regions of the world by other Zambian competitors.

The critical point to note for the purpose of this Review is that officials of the Commission are clearly aware of the fact that in enforcing merger provisions of the competition legislation they have to play a fine line. On the one hand it must ensure that mergers in Zambia do not lead to adverse effects on its trade or the economy, and on the other, that FDI is not curtailed by unnecessary administrative hurdles. Members of the business community agreed that the Commission's past authorizations of mergers have shown a good balance between competition objectives and concern for policies aimed at promoting foreign investment in Zambia.

7. Rule of law and commercial justice

A well functioning commercial justice system is an essential part of the infrastructure necessary for the private sector to develop. Modern business laws coupled with an efficient judicial system are a prerequisite for investor confidence in the rule of law. In carrying out this Review, businessmen were interviewed, and they expressed the view that the commercial justice sector in Zambia was failing to adequately serve their needs. Some dissatisfaction expressed related to delays due to continual adjournments by the Zambian courts; and lack of awareness of commercial laws among many Magistrates and Judges. The Review also noted that many of the current commercial or business related laws are outdated and some modern business practices are not covered by the laws on the statute books.

The unsatisfactory state of Zambia's commercial justice sector in both the adjudicative and legislative areas could have adverse implications for the country's economic reform programmes, as in the cases given below:

- Business contracts may be constrained, with undue reliance being placed on personal relationships as a contract enforcement mechanism. This results in businesses being risk-averse, and doing business with limited, well-established networks;

- The poor commercial justice environment could become a significant constraint to FDI, partly because foreign investors expect as good a commercial justice system as elsewhere and partly because foreign investors tend to be excluded from the local established networks that are not reliant on the justice system.

Zambia's commercial justice system must therefore change in order to meet the needs of a modern, liberal economy, in line with Government policy of creating an enabling environment for the private sector in general and FDI in particular. The current system, based on its colonial past, in terms of its institutions, structures and culture, needs reform in court administrative procedures to reflect a business and market forces orientation; and the commercial laws need to be modernized to keep pace with current trends. Possible key reforms could include the following:

- Develop a customer service approach at Courts responsible for commercial disputes. This should involve developing a clearance programme for backlog cases and an efficient case administration system (e.g. ensuring the proper use of adjournments and adopting a strict practice of hearing cases on a day to day basis); and a forum for dialogue between the court administrators and the private sector;

- Reform the civil procedure rules. The current rules need fundamental review to bring them into line with modern norms. Key changes should include abolishing needless steps in the proceedings; ensuring that weak cases are quickly disposed of; and enhancing the role of alternative dispute resolution;

- Initiate a programme to overhaul all outdated commercial laws. This may be a medium to long-term agenda. It should therefore commence with dialogue about prioritization of legislation for the reform agenda. Such dialogue should have strong input from the private sector;

- Establish procedures to enable the Government to assess the regulatory impact of its policy proposals on business, by creating a regulatory impact assessment capability.

8. Intellectual property protection

The Patents Act, Trade Marks Act and the Registered Designs Act (Caps 388 to 402, respectively, of the 1995 Edition of the Laws of Zambia) provide the legal framework for intellectual property protection in Zambia. Zambia is a member of WTO and as an LDC, it is given up to 2006 to conform to TRIPs for normal patents, whereas for the pharmaceutical sector, it is up to 2016. The Patents and Companies Registration Office is responsible for administering the Acts. No breaches of intellectual property rights were brought to the attention of the Review team.

9. Licensing and the administration of regulations

For many investors, the process of establishing a business is the most critical and time sensitive aspect initially when they investigate whether to invest in the country. Therefore, the administrative requirements and the timeframe for completing requirements can often influence an investor's decision on countries to invest from its company's short list.

All investors have, of course, to establish the legal entity through which they will operate. Procedures for company registration in Zambia is fairly straightforward and does not seem to pose an impediment to investors. A certificate of incorporation is generally issued by the Patents and Companies Registration Office (PACRO) within a few days of submission of the necessary documents.

PACRO is undergoing computerization and in accordance with section 369(3) of the Companies Act, the manual registers that were in use are to be discarded and replaced by an electronic register. For existing companies and business names to be included on the electronic register, the Registrar has requested all registered companies to re-submit details of their current status. This was done by way of questionnaires, made available at all provincial centres and selected district councils throughout the country. The exercise started on 15 May 2002 to run for about one year. Those companies that did not respond would be deregistered. The office has also embarked on de-registering companies and business names that do not file annual returns. The process of getting onto the electronic register and the need to file an annual return to the company registry does not seem to impose an undue burden on enterprises. It would be useful for the Government to take full advantage of this initiative to streamline other entry measures and reduce the bureaucratic steps for foreign investors. In this connection, this Review makes some recommendations to eliminate duplication in some business registration requirements.

Obtaining business licences in some sectors is one of the onerous entry requirements in Zambia. In many cases, the sectoral requirements may involve a number of different authorities for the same business proposal (see Box II.4). The number of licences, the time to obtain them, the discretion given to the authorities in their decision-making process, the requirement for annual renewal, with associated, often uncoordinated inspections, and the cost of fees add up to being a major impediment to many foreign investors.[19]

[19] Since the completion of the field work for this study, the issue of business licences has been under review through the Private Sector Developmement Programme.

Box II.4. The tourism sector: requirements for entry of FDI

A foreign investor may be required to obtain some or all of the following authorizations to set up a business in the tourism industry:

Zambia Wildlife Authority Permit: Investment projects located in a Game Management Area require a permit issued by the Zambia Wildlife Authority (ZAWA). Applications for the permit should be supported by (a) the project proposal; (b) a list of shareholders; (c) information on promoters' business experience; (d) a recommendation letter from the District Council.

District Council Recommendation Letter: The District Council may issue a recommendation letter to ZAWA, upon submission of (a) a letter of intent; (b) a Letter of Consent from the chief (Game Management Areas fall under traditional land which is under the jurisdiction of the local chief); (c) a project proposal; and (d) building drawings

Tourist Enterprise Authorization Licence: The investor will also require a Tourist Enterprise Authorization Licence. The Ministry of Tourism issues the licence upon submission of the following documents:

- Five year business plan
- Cashflow statement or proof of capital requirement
- Building and or architectural plans
- Letter from promoters commercial bank
- Financial and personal information about the shareholders
- Curriculum vitae of the shareholders
- Copy of the company's certificate of incorporation
- Memorandum and Articles of Association (for limited liability companies)
- Title deed or lease agreement
- Most recently audited accounts (for existing businesses)
- Environmental Impact Assessment or project brief (for small companies)
- No objection letter from ZAWA (for project locating in Game Management Areas or National Parks)
- Investment Certificate issued by the Zambia Investment Centre.

Hotel Licence: If the investor intends to provide lodging services he/she will require a Hotel Licence. The Ministry of Tourism through the Hotels Board may issue a hotel licence to the applicant upon submission of (a) a Tourist Enterprise Authorization Licence (b) a Health Permit and fire safety certificate from the local council; and (c) a liquor licence from the local council. The furniture and equipment must be in place and the premises must pass final inspection from the Hotels Board.

This Review proposes the simplification and streamlining of these kinds of procedures. There is also scope for Zambia to use the company registration computerization process to improve sectoral licences registration systems, drawing on best practice examples. For instance, more and more countries are moving towards assigning businesses a single identification number

that is applicable for all administrative transactions for the operation of the business, including registration, taxation and other licensing procedures. Countries have also moved towards making the business registration process web-based or, at a minimum, web accessible.

In this context, the following are some specific recommendations to make sectoral licensing more efficient and transparent while eliminating duplication:

- Introduction of a single business identification number that combines the company registration, taxpayer identification numbers and sectoral licences;

- Introduction of a mechanism for inter-agency information sharing so as to limit the duplication of information requirements by various government agencies. An example of duplication of information requirements has been illustrated in Box II.4 showing similar information requirements for a number of different licences;

- In the case of procedural authorizations (i.e. without regulatory requirements such as health and environmental impact assessments), establishment of deadlines for processing applications, and introduction of a system for *de facto* approval of applications that are not administratively approved within an established timeframe;

- Simplification of the forms and supporting information requirements. In the case of individual agencies, this should include consolidating the often numerous forms into one single application form.

Apart from business licences, other areas of licensing and registration where foreign investors face severe bottlenecks are the issuance of work and residence permits and acquisition of titles with respect to traditional land. A number of recommendations have are made in this regard (see sections B.3 and B.4 above).

The administration of regulations governing foreign investors is greatly affected by the perception towards FDI by individuals and government bureaucrats. In this connection, the Review was informed that some Government departments seem more welcoming of FDI than others. This creates the impression that there is lack of a coherent FDI policy followed by all Government agencies. It is recommended that in mapping the way forward, ZIC should endeavour to have the support, at the highest levels, of all Government agencies that implement FDI policy. This could be done through a series of workshops and seminars addressing both fears about FDI as well as its advantages.

C. Proposed amendments to the investment code and related issues

1. Proposed new requirements

At the time of this Review, the Zambia Investment Centre initiated proposals to amend the Investment Code which it considers would enhance the effectiveness of the Investment Act in wooing *bona fide* investors. But it has introduced more restrictions which it deemed will give them better control over *bona fide* investors. The main proposals of ZIC include the following new requirements :[20]

[20] The discussion in this review focuses on the initial amendments proposed. It is possible that some of the provisions in the initial draft amended Code may have been dropped since then.

a) Compulsory registration of foreign investors

The proposed amendment introduces control on investments coming into Zambia. While the current Investment Act provides that registration is optional to obtain an Investment Certificate, the proposed amendments make registration of all foreign investors compulsory. Furthermore it also requires the submission of annual returns to the Zambia Investment Centre. ZIC's arguments for this proposal is that compulsory registration will (i) ensure that all foreign investors are operating in accordance with approved business plans, terms and conditions of the Investment Certificate as well as other relevant provisions of the laws of Zambia; (ii) it will enable ZIC to ascertain more easily the levels of FDI inflows, which will improve information collection and make for more effective coordination and facilitation of FDI.

b) Compulsory registration of foreign traders

The Investment Act does not regulate trading activities but the proposed amendment provides for mandatory registration of foreign traders as well as their submission of annual returns to ZIC. It will require foreigners to provide an acceptable minimum amount of investment in assets. It is understood that this requirement is intended to sift out petty traders who are not genuine "serious" investors. The proposed amendment would ensure that District Councils do not issue any trading licence to a foreigner that does not possess an investment licence.

c) Minimum capital investment requirements for foreign investors

A provision is made to introduce a minimum investment level by foreign investors. The Minister would determine the required value from time to time by notice in the Gazette after consultation with the Zambia Investment Centre and other stakeholders. The reasoning given is that this will encourage quality investment in the country.

d) Reserving some business sectors for Zambian nationals and residents

There is a provision which will empower the Minister of Commerce, Trade and Industry in consultation with ZIC and other stakeholders to determine the business sectors to be reserved for Zambian nationals and residents. This proposal is intended to empower Zambians to do business in those sectors, which they can adequately provide for, and that foreign investors do not crowd them out.

e) Investment Certificate revocation

Under the current Act, the Investment Certificate can be withdrawn from a non-complying investor but the investor will still be able to operate under the provisions of other licences. Under the new proposal, however, once the Investment Certificate is withdrawn, all other licences obtained under the provisions of other Acts for purposes of investment are automatically withdrawn. The immigration status would also be cancelled. The provision is deemed to strengthen compliance by investors to the Investment Act and other laws of Zambia.

f) Provision for offences and penalties in the Act

The proposed amendments to the Investment Act introduce provisions for offences and penalties covering non-compliance in respect of, among others, the following:

(i) ministerial directives given through Statutory Instruments;
(ii) mandatory registration requirements pursuant to the recommended amendments mentioned above;
(iii) annual returns;
(iv) payment of annual licensing fees.

2. Proposed new incentives

A number of new incentives schemes are proposed in the draft amended Investment Code. Some of these affect the existing sectoral schemes. It would seem that the decision on granting more incentives have not benefited from a critical analysis to justify whether the current incentives regimes are adequate. These proposals should be further reviewed.

Among the new incentives recommended in the draft amended Investment code, is the move to re-introduce the "Special Incentives" previously granted under Part IV of the 1991 Investment Act before its repeal and Part V of the 1993 Investment Act before its amendment. Part V of the 1993 Investment Act and Part IV of the repealed 1991 Act provided the following incentives:

(i) Exemption from customs duties on all machinery, equipment and parts required for the establishment, rehabilitation or expansion of an enterprise for use exclusively in that enterprise.

(ii) Exemption from tax on dividends for a period of seven years from the time of the first dividend payment.

(iii) Exemption from payment of company tax on income for a period of three years from the date of commencement of business and thereafter payment of such tax for the following two years at the rate of seventy five percent.

(iv) Full repatriation of profits and dividends.

These "special incentives" would be granted for each of the investor categories mentioned below in addition to the incentives also described under each category.

Pioneer status incentives to encourage innovation and investments in new products and technology development: These are incentives meant for investors who are the first to invest in an area involving new technology, skills and products. Pioneer Status Incentives include a tax holiday for 5 years and exemption from paying customs and excise duty, import duty and Value Added Tax (VAT) on raw materials pertaining to pioneer activities for the first five years of operation. The duration of the pioneer status shall be determined by the relevant ministries.

Corporate tax incentives tied to investment levels to promote and encourage large and quality investment. For new investments of US$5.0 million and above, it is proposed to reduce the corporate tax to15 per cent for five years with effect from the first year of paying corporate tax.

Employment Creation Investment Incentives to increase employment opportunities. A company that employs 50 additional permanent employees or increases its permanent employees by 25 per cent will be allowed a tax deduction equivalent to twice the additional employees' remuneration.

Use of Local Materials Incentives to promote utilization of local raw materials and create backward linkage investments. A company that uses in its production 60 per cent of local raw materials would be taxed at normal rate of the tax applicable in that industry reduced by 40 per cent of that tax rate for a period of five years from the first year of paying corporate tax.

Incentives for Strategic or Major Investments. There will be a provision to empower the Ministers of Commerce, Trade and Industry and of Finance and National Planning to negotiate and determine special incentives packages for specific major investments.

Incentives for Rural Areas Location of Investments. They will be exempted from payment of corporate tax and from withholding tax on dividends and tax on interest or royalties.

Joint Venture Incentives to encourage foreign investor partnerships with Zambian entrepreneurs. They comprise exemption from payment of corporate tax for a period of ten years from the first year of operation and no withholding tax on dividends and tax on interest or royalties, for a specified period of ten years. A Joint Venture Investment would be defined as one where a Zambian citizen holds 40 per cent or more of fully paid-up share capital in an enterprise registered in Zambia.

Incentives for Domestic Investors aimed at "empowering" indigenous Zambian entrepreneurs to play a major role in business and economic development. They will include exemption from paying corporate tax for a period of ten years, and exemption from paying withholding tax on dividends and tax on interest or royalties for a period of ten years.

3. Evaluation of the proposed amendments

It is recommended that many of the proposed amendments should be reconsidered, as they are likely to have a detrimental impact on investment flows and others should be adopted with certain modifications. The reasons are as follows:

- The proposed compulsory registration of all foreign investors and traders is in part designed to give the Investment Centre power to first approve every foreign investor prior to investment. This seems to be a step backwards in Zambia's liberalization process. The arguments provided for the proposal seem to be partly premised on the belief that an Investment Promotion Centre should in the first place determine whether an investor's business plan is a good one and thereafter monitor operations to ensure compliance with the plan. The best judge of the business plan is the investor that risks the money. Government officials should confine themselves to ensuring that the

investor conforms to regulatory requirements (e.g. environmental or competition issues). On the other hand, the desire to have information on the levels of FDI inflows is understandable.

- This Review recommends that registration be limited for the purpose of collecting information only but not for obtaining approval of the investment. Only investors applying for incentives through the grant of an Investment Certificate from the Centre need go through an approval process. In making the recommendation about registration for information purposes, this report re-emphasizes that that consideration must not add unnecessary bureaucratic burdens to new investors. Only information directly relevant to monitoring FDI statistics should be requested. In this connection the suggestions made in section B.9 should also be borne in mind.

- Imposing minimum size thresholds for FDI in order to get only "quality investment" is a questionable policy. First of all, "large" investments are not always the most beneficial to the domestic economy nor are they always the most successful. Indeed some of the most successful businesses grow from initially humble beginnings. Secondly, an economy like Zambia is likely to attract the small and medium size FDI, especially in the manufacturing, agro-processing and tourism sectors. With this in mind, policy makers often find themselves in a dilemma on where to draw the line about what is really "small" in the particular circumstances of their country. The result is often an arbitrary figure that is constantly adjusted because the fundamental reasoning for the policy is flawed.

- The proposal to reserve some business sectors for Zambian nationals and residents is understandable but this Review suggests it should not be through a blanket exclusion clause, but by introducing a "reserved list" of business sectors. Foreign investors would then be required to seek approval if they wish to invest in these sectors reserved for local enterprises. This gives an element of flexibility in order to permit FDI on a case-by-case basis where it is considered beneficial. For instance, there may be situations where a national investor (already in operation) may wish to establish a joint-venture with a foreign investor in order to expand the business or access foreign markets. Such a venture may be approved subject to procedures that ensure that it is not a total buy-out or a "fronting" by a local investor for a foreign investor. To avoid the possibility of discrimination in implementing the flexibility clause, clear rules need to be made at the outset on how powers of discretion in this regard will be exercised. Furthermore, in drawing up the "reserved list", the Zambia Competition Commission should be consulted to ensure that reservation of a particular business sector for just Zambian investors will not shut out competition. It is presumed that this list will in any case be very limited.

- Assuming the recommendations of this Review are adopted, only investors wishing to avail themselves of special incentives need apply for an Investment Certificate as has been the case so far. The right to invest and operate a business is not granted by the Certificate. Logically, cancellation of the Certificate should only result in cancellation of the incentives. It seems the Investment Centre is concerned that some foreign investors receive fiscal incentives based on commitments made prior to investment but leave the country or venture into other businesses as soon as the incentive scheme ends without fulfilling their part of the bargain. One of the purposes of the proposed amendment to the Act is to enable the Centre to "punish" such investors should they

continue operating in the country. Opportunistic investors who will abandon a particular investment when fiscal incentives run out will always be there. The issue is not necessarily whether they are abusing the system but whether the incentives scheme is designed to promote sustainable investment. Zambia could consider relating its incentives scheme to a post-investment audit system. Investors would receive fiscal incentives upon reaching agreed milestones.

- Investment Codes are often enacted not only to legislate for matters concerning investment, but also to provide a signal to foreign investors that they are welcome. Thus, sometimes, guarantees for repatriation of profits, international arbitration etc are already enshrined in diverse legislative instruments such as the Exchange Control Act or the Constitution but are all collectively repeated in an Investment Code/Act because it is viewed as the first piece of legislation that a foreign investor will likely check. As an "investment promotion" document, many countries prefer not to include in it provisions for offences and penalties as they are regarded as potentially frightening. Assuming that the penalties proposed to be provided for in the Zambian Act are only fines of a minor nature, this should cause no problem. But if the Investment Code starts reading like a Penal Code, the effect could be quite negative.

- Generally speaking, the proposed new fiscal incentives address some important development related issues that many developing countries have to address: technology development, employment creation, creating backward linkages and joint ventures, and rural development. To that extent, they are very relevant. But they seem to be neither innovative nor based on research related to the peculiar situation of Zambia on each of those issues. They are simply a reproduction of legislation that had been previously repealed – probably for good reason. A more sustained analysis of competitiveness such as the one described in Annex 1 should be undertaken. The proposed new incentives will also be difficult to monitor effectively if investment volumes pick up. Some can be readily manipulated in the absence of very intrusive and time consuming monitoring – exacerbating or confirming existing concerns about the probity of foreign investors. Moreover, the new proposals do not seem to take into account the more recent sectoral incentives schemes arrived at after extensive negotiations with investors. It is beyond the scope of this Report to analyse each of the proposed set of new incentives (including the impact on revenue collection). But it is a recommendation of this Review that an appropriate fiscal analysis of each of the proposals be carried out before the proposals are submitted for the legislative process.

D. Assessment and recommendations

Zambia has over the last decade clearly tried to put in place a policy environment conducive to attracting FDI. It enacted an investment code that provides a very open scheme for FDI entry and it has also tried to design attractive incentives schemes at the sectoral level.

But Zambia's operating conditions have not been in tandem with its liberalization policies. This has been caused by a number of reasons. First, there remains much scepticism amongst many Government officials and some of the domestic investors about the benefits of FDI. They seemed to perceive that foreign investor is out to swindle Zambia and must be tightly regulated at every step of their business transactions. Second, while the Investment Act itself may provide for a liberal environment, the rest of the legal structure does not.

Many of the business related and sectoral laws and regulations still provide too many administrative hurdles and give too much discretionary power to the Government officials. Table II.2 provides an overall assessment of the *operating* conditions, classifying the main components as identified in section B into high, medium and low standards.

Table II.2. Assessment of operating conditions

Section	High standard	Medium standard	Low standard
B.1	Foreign exchange Control		
B.2		Taxation	
B.3			Employment (severance payments)
B.4			Non-citizen employment
B.5		Land	
B.6	Competition policy		
B.7		Rule of law and Commercial justice	
B.8	Intellectual property protection		
B.9			Licensing

In line with the Government's objective to attract increased FDI into the country, the following is a summary of the main recommendations on improving the investment framework.

Treatment and protection of FDI

- Expand the BITs network, taking into account best practices elsewhere with respect to provisions on treatment and protection issues.

- Clarify the method for determining market value with respect to the compensation provision in the Investment Code, by including a provision that the market value shall be calculated in accordance with generally recognized principles of valuation.

Taxation and incentives

- Address concerns of the business community, especially on refund of VAT; the large threshold for making claims; improve the offset scheme and make it effectively operative; cumbersome forms and the high incidence of audits following the submission of claims).

- Take an integrated view on fiscal incentives. Proposals on new incentives schemes should take account of what is already given in existing sectoral schemes. The new proposals need further review as they do not seem to be a result of a critical analysis of inadequacies in the current incentives regimes. Furthermore, the incentives scheme should be subjected to a post-investment audit.

- Expand its DTT network to include more Asian countries, especially those which it is aggressively seeking to attract to invest in Zambia.

Employment

- Review the policy on redundancy payments. The current policy encourages many investors to opt for short-term contracts that are not conducive to skills-transfer programmes.

Non-citizen employment

- Review the immense discretionary powers of Immigration Department, which need to be curbed. The Department should be required to issue reasons for its decisions.

- Conduct a training programme on FDI policy for immigration officials.

- Issue clear guidelines on the approval process of work permits for foreign nationals to be employed in managerial, technical and advisory positions.

- Issue a policy statement on the implementation of a training and localization programme.

Land

- Develop and implement a specific land registration program targeted at foreign investors who wish to invest in traditional land areas. This effort may be initially targeted at the areas more suited to investment in agriculture and tourism. The tenure system is also a priority area for reform.

- Consider the use of commercially operated industrial zones as a short to medium-term means of providing access to serviced industrial and commercial land. Over the longer term, it will be necessary to address the policy underlying issues, given the importance of land acquisition and of an open market in land for economic growth.

- Review the fees structure for land registration/acquisition.

- Allocate adequate resources, both financial and human to the Survey of Titles Department.

Rule of law and commercial justice

- Develop a customer service approach by the Courts responsible for commercial disputes. This would involve developing a case backlog clearance programme; an efficient case administration system; and a forum for dialogue between the court administrators and the private sector.

- Review the civil procedure rules and bring them into line with modern norms. Key changes should include abolishing needless steps in the proceedings; ensuring that weak cases are quickly disposed of; and enhancing the role of alternative dispute resolution.

- Initiate a programme to overhaul all outdated commercial laws. The programme should have input from the private sector.

- Establish procedures to enable the Government to assess the regulatory impact of its policy proposals on business, by creating a regulatory impact assessment capability.

Licensing and administration of regulations

- Introduce a single business identification number that combines the company registration, taxpayer identification numbers and sectoral licences.

- Introduce a mechanism for inter-agency information sharing so as to limit the duplication of information requirements by various government agencies.

- Establish deadlines for procedural authorizations (i.e. those which do not have regulatory requirements such as health and environmental impact assessments), and introduce a system for *de facto* approval of applications that are not administratively approved within an established timeframe.

- Simplify forms and supporting information requirements for business licences. In the case of individual agencies, this should include consolidating the often numerous forms into one single application form.

Review of the investment code

The proposed amendments to the Investment Act need to be reconsidered. Some reforms are necessary but they should be in the right direction:

- Only investors applying for incentives need go through an approval process. Other investors should register for information only.
- Minimum size thresholds for FDI should not be imposed.
- A limited "reserve list" of business sectors for which foreign investors need approval to invest in could be introduced.
- As an "investment promotion" document, the investment code should not be revised to read like a penal code.

III. STRATEGIC PERSPECTIVES: ENHANCING THE ROLE OF FDI IN DIVERSIFICATION AND EXPORT GROWTH

A. Introduction

Since the 1990s, FDI has come to play an increasing role in Zambia's economy, contributing to increased capital inflows and investment, rehabilitating the copper industry and boosting the production and exports of non-traditional products and services. However, Zambia's has under-performed in using FDI in support of development and poverty reduction. Even though it has in many respects greater potential to attract FDI than other LDCs in the region, it has received considerably less FDI than countries such as Mozambique, the United Republic of Tanzania and Uganda. Moreover, spillovers from FDI to local enterprises, including technology transfer, have been rather limited.

Zambia has not fully used the potential of FDI to contribute to overall competitiveness of the national economy and to diversification of output and exports. Economic diversification to reduce the dependence of the economy for foreign exchange earnings and income on a single commodity, copper, has been a long-term objective of subsequent Zambian governments, reiterated recently in the context of FDI. The withdrawal of Anglo-American from Zambia in 2002 has triggered renewed interest in the issue of diversification. Shortly after Anglo's announcement, a task force was established by the Government to address this issue anew. The task force urged the Government to "accelerate efforts to diversify the Zambian economy as a matter of urgency by implementing, in calendar year 2002-3, the necessary policy changes and public investments" and also recommended the preparation of a *National Economic Diversification Programme*. Such a programme has subsequently been prepared. Activities identified as priorities have included agriculture, agro-processing and tourism. They have not included activities within the mining sector and services other than tourism as promoting diversification.

In fact, Zambia's economy has diversified: nowadays it is much less dependent on copper than ever before. The share of mining in GDP has declined from 50% after independence to around 20% in the early 1990s and about 8% today. The share of copper in exports fell from 90% in 1969 to 53% in 2003. But this has happened owing to *both* the expansion of non-copper sectors and industries (notably agriculture, manufacturing and services such as trading and tourism) *and* the drastic decline of the copper industry (chapter I). Yet, copper prices have increased significantly in 2004, and the copper industry is growing again, owing to FDI (in fact, the growth occurred before the prices increased). This should facilitate diversification, as the revival of copper mining should generate resources to finance the diversification programme.

New promoted activities will sustain diversification only if they are internationally competitive. This calls for the inclusion of infrastructure services in the programme of diversification. Even though these services are not tradable and do not generate foreign exchange revenues directly, they are inputs into the production of other goods and services. They are thus a key determinant of the competitiveness of the entire economy. In Zambia, as will be seen below, they are un-competitive, and often of poor quality or unavailable, (e.g., roads to areas with minerals deposits), thus hampering competitiveness of priority activities and copper mining. While higher copper prices provide much welcomed relief to the industry,

diversification programme should not neglect the need to build a competitive copper mining industry. Copper is and will remain important for the Zambian economy, but its mining is not competitive (this was one of the reasons for its decline). Higher copper prices will be around for some time, but will not last forever. In conclusion, the diversification strategy should not be viewed as developing some activities at the cost of others, but encouraging activities, in which Zambia has comparative advantages and in which sound investment opportunities arise, to grow.

In the short run Zambia's ability to attract substantial FDI and benefit from it will depend on the performance of its mining sector. To fully exploit its FDI potential and to increase FDI contribution to diversification and competitiveness, Zambia has to address weaknesses in its investment climate, which have hampered so far the achievement of these objectives. Chapter II examined weaknesses in the investment framework and offered recommendations on how to deal with them. This chapter first reviews FDI potential (emphasizing obstacles to turning potential into investment opportunity), including how preferential access to international markets can enhance it. It then examines areas of policy, which are key to increasing FDI contribution to diversification, competitiveness and linkages with local enterprises. It concludes with the investment promotion.

B. Investment potential

At the *country level* Zambia has a number of advantages that are attractive to foreign investors, when compared to other countries in the region. The country is peaceful and political and security situation is stable. According to a recent study, as regards the quality of governance, Zambia is among the leading countries in Africa.[21] It still has many natural endowments, which can be commercialised, thus representing FDI potential. Although its local market is small, Zambia has free or preferential access to large international markets: to regional markets, as a member of COMESA and SADC, and to developed country markets under GSP scheme, under the ACP-EU Agreement, the Cotonou Agreement, the EBA initiative (to the EU) and under AGOA (to the United States). Thus, Zambia is in a good stead to attract export-oriented FDI, capitalizing on the country's comparative advantages and market access. In addition, its long history in mining has led to an industrial base, which can be built upon. The economy is relatively open to trade and most of the policies that restricted private economic activities in the past have been removed. The country was ranked 2nd by the Openness to Trade index and 1st for its Average Tariff Rate in the African Competitiveness Report 2000. Its workforce is large, low-cost and well educated at the basic level: an illiteracy rate of 21% (in 2001) is lower than Botswana and Ghana.

In a competitive environment for FDI, Zambia's comparative advantage and access to markets may not be enough to win the race for attractive types of export-oriented FDI, especially in manufacturing and services such as tourism, where the competition among countries is particularly intense. Ultimately, success will depend on Zambia's ability to turn comparative advantage into a competitive advantage. FDI, representing not only capital, but a package of resources necessary for competitiveness, which are very scarce in Zambia, including technology, technical and managerial skills, the knowledge of, and access to, marketing channels, can help, as it has already done in some industries and individual firms. But for such FDI to be attracted on a much larger scale than so far, Zambia has to create a

[21] Jeffrey Sachs et al, *Ending Africa's Poverty Trap*, Brookings Institution, Washington D.C., as cited in *The Economist*, 30 October 2004, "How to save the world", p. 90.

competitive operational environment for firms, which would reduce high costs of doing business in Zambia and improve infrastructure and the availability of producer services.

1. Potential by sectors and activities

Zambia is well endowed with natural resources. Copper mining has been a mainstay of the economy for many decades. The importance of copper exports has declined somewhat but copper still commands a high proportion of total exports. In recent years the non-traditional export sectors (i.e., non-copper mining), such as horticulture and floriculture, have grown and foreign investment has played a key role in these activities. Potential for investment in higher value added activities in mining, manufacturing, services and agriculture are also considerable. Zambia has also under-utilized rural resources, including unspoiled wilderness areas which could be tapped for tourist development.

a) Resource-based activities

Copper. In spite of a long history of copper mining, Zambia still has abundant copper resources in both newly discovered deposits (such as Lumwana and Kansanshi deposits in north-western province) and in the existing mines, where production has recently expanded under foreign ownership. The quality of Zambia's copper compares favourably with that of other major world copper producers. Medium-term prospects for growth of world markets for copper are favourable.[22] Investment opportunities in copper have been boosted by the 80% increase in copper prices since the last year. This has greatly improved the chance to develop the Konkola Deep deposit, the largest in Zambia, with estimated reserves of 400 million tonnes and an annual production capacity of 200,000 tonnes.[23]

Among Zambia's strengths auguring well for exploiting the copper potential is its regulatory framework for copper mining. Introduced in the mid-1990s, it is attractive to potential investors: the treatment of mining FDI in terms of licensing, incentives and taxation is now competitive with those of other countries where mining is an important economic activity. Finding recently new owners for two large mining companies – Ramcoz and KCM – has also greatly improved prospects for copper production. With significantly increased copper prices, the need to provide incentives (which have resulted in low tax revenues from copper mining) has become questionable. The deal with Vedanta, with KCM operating profitably at current prices, has been concluded without any special tax concessions, increasing prospects for greater tax revenues.

Zambia's main weakness stems from its relatively high production costs. For the world's most efficient copper producers, these costs (in terms of cash costs per pound of copper) are below $0.10 cents. The production costs of other major producers range from S$ 0.30-to-S$ 0.45 cents per pound. In contrast, the weighted average cost of Zambian copper mines is US$ 0.58 cents per pound. Until recently, the production costs of most mines in

[22] The volume of world exports of copper ores and concentrates rose by 75% between 1995 and 2000, from 2,6 to 4,5 million tons. The International Copper Study Group expects world refining capacities to increase by 11 per cent between 2002 and 2006.

[23] The Konkola Deep mine (the main asset of Konkola Copper Mines, recently acquired by Vedanta Resources from the United Kingdom, see chapter I) is one of the wettest in the world. It requires some $1 billion of new investment to use its reserves. Huge capital requirements, making investment too risky, were given by Anglo-American, the previous owner of KCM, as an official reason for its withdrawal from Zambia. Vedanta has committed to a feasibility study on developing Konkola Deep by the end of 2006. It will proceed with the expansion if the results are promising (The EIU, *Country Report. Zambia*, September 2004, p. 23).

Zambia were over US$ 0.80 cents per pound. Increased copper prices have eased pressure on costs, but they will not last for ever. In the long-term the high costs of production compared to competitors pose a major threat to the growth and investment potential of the Zambian copper mining industry. The reasons for the inefficiency of the Zambian mining industry are numerous. Some are internal to the mines and include inadequate investment, overstaffing and poor management, where the situation started improving with a large recent inflow of FDI. Some are external and include high transport costs, unpredictable costs of locally supplied inputs, and high costs and availability of energy. Since these are also obstacles to exploiting investment potential in non-copper activities, they will be discussed below.

Gemstones. Zambia has an abundance of precious and semi-precious gemstones. These include emeralds, tourmalines, aquamarine, amethyst, garnet and malachite. Zambia has the second largest deposits of emeralds in the world and Africa's largest deposits of aquamarines and amethyst, with the quality of the latter considered amongst the best in the world. The focus on copper has left gemstones potential largely unexploited. It is only recently, thanks to small-scale mining investment - much of it by foreign investors - that Zambia has began to gain world recognition as a supplier of gemstones. A trade and investment mission by government officials and representatives of the local business community to India -- a leading country in gemstone cutting and polishing -- has helped generate interest in Zambian gemstones. Some investors engaged in gemstone mining, who were interviewed for this Report, have suggested that with the right policy environment, appropriate infrastructure and institutional support, the sector has the export potential greater than the current value of copper and cobalt exports. International demand for gemstones is strong, not only in Europe and North America, but also in South-East Asia.

Gemstone mining is, however, plagued by many problems, hindering its growth and investment prospects. Key obstacles to investment that existing investors (both local and foreign) have singled out during interviews for this Report as requiring urgent attention are the following:

- **Lack of finance for investment and working capital**. There are currently about 450 registered investors with 10-year gemstone licences.[24] With the exception of about seven large and medium-sized foreign companies, the rest are small-scale local and foreign investors. Access to capital from local financial institutions for investment, and particularly working capital, is critical to them. However, partly because of the extremely high and volatile interest rates and also because of the reluctance of local banks to provide credit to small investors at a time of macroeconomic uncertainty, the majority of licence holders are either not operating at all or are operating at much lower capacity. The small-scale foreign investors frequently initiate their projects with finances obtained overseas, but as the project advances they use local credit facilities to raise funds for working capital. At the current bank lending rates, that option is not viable.

- **Inaccessibility of mining areas**. Zambia's transport network has been developed with a view to cater to the needs of copper mining, which is concentrated in the Copperbelt region. But most gemstones deposits are spread all over the country, in rural areas, away from the transportation network. One of the leading companies in gemstone production, for example, Old Mukushi, is located 100 kilometers from

[24] There are also more than 400 holders of "artisan mining rights", which need to be renewed every two years.

the nearest tarred road, while another leading firm, Mapatiza, is 70 km away. The distance is even greater for firms operating in the north-eastern part of the country. Transportation of precious stones through remote areas with poor roads requires special protection measures, which add to the costs of transport (one mine has had to hire helicopters to transport precious gemstones to its bi-monthly auctions). Some of the mines close during the rainy season, because they simply become not accessible or because the equipment and energy sources needed to keep the mines dry are lacking.

- **Low-level of mechanization.** Some of the foreign investors interviewed indicated that while best-practice gemstone mining calls for investments of several million dollars in machinery and equipment needed for efficient and environmentally friendly production and/or to make mines operational during the rainy season, they are reluctant to raise the funds from overseas because of the uncertainties in the current macroeconomic policies and the ambivalent government attitude towards the sector's development. Many of the foreign investors with licences are instead utilizing less efficient labour-intensive methods and playing a game of wait-and-see. In addition, the slow process of privatization of at least two of the State-owned gemstone mining operations is delaying the arrival of potential FDI to the subsector.

- **Lack of appropriate energy sources.** Electricity is an essential energy source for modern and efficient mining operations. While Zambia produces hydroelectricity, the electricity supply lines, like the country's transport network, are designed to cater to major cities and the needs of the copper industry. Most of the gemstone mines in rural areas are not connected to the main electricity grid provided by the Zambian Electricity Supply Corporation (ZESCO). They have to resort to self-generated electricity, which can be expensive even for small-scale operations. Some of the small-scale mines claim that generating their own electricity costs them three times more than what they would have paid had they been connected to ZESCO.

- **Cumbersome administrative procedures**. Because there is a good deal of illegal gemstone mining and trading activity, investment projects in the sector are subject to numerous controls and documentation procedures. A wide range of government departments are involved in this process, including the Ministry of Mines, ZIC, regional mining bureaus, police, immigration authorities, Ministry of Labour and Zambia Revenue Authority. According to investors in the sector, the multiplicity of controlling authorities has raised two types of problems. First, since there is no effective coordination among the various agencies, the regulatory system lacks transparency and is prone to abuse. Second, investors spend a considerable amount of time and resources processing permits and other documents necessary to initiate their projects. Even after the projects become operational, firm owners or their managers continue to devote excessive time and resources to obtaining permits – for certification, marketing, exports and so forth. In most cases these documents can be processed only in Lusaka, which means weekly trips from mine locations to the capital, thereby adding to the costs of doing business in the sector.

Other minerals. Quarrying opportunities occur for lime, marble, granite, silica, tantalite and other similar minerals. They hold good export prospects in regional and international markets in either raw form or as processed chemicals. For example, tantalite, the base material used for the manufacture of key components in cellular telephones, is prevalent in the southern part of Zambia but to date this potential remains unexploited.

Agriculture. Arable land in Zambia is estimated at 74 million hectares, and about 14 per cent of this is currently used for agriculture. There is also plentiful water supply from rivers and lakes, which provide the country with considerable potential for irrigation and hydroelectricity supply.[25] Foreign investors' interest in agriculture is increasing. FDI has been instrumental in increasing exports of horticulture and floriculture products in recent years. Besides sugar and cotton production, which are major cash crops, Zambia can also easily support the growing of fresh and out-of-season horticulture products. The rich variety of crops gives Zambia greater scope to move into higher value added agro-processing. There are growth prospects for major staple food and processed food products in the regional and developing country markets. While Zambia has preferential access to COMESA and SADC, tariffs for food and processed food products are high in Asia, Arab and North African markets. Zambia is paying MFN duties in these markets as it is not a member of the Global System of Trade Preferences among Developing Countries (GSTP) under which many of the major developing countries have exchanged tariff preferences between themselves.

b) Manufacturing

Zambia does not have a large manufacturing base despite many opportunities for upstream and downstream activities deriving from mining and agro-processing. It has good quality cotton but textiles production is by far less developed than in comparable African countries; primary production of copper is not being sufficiently leveraged to produce copper products, and agro-processing is not fully tapped.

Textiles. Zambia has a comparative advantage – the availability of cotton – which has not yet been turned into a competitive advantage in the production of textile products in spite of the privileged access to a large United States market under the Africa Growth and Opportunities Act (AGOA). AGOA grants Zambia and other eligible African countries unlimited duty-free and quota-free access to the US market. So called AGOA I (originally due to expire in 2004, but currently extended until September 2007) has no local content requirement for fabrics (which means that they can be imported from cheapest sources), AGOA II will require that the yarn or fabric be either produced locally to encourage backward integration or they be sourced from the United States and/or from other AGOA-eligible countries. But to date, Zambia has made only indirect use of the market access opportunities under AGOA. Cotton and poly-cotton yarn still account for over 90 % of Zambia's exports of textile-related products. The industry had suffered from the lack of investment and poor management in the 1980s and early 1990s. This was partly reversed in the post-liberalization period when new investors, including FDI, acquired the operations. In 2000, cotton and other textiles were the second largest item in non-traditional exports, increasing to $75 million from $7.6 million in 1990. In the following 2 years, it fell to around $42 million. Most of these exports, consisting mainly poly-cotton yarn as inputs for production of garments, have gone

[25] One estimate shows that Zambia's water potential could enable it to irrigate up to 500, 000 hectares of land. Currently only 13 percent of this potential is utilized, mainly by medium- and large-scale farmers. See, WTO ((2003), Trade Policy Review: Zambia 2002, WTO, Geneva., p.57

to other AGOA-eligible countries, namely, Lesotho and Mauritius, and to South Africa under the SADC Trade Protocol. Garments production in Zambia is hampered by high production costs.[26] For example, Zambia is not able to compete in textiles exports to Europe, because of the high cost of transport vis-à-vis producers in Central and Eastern Europe and even in Central Asia.[27] The regional market offers potential for exports of textile products, although even within this market the cost of transport can be a deterrent.

Copper products. At present, diversification of copper mining towards copper products has been limited to unwrought metals, copper wires and cables. FDI in mining supply industry is insignificant, although there is wide scope for vertical diversification towards export-oriented upstream and downstream activities – such as the production of copper-based products, mineral-based chemicals as well as explosives and other inputs used for mining. Africa Explosives Ltd (AEL), a foreign-owned company in manufacturing explosives for mines which acquired the State-owned Kafironda in 1997 under the privatization programme is indicative of this potential (box III.1). World demand for copper products is strong and prospects are good. China, India, Taiwan, Province of China, and several South-East Asian countries as well as, for example Saudi Arabia, are intensifying industrialization process and will be important consumers of copper and metal products for the years to come.

Agro-processing. To date agro-processing is limited mainly to sugar refining, cotton ginning and spinning of yarn cotton, and some amount of dried paprika for exports. There is considerable scope for increasing sugar production and expanding the range and improving the quality of sugar products such as bagasse for generating electricity and its by-product, filter cake which is used in the production of fertilizer and rum. Presently, Illovo of South Africa with some minority foreign partners is the main sugar producer, selling 65 % of the refined sugar domestically and exporting the balance to the region.[28]

c) Services

Tourism still represents major potential growth industry for Zambia, in spite of its recent rapid growth: tourism revenues rose from $35 million in 1990 to $91 million in 2000. Zambia's image as a tourist destination is far from fully tapped. Zambia's attractiveness lies in its diversity, which includes: an accessible wildlife; a varied and impressive scenery; unspoilt wilderness areas; abundant water resources; a rich cultural and natural heritage sites; sunny and hot climate. Zambia has 19 National Parks and 34 Game Management Areas (GMAs) covering 33 % of the country, but only 5 % has been developed for tourism. The country also has over 35 % of the water resource in Southern Africa and the world famous Victoria Falls is located within its borders. Zambia, a democratic country, with a history of political stability and peace, is in a position to meet the growing demand for specialized tourism such as adventure tourism. It has the potential to develop special interests activities such as white-water rafting, hiking and fishing. These are upscale tourism activities, often generating high returns per tourist. Recent growth of tourism has been largely due to a

[26] See World Bank (2003), "Zambia: the challenges of Competitiveness and Diversification", report No. 25388-ZA, World Bank, Washington DC. This study has benefited from some firm level insights.

[27] It is estimated, for example, that transporting a container of yarn from Zambia to Germany costs six times more than from Uzbekistan, which is emerging as an important supplier of yarn to European spinning firms. Transport cost disadvantage makes Zambia uncompetitive even under duty-free market access.

[28] There are new players in the industry such as Kafue sugar and Kalungwishi sugar that are worth noting.

Box III.1. Developing mining supply industries

After taking over Kafironda, the Zambia's State-owned explosives company, African Explosives Limited (AEL) a top explosives producer of South Africa, invested in new equipment and introduced new products and services, improving the key aspects of blasting techniques in Zambia's mining, and exporting them to DRC and Zimbabwe. The world market for explosives has been changing to bulk systems for both surface and underground mining. AEL has introduced these systems – relying on electronic detonators for which AEL is a world leader – to a number of mines in Zambia, significantly improving blasting efficiency and providing cost savings to the customers. Zambia is becoming a platform for the introduction of this technique to the Central African market. In addition, AEL, through its Zambian subsidiary, has started producing and supplying mini-bulk explosives, which are specifically designed and tailored to the quarries and small-scale mining operations that are commonly found in Zambia. It has also set up a technical support team to provide training needs and blasting solutions for its Central African customers.

Source: African Mining, May-June 2000, Vol. 5. No. 3

rapid increase in private investment. FDI has created new tourism facilities in the Livingstone District, attracting international clientele. Since the mid-1990s practically all publicly-owned tourism lodges and four major hotels in the country have been privatized. Major tourist attractions, however, are in rural areas, which lack adequate access roads, electricity, telecommunication facilities and airline connections to main tourism markets. If these constraints are eased or removed, the growth potential for Zambia's tourism industry is estimated at doubling its recent direct and indirect contributions to employment and national economy.

Infrastructure services. As mentioned earlier, telecommunications, water, electricity and transport services are strategically important for diversification strategy. They impact on Zambia's economy competitiveness directly and indirectly and thus are important determinants of future investment and growth. Except for the Zambia Railways which was put up for concessioning in December 2003 and the liberalization of the cellular phone industry, other infrastructure services are still provided under monopoly conditions by state enterprises, most of which are poorly managed, are weak financially and provide uncompetitive services hampering competitiveness of many activities representing investment potential, as discussed earlier. If they are put up for privatization, they represent a significant FDI potential. The reform and reinvigoration of these key services will be a great challenge to the Government to pave the way for the country to realize its overall FDI potential.

2. Market access

Export-oriented FDI has driven recently Zambia's exports of non-traditional products: metals, agricultural and industrial products. Export market access is Zambia's key locational advantage for attracting FDI into manufacturing. Such FDI can exploit Zambia's rich resources, including agricultural raw materials, for processing. A window of opportunity for

Zambia to attract export-oriented FDI is provided by two market-related factors: first, the privileged access granted to LDCs to the developed countries' markets under various preferential trade schemes. Second, Zambia has duty-free access to regional markets such as COMESA and SADC. Zambia is a member of both regional trade agreements. While trade and investment opportunities are considerable and that Zambia has a wide range of resources, to date, these resources remain under-utilized and the opportunities unexploited.

Two caveats need to be made immediately. One is, that to exploit these opportunities, Zambia needs to improve its land and/or air transportation links with these markets (see below). Second is that Zambia shares privileged or preferential access to these markets with other countries. It therefore needs to be competitive vis a vis these countries, that is, turn its comparative advantages into competitive advantages, as pointed out earlier. FDI can help enhance certain aspects of export competitiveness, but Zambia has also to do its part: provide competitive infrastructure and other inputs needed for exports, including the improvement and stability of key macroeconomic policies such as interest rates, inflation and the exchange rate.

a) Preferential opportunities for trade and investment with the EU

Duty free and quota free access into the European Union under the Everything But Arms Initiative (EBA) for LDCs, which was introduced in 2001, grants better access conditions than under two earlier trade arrangements, the ACP-EU Agreement and the Cotonou Agreement.[29] For more than 1,000 *agricultural and food industry products* preferences are no longer limited to a partial reduction of duties, as was the case with ACP imports. There is therefore a large, hitherto untapped potential for expanding exports to the EU. As of mid-2009 there will be no tariff quotas limiting duty free access of any agricultural or food industry products. Among others, sugar, canned fruits, fruit juices, jams and marmalades will be included. This opens a new perspective for export-oriented investments, which will enable exporters to rely upon stable and duty-free market access. Such market preferences have recently contributed importantly to the rapid growth of two non-traditional exports (fresh vegetables and cut flowers) from Zambia by foreign firms. Zambian horticultural exports take place out-of–season, during the European winter period. There is substantial potential for export growth of both fresh fruits and vegetables and processed fruits and vegetables in the traditional UK and other EU markets. Zambia's sugar exports presently benefit from the ACP-EU Sugar Protocol. Zambia receives a EU intervention price, which is higher than prevailing market price based on an allocated national quota. Exports under ACP quota fluctuates between 70,000 tons and 80,000 tons annually. In 2003/2004 the duty-free EBA quota has added another 100,000 tons of export opportunities to EU for LDC sugar exporters.

Zambia has so far been less successful in leveraging trade preference for *semi manufactures and manufactures* to achieve vertical diversification. The tariff and quota preferences applied on textiles and clothing are substantial as the EU market imposes stringent import quotas on major Asian exporters. Zambia has made only modest use of these large preferences, mainly in the form of limited exports of uncombed cotton yarns and modest exports of cotton fabrics to EU. When the MFA quotas for textiles and clothing are dismantled in 2005, ACP countries will still enjoy a relatively high tariff advantages of 12% *ad valorem* for clothing products, implying a high effective preferential advantage in terms of

[29] The EBA scheme is not time-bound. All other requirements and provisions of the GSP scheme of the EU are applicable, including its general provisions and policy conditionality, its rules of origin and the requirements for direct transport and certification.

value added. In addition, since May 2004, enlargement of the EU market has enhanced access to rapidly growing markets for semi-manufactures, manufactures and foodstuffs. In addition, the new EU member countries will take over the EU Common External Tariff and its preferential arrangements. New market opportunities will arise for copper products. New EU member countries, many of which are important copper processors and importers of copper products, will reduce their duties on Zambian products to zero (from 9 % on refined cathode copper and 13 % on wire rods, bars and plate) as they take over the EU preferences extended under the Cotonou Agreement, the GSP and the Everything-but-Arms schemes.

b) Preferential opportunities for trade and investment with the United States and Canada

Zambia benefits from duty-free access for a large number of agricultural and industrial products to the US market under the US GSP scheme and the US Africa Growth and Opportunities Act (AGOA). These schemes have been extended to include agricultural products such as tomatoes, cucumbers, dried onions and orange-, grapefruit- and other citrus fruit juices; and manufactures such as clothing, footwear, travel goods and a number of other industrial products. AGOA has created substantive impact particularly on textiles and garments exports for several LDCs, namely, Lesotho, Madagascar and Malawi. However, Zambia has not used it to its advantage, as noted above. Using Zambia as a base for textile and garments production to enter the US market will be enhanced when the third country fabric rule will no longer apply, after September 2007 because Zambia can easily meet the fabric sourcing requirement. AGOA III will be a real challenge for Zambia as it has the raw material and could attract investment aimed at textiles and garments production, including backward integration into fabric weaving and knitting. Currently, Mauritius, South Africa and several Far East producers are investing in garments production in some AGOA-eligible countries of Africa to gain access to the US markets. Zambia has failed to attract any share of these investments. AGOA also allows for the expansion of agriculture and food industry exports to US. American food safety requirements are particularly strict, however, and many import prohibitions are applied for health and sanitary reasons to African countries as a whole. American investment could help in making inroads into the US market as the investors can bring in the standards to meet the market requirements.

Zambia's exports also stand to benefit from special market access given by *Canada.* Since 2003, Canada has extended duty and quota free access without any time limit to all LDCs' exports.

c) Preferential trading opportunities with Japan

From April 2001, as an LDC, Zambia could benefit from duty free preferential access to the Japanese market for a large number of industrial and agricultural goods, including textiles and clothing products. In 2006, Japan will lift the quota ceiling on imports of copper and copper products. Presently, Zambia exports primarily copper anodes to Japan (close to $50 million annually). Improved market access will put Zambian exports on an equal footing with the domestic industry, whereas quotas will remain in effect against other major suppliers from Asia and Latin America. Duty-free access for Zambia and other LDCs implies a tariff preference ranging between 4% and 6% for refined copper products.

C. Policy challenges for Zambia

What then Zambia can do, apart from further improving the investment framework (chapter II), to, firstly, better utilize its FDI potential in terms of boosting FDI inflows (annual inflows of at least $300 million seem to be within Zambia's reach, at least for some time)? And secondly, and perhaps more importantly, what can it do to significantly enhance benefits from FDI, in particular stronger spillovers to, and linkages with, local enterprises, and greater FDI contributions to the diversification and competitiveness of Zambian economy? Actions and policy challenges, which can improve investment conditions across the board include further consolidation of macroeconomic policy, improvements of physical infrastructure including through privatization, human capital and domestic enterprise development and ensuring coherence and consistency of Zambia's FDI policies, including investment promotion efforts.

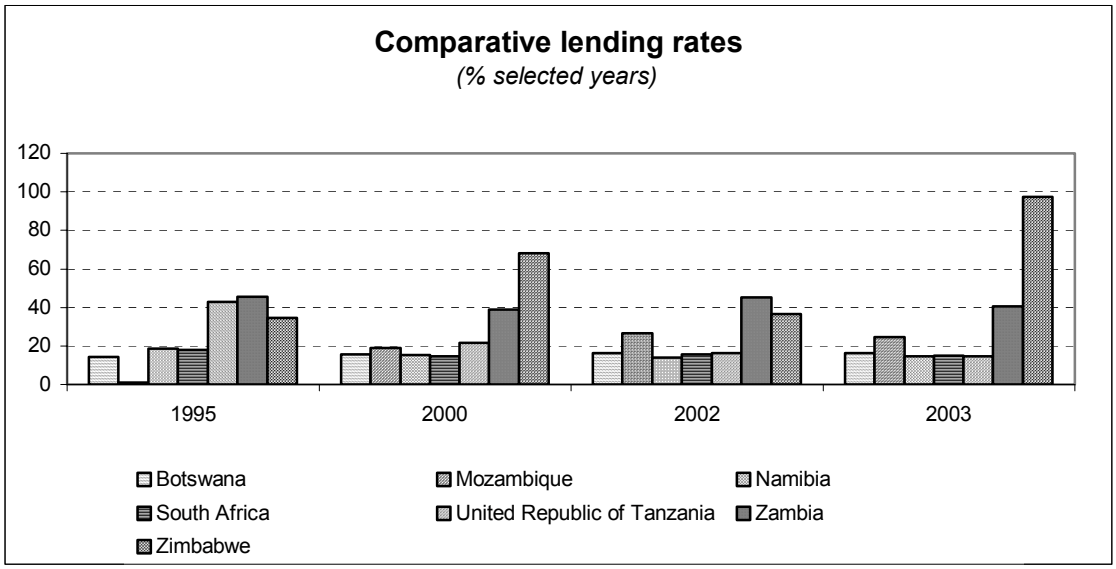
1. Macroeconomic climate

FDI policy in Zambia has not treated macroeconomic policies as an integral part of investment promotion efforts. There has been an erroneous perception in Zambia about the key determinants of FDI inflows, which were understood mainly in terms of fiscal incentives, entry procedures and the provision of one-stop-shopping service. The persistent instability of macroeconomic policies (chapter I) has been viewed simply as an unfortunate problem that hinders mainly domestic investment but not necessarily FDI, especially export-oriented FDI. This view was reinforced by relatively high FDI inflows during the 1990s, seemingly not affected by policy instability. But inflows were largely associated with privatization and concentrated on copper, which is indeed less prone to macroeconomic instability: copper is sold in world markets, with earnings denominated in foreign currency, large mining companies have access to international credit markets and their profitability is less exposed to fluctuations in local interest and inflation rates or volatility in the exchange rate. Large international hotels catering to international tourists can be in a similar situation. But linkages of local enterprises to mining companies and hotels are strongly and adversely affected by all these factors. Furthermore, not all FDI in Zambia operates in such an enclave environment. As noted above, foreign investors in non-copper mining, agricultural and agro-processing sectors as well as in manufacturing are mainly SMEs, as are most domestic companies.

Thus instability of key macroeconomic indicators such as domestic lending rate, exchange rate and inflation rate, is a major concern to both foreign and domestic investors in Zambia, as it tends to raise the level of uncertainty and risks in their current operations and investment decisions:

Financing. For local entrepreneurs a major obstacle to investment plans is the high cost of capital. This also affects small- and medium-sized foreign investors, operating in non-traditional export industries, relying on local financial institutions for mobilizing investment and working capital. The inability to raise capital prevents the creation of linkages between local and foreign firms. Zambia's lending rates were about 45-to-50 per cent at the end of 2001, by far the highest among comparator countries (figure III.1). Although this rate has gone down since then, the lending rate of commercial banks remains high at around 44% in 2003. High interest rates have been caused by government borrowing to fund the national debt and monetary growth. Government borrowing is thus having a "crowding-out effect" on private sector borrowing. There is also a lack of funds available to local banks due to low national savings levels.

Figure III.1 Comparative lending interest rates (%) 1995-2003



Source: World Bank

Exchange rate volatility. There has been a rapid and large fall in the exchange rate in the post-liberalization period, from 34 Kwacha per US$ in 1990 to 5,000 Kwacha per $1 in the early 2003 (figure III.2). Such currency instability generates uncertainty and raises the risks of investing, particularly for those enterprises producing for local and regional markets, and also for those that rely on the availability of foreign exchange at a predictable price for importing inputs and repatriating profits. It also discourages local banks from offering credit facilities denominated in foreign currency because of the foreign exchange risks involved. Exports are also adversely affected as firms need to absorb the impact of currency risk. According to a recent study by the World Bank, in 2002, "exchange rate changes were the second biggest factor which affected firms' competitiveness" in Zambia.[30]

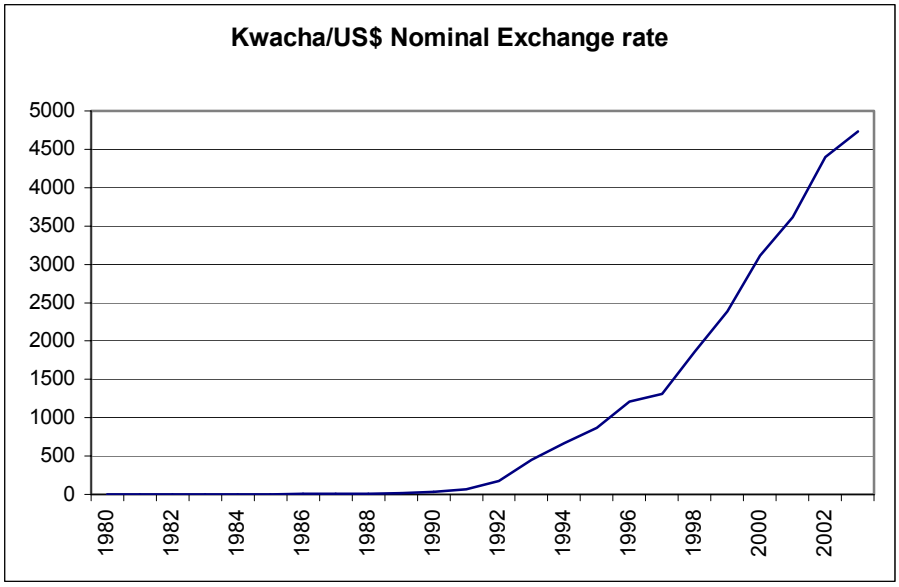
Persistently high inflation rate. While inflation rate has come down radically from the high level of the 1990s, which at one stage it was over 200%, it still remains high at 18% in 2004. This rate is still much higher than in competitor countries in the region. The problem is that erratic changes in inflation rates, the type experienced in Zambia, creates uncertainty in business transactions. It also distorts the informational content of relative prices. In general, it makes investment plans and decisions difficult as investors have no way of predicting how input prices will move and by how much.

Recommendations on improving the macroeconomic climate for investment

If Zambia is to create an investment policy environment that is attractive to both domestic and foreign investors, and to all types of investment, it must treat macroeconomic policies as an integral part of its investment climate and investment promotion strategy.

[30] See, World Bank (2003), "Zambia: the challenges of Competitiveness and Diversification", report No. 25388-ZA, World Bank, Washington DC.

Figure III.2 Kwacha/US$ exchange rate 1980-2002



Source: World Bank

This report thus recommends that attaining macroeconomic stability should hold a central place in Zambia's investment promotion strategy. Endless refinements in specific policies and incentives to attract investment without tackling the persistent problem of macroeconomic instability will not lead to the desired outcome. In Zambia, the key to achieving macroeconomic stability is a reduction in the fiscal deficit of the central Government, which, as explained above, has been the main trigger for macroeconomic volatility. The challenge of controlling fiscal deficit is not something unique to Zambia. Many countries, including Zambia's neighbours, face similar pressure but have managed to reduce their deficit, thereby creating a more secure investment environment. Deficit reduction calls for discipline and careful management of public expenditure. This will help reduce inflation, allow for more stable and predictable movements in exchange rates and exert downward pressure on interest rates for investment and working capital.

A macroeconomic stabilization programme has to go hand-in-hand with efforts to reduce external debt, which could easy derail a stabilization programme if it reaches unmanageable levels. The situation could ease in the future, helped by the fact that the country has recently reached the HIPC Completion Point. This should help to alleviate the debt burden and conserve the foreign exchange which could be used to support the development of private investment.

Short-term measures to boost lending to local and foreign small and medium enterprises are needed. Availability of credit by multilateral and bilateral lending agencies at concessional rates to national banks, particularly through schemes catering to SMEs, should be encouraged. A number of international agencies are currently involved, including the IFC, PROPARCO of France, and CDC of the UK. The European Investment Bank has a SME lending programme in place, which has been found to be useful in supporting small and medium-size investors.

As a longer-term goal, the Government should encourage the banking sector to develop facilities for long-term credit and venture capital financing. It should further explore the possibility of establishing a financial institution assuming the role of an investment partner in new projects (similar to that played by the Office for the Promotion of Private Power Investment). Such an institution could progressively divest its shares to local enterprises, as well as extend guarantees to domestic investment partners to facilitate access to bank credit and reduce costs.

2. Infrastructure services

Poor infrastructure services – transportation, telecommunication and electricity services – are a formidable barrier to exploiting investment potential in Zambia, making many activities and industries uncompetitive, as repeatedly emphasized above. In large areas of the country with significant investment potential services are simply not available. Existing services are among the most expensive in Africa. In addition they are often unreliable. Not surprisingly, when compared to other countries, infrastructure services in Zambia are pointed to as a major obstacle by most investors (World Bank, World Business Environment Survey 2000).

a) Transport

Zambia's landlocked location makes transport inherently expensive. However, this disadvantage is compounded by Zambia's poor transport system. Transport costs account for 60% to 70% of the cost of production of goods and commodities in Zambia.[31]

Until the recent restructuring of the Zambian railways - with the assistance of SIDA (box III.2) - the railway system was rapidly deteriorating due to poor maintenance, lack of investment and neglect for many years. The freight traffic declined from 4½ million tons to about 1½ million tons between 1990 and 1996.[32] Breakdowns and other operational problems were becoming more frequent with negative consequences on the delivery of both exports and imported inputs as well as the cost of inputs and ultimately the cost of production.

The road transport system does not provide a viable alternative to the railways. Less than 10 percent of the total roads in Zambia are tarred and accessible in all weather conditions. The shift from trains to road traffic costs the Zambian economy $100–150 million per year in increased road deterioration and fuel costs.[33] The road freight cost from any of the regional seaports to Lusaka is higher than the cost to the capital city of other countries in the Southern African region.

Agricultural exports to regional markets are supplied by road, with more than half of processed food exports going to the Democratic Republic of Congo. The poor road system, increasing the cost of road transport and, in addition, delays on account of truck and fuel shortages, considerably reduce Zambia's attractiveness as a location for FDI aimed at supplying markets in the region, in spite of Zambia's privileged access to these markets.[34] According to estimates by the World Bank, for example, it costs approximately $7,000 to

[31] World Bank (2002), *Poverty Reduction Strategy Paper*, April 2002, Washington D.C.
[32] CUTS (2002), "Zambia Investment Policy Report", April 2002, Lusaka
[33] CUTS (2002)
[34] The withdrawal of the State sector from haulage business in the post-liberalization period has left a huge gap, which has not yet been filled in by the private sector. As a result, some 60% of cross-border exports had to be carried by foreign trucks (coming mainly from Zimbabwe and South Africa), which added to the cost of transport.

send a truck from the Copperbelt to Uganda.[35] The price of diesel, which is the main fuel used by road freight trucks, is high in Zambia due to high taxes on diesel. Diesel and tyres, which are more expensive in Zambia than elsewhere, contribute over 50% to the costs of transportation.[36] Gemstone mining is particularly affected by the lack of a proper road network as most of the precious and semi-precious minerals are found in remote areas of the country.[37]

Air transport is especially important for non-traditional export industries, notably horticulture, floriculture and tourism. After the liquidation of Zambia Airways in 1994, the country has been serviced by small-scale private operators. There is insufficient provision of rural routes and air cargo transport. Horticulture and floriculture producers interviewed indicated that insufficient cargo connections to Europe have hampered their investment expansion plans. Larger firms in the industry use charter flights, although their output is often not large enough to utilize full capacity. Smaller exporters often make use of the excess capacity. Because of high landing fees and also the high cost of aviation fuel in Zambia, due to high taxes, charter flights are arranged only when there is sufficient supply for export. Otherwise, cargo space of passenger planes is used, if available.

b) Telecommunications

Telecommunication services are not available in many areas of Zambia, and those available are among the most expensive in Africa, affecting the ability of investors to conduct business within and outside the country. Fixed lines are provided by the state operator ZAMTEL and there are two private mobile phone operators, Celtel and Telecel. Zambia's teledensity for fixed and mobile phones of 19 subscribers per 1000 inhabitants is much lower than in many countries in the region, and costs for international calls to the US are very high and highest among 6 comparator countries (table III.1). Waiting time for a new fixed line connection was on average nearly seven years in 2001. COMMENTS " xx" Telecom expansion would help exploit investment opportunities, including the development of agriculture and mining in relatively isolated areas. All nine provinces in Zambia are gradually receiving telephone coverage.

Table III.1. Zambia comparative telecommunications indicators, 2002

	Zambia	Ghana	Lesotho	Namibia	South Africa
Fixed and mobile phone subscribers (per 1000 people)	19.43	20.83	..	121.59	364.32
Telephone cost of call to US ($ per three minute call)	4.40	1.26	2.31	..	0.58

Source: World Bank World Development Indicators, 2003.

[35] World Bank (2003), op cit, p.33. The study also points out that the ban on foreign trucks transiting Zambia (e.g. from Zimbabwe to DRC) to pick up load in Zambia on the return journey has denied Zambian firms from using excess truck capacity.
[36] World Bank (2003), ibid. p.13
[37] For example, one of the leading companies in gemstone production, Old Mukushi, is 100 km away from the nearest tarred road, while another equally leading firm, Mapatiza, is 70 km away.
[38] African Connection, Centre for Strategic Planning (2002), "Zambia: Rural ICT Market Opportunity Report", October 2002, Vancouver.

c) Energy

The availability, cost and reliability of energy supply are critical for many investors, in particular those engaged in energy-intensive production. Except for oil imports of about 15,000 barrels a day, the country is self-sufficient in energy. It is richly endowed with hydroelectricity sources and coal as compared to other countries in the region (Table III.2) and it is a net exporter of hydroelectricity. Domestic energy sources are not fully utilized. Hydropower potential is estimated at 6,000MW although installed capacity is only 1,715 MW.[39] Proven coal reserves are 30 million tonnes with probable reserves of several hundred million tonnes. However, there is only one coal mine in operation, Maamba Colliery. Its output has declined from 192,000 in 1998 to 92,000 tonnes in 2003, owing to a chronic shortage of working capital.

The country's electricity is supplied by the state-owned Zambia Electricity Supply Company (ZESCO), which provides 65 per cent of its output to copper mining companies. In addition, most of these companies buy their electricity from the private power distributor, Copperbelt Energy Company, which bought the power division of ZCCM, when it was privatized in 1997.

Only some 23% of Zambians have access to electricity. This hinders the emergence of agriculture-based enterprises by retarding the development of activities such as irrigation and food processing. Ongoing technical problems at two hydroelectric power stations operated by ZESCO have caused a 16% decline in power generation between 2001 and 2003, halving electricity exports. Electricity tariffs are among the highest in the region, undermining export competitiveness of copper (Box III.2) and non-traditional exports as well as fuelling inflation.

Box III.2. The importance of electricity for efficient mining

The costs and reliability of the electricity supply is therefore critical for the operations and competitiveness of a modern mining industry. An efficient mining operation requires electricity supplies 24 hours a day. Electricity represents an important proportion of the costs of production. For example, every month KCM spends about $ 20 million on operations. Half of that covers the costs of electricity, which is used, among other things, to pump out about 300,000 cubic meters of water per day. For every ton of ore mined, 50 cubic meters of water are pumped out. In the past, the method of distribution and the practice of cross-subsidization applied by ZESCO were the main causes of high production costs for most, if not all, of Zambia's mining divisions. The tariff charged by ZESCO to the mines was not determined by market-based supply and demand, but was fixed at a level that enabled ZESCO to meet its overall objective of supplying electricity to domestic consumers at lower rates. This policy of charging the mines higher rates to subsidize household consumption was one of the factors contributing to the high costs of production of Zambian mines. Although this policy was reviewed as part of the privatization of the mines, current tariff rates are still lopsided and need to be reviewed.

[39] World Bank (2002), *Poverty Reduction Strategy Paper*, April 2002, Washington D.C.

Table III.2. Comparative production from primary energy sources

Country	Oil ('000 barrels per day)	Coal (Million Short Tons)	Hydro (Billion KwH)
Botswana	0.00	1.06	0.00
Ghana	7.00	0.00	8.36
Lesotho	0.00	0.00	0.00
Mozambique	0.00	0.02	6.98
Namibia	0.00	0.00	0.00
South Africa	26.21	250.28	2.06
Tanzania	0.00	0.01	2.36
Uganda	0.00	0.00	1.91
Zambia	0.00	0.21	7.71

Source: United States Energy Information Administration, International Energy Annual 2001

Recommendations on improving infrastructure services are (see also the next section on privatization):

- Revise taxes on basic fuel. Diesel and aviation fuel are significantly more expensive in Zambia than in many other countries in the region due largely to the relatively high taxes. The taxation policy should be reviewed with a view to making taxes comparable to competitor countries. For the economy as a whole, the multiplier impact of higher diesel and aviation fuel prices are much more damaging than would be the loss of revenue from lower taxes.

- To fully utilize investment and exports potential in agricultural exports, the Government must give the priority to removing the present bottleneck in air cargo transport. Measures leading to lower airport landing fees and tax incentives for private air cargo service providers should be seriously considered.

- Urgent attention should be given to the construction and improvement of roads that link main tarred roads with rural regions where known and exploitable deposits of gemstones and other non-precious stones are located. At present, lack of all weather roads to resource rich locations is a major deterrent of potential investment in non-copper mining.

- Another priority area, which requires an urgent attention, is the pricing and method of distribution of power to the business sector. Zambia has the capacity to generate enough electricity to supply domestic as well as export markets. It is not clear why it uses less than 30 per cent of its hydropower potential. The efficiency of power generation and distribution in Zambia needs to be reviewed with a view to expanding and improving extraction of domestic energy sources to reduce electricity costs and increasing the role of the private sector in energy generation and distribution.

- Improve rural access to electricity through applying least cost solutions in regions with investment potential, particularly in mining and agriculture. The electricity tariff structure for mining and other businesses must be reviewed with a view to eliminating distorted pricing system.

3. Privatization

Since the early 1990s, the role of the private sector in Zambia has increased greatly, owing to a comprehensive privatization programme. It covered a wide range of public enterprises, from small to large firms, in particular in manufacturing and the mining sectors. But public enterprises in infrastructure services, discussed above (transport, telecommunications and energy), have not yet been fully included in the programme. These are: Tanzania Zambia Railways (Tazara) in transport, ZAMTEL in telecommunications and ZESCO in energy. The overwhelming majority of investors in Zambia interviewed identify the high cost and unreliable infrastructure services as the main reasons for Zambia's poor competitiveness record and low level of investment, in particular in export-oriented activities. The delay in the privatization of these enterprises, providing essential inputs to all goods and services produced in Zambia, may have denied Zambia potential competitiveness gains, so badly needed, from private sector participation. The option of further public investment in these critical services is not likely in the near term given the heavy burden on Government expenditure. These services require drastic improvements not only through the injection of new massive investments, but also, and perhaps more importantly, technology and management, which the public sector does not have.

The Government's policy of extending private sector involvement to the rail transport services is already quite advanced. Zambia Railways (ZRL, with some 1,100 kilometres of track) has been successfully concessioned with the contribution of ODA by the Swedish development agency (Box III.3). In the early 2003, ZRL was concessioned for 20 years to a consortium of two South African companies, auguring well for boosting freight volumes and reversing the drastic decline in passenger transport. In addition, the Government will receive from the consortium $253 million during this period as well as 5% of turnover. Government also plans to concession Tanzania Zambia Railways (Tazara, with 1,860 kilometres of track), known for overstaffing, weak management and poor service.

But the privatization of telecommunications and energy companies (as well as Zambia National Commercial Bank) has stalled. Instead, the Government has opted for their "commercialization", that is keeping them under state control, but introducing private-sector management and practices and, in some cases, offering private firms a minority stake. At present, there are doubts in Zambia about the benefits of privatization for consumers and whether the speedy privatization programme implemented since the early 1990s has been valuable for the economy as a whole. These doubts were valid in the context of problems, discussed earlier, with the privatization of the copper mines. But these problems have been corrected, and the copper industry is back on track, with rapidly expanding production, employment and exports, for the first time since decades. This would not have been possible without the engagement of foreign firms in privatization. The upward movement of the industry started well before the increase of copper prices in 2004, fuelling further expansion. Also the experience with the privatization of manufacturing companies has been positive. As indicated in chapter I, a number of ailing state-owned companies have been turned into successful exporters.

Of course, privatization of telecommunication and energy services alone is no guarantee of success, which in Zambia's case has to be measured in terms of competitiveness improvements, that is, greater availability, better quality and lower prices of services. It has to be carefully prepared and executed. Otherwise it can lead to adverse effects and further public resentment about privatization, as has been the case in many countries. Concerns about

transferring the monopoly power to private hands and possible monopolistic practices should be addressed by regulations put in place before privatization and through the creation of strong and independent regulators. Issues relating to the provision of services in remote geographical areas, where these services are not profitable but are socially desirable, should be dealt with through legal powers provided to regulators. Possible adverse social effects of privatization should also be addressed.

Box III.3. The role of ODA in private sector participation: the case of Zambia Railways (ZRL)

The successful concessioning of Zambia Railways has been due in part to the assistance of the Swedish government, through its development agency SIDA. It is an interesting example of the role bilateral aid can play in establishing conditions for private sector provision of infrastructure services.

SIDA's involvement in ZRL started in 1997, when it provided SEK 25 million to help fund the restructuring programme of the company. In addition, SIDA provided management expertise: five experts for 2.5 years serving in senior posts in the management team of ZRL, including a managing director. In 1998, the tasks of the team were extended to preparing ZRL for eventual concessioning. The core mandate of the team during its five years of work included several tasks: reducing overstaffing, introducing new procedures, and reorganizing the company focusing on large customers and the core railway business and selling non-core assets such as land and buildings.

The process was very successful and resulted in the concessioning of ZRL in 2003 to foreign investors, aimed at a well-functioning railway under private management, providing a regular stream of revenue to the government. The annual payment to the government is inclusive of a subsidy paid by the government so that non-profitable passenger services are maintained by the concessionaire, in addition to the lucrative freight business.

Source: UNCTAD presentation on ZRL by Goran Malmberg, MD, October 2003.

Recommendations concerning privatization are as follows:

- The Government should proceed with the privatization of public enterprises in transport, energy and telecommunications. It is unlikely that any other method of dealing with inefficient enterprises and draining the government budget will ensure badly needed drastic improvements in the provision of infrastructure services.
- The privatization major utility companies has to be carefully planned, prepared and executed, addressing concerns related to monopoly power, universal provision of services and adverse social affects through regulations prepared before privatization and setting up strong and independent regulatory bodies.
- Given public resentment about privatization and the general lack of awareness about the objectives of the privatization programme and its benefits for the economy, the

government should conduct an assessment of the privatization experience to date, focusing on the benefits and costs to consumers, businesses and the economy as a whole, and the lessons thereof. The assessment should be used to build consensus in favour of privatization.

4. Human capital and local private sector capabilities

Adequate availability of local skills and the presence of a dynamic domestic private sector are essential conditions for attracting FDI and benefiting from it. Assimilation of knowledge and advanced skills into the local economy takes place through spillover effects and linkages of domestic enterprises, as buyers or suppliers of inputs, with foreign affiliates. Prior to economic reforms in the early 1990s, the private sector in Zambia was relegated to secondary role as the state sector was the dominant force in the economy controlling over 80 per cent of the country's productive and service-related activities. This situation has changed somewhat since then. Thanks to privatization and the introduction of policy measures that championed private investment, the private sector in Zambia has re-emerged again.

The bulk of the small- to medium-scale state-owned businesses that were privatized in the 1990s were acquired largely by local investors. In terms of value, however, the contribution of FDI has been significant as the scale of investment needed to acquire the large and strategic industries was too high for most local investors. FDI inflow through privatization has resulted in the introduction into Zambia of technologies and training practices that are in common use elsewhere but new to Zambia. These developments have presented challenges to both workers, who must acquire the skills needed to remain employed in the new economic climate, and to the new investors who had to provide training or introduce re-skilling programmes. More significantly, it has presented a real challenge to the nascent local private sector, which has to achieve growth while adapting to an open and competitive economic climate. The problem has been particularly severe in the services sector (for example, hotels, supermarkets) where in the past lack of competitive market environment created less pressure to seek high quality skills to provide high quality service.

The pressure to adjust to an open and unprotected economic environment has created a great deal of anxiety and misperception among local entrepreneurs. They regard the existing investment policy framework as inhospitable to domestic investors and favourable to foreign investment only. The revision of the country's investment code (discussed in chapter II) was partly in response to these concerns. The proposed amendments go a long way in accommodating local investors. While this is important, it is worth nothing that, in the long term, the most appropriate investment policy framework is one that is attractive to all investors, domestic or foreign.

Beyond adjusting the investment code, the Government needs to take into account the major obstacles that are currently hampering private sector development and the transfer of skills and knowledge from foreign affiliates to local enterprises through direct linkages and spillover effects. These include the high cost of domestic borrowing, which was singled out by many small- and medium-scale investors as the primary reason for their reluctance to undertake new investments. The bureaucratic and administrative obstacles to doing business, reminiscent of pre-reform days, were the other major factors identified by the private sector operators as barriers to investment. The total absence of frank, transparent and substantive public-private sector dialogue, in particular on policies that directly affect local investors, was also mentioned. The consultations with the private sector conducted during the revision of

the investment code have recently given hope that the Government may be beginning to listen to private sector concerns. Some local investors were also critical of the rapid speed with which the economic reform programme was implemented as it gave very little of the learning time necessary for local firms to adjust and prepare themselves for an open and highly competitive market environment.

In fact, since the mid-1990s, the Government has restructured the educational and training programmes in the country with a view to creating a national system that meets the skill requirements and needs of the new economic system. To that end, in 1996, it formulated the Technical Education, Vocational and Entrepreneurship Training (TEVET) policy. This was a major improvement on the past practice and highly relevant for private sector development. The policy was based on an integrated approach and has much broader perspectives of private sector needs than those adopted in the past.[40] Four elements are worth highlighting. First, it incorporates entrepreneurship development, which was given a scant attention in the past. Second, the new policy encompasses all types of technical education and vocational training like nursing, extension services training, community development and engineering, thereby giving greater attention to a wide range of technical skills. Third, it acknowledges and covers training given at both the formal and informal sectors. Finally, it recognizes the importance of enterprise-level training and the need for interaction between enterprises and public-sector training institutions.

The positive efforts aside, within the private sector, in particular among foreign investors, there is now a general consensus that skills relevant for modern and competitive market environment are lacking in Zambia. Indeed, many identify skills shortage as the main reason for their reluctance to introduce more advanced technologies and to increase investment in skill-intensive and higher value-added production system. Interviews conducted with a number of foreign investors in Zambia on the issue of skills supply and constraints reveal the following findings:

- Most of them had little expectation of finding all the skills they need and came into the country prepared to train and develop in-house the specific skills needed, and, indeed many of them do this;

- Practically all rely on imported skills for management and highly technical tasks. Therefore, work permits are an important condition to attract FDI. A number of foreign firms indicated that, if the option of importing skilled management and technical personnel was closed, they would not have been able to maintain their investment in Zambia;

- There is no interaction between the foreign enterprises and public sector training institutions. Thus, public institutions such as TEVET are yet to develop capacity to properly assess the knowledge, training and skill requirements of individual enterprises;

- With the expansion of the private sector, employee turnover has become common and a major concern to enterprises, forcing them to increase salaries to keep skilled workers, and perhaps one of the factors contributing to wage inflation;

[40] See, Government of Zambia (1996), Technical Education, Vocational and Entrepreneurship Training (TEVET) Policy, Ministry of Science, Technology and Vocational Training, Lusaka.

- There seems to be very little inter-firm cooperation in training, as the training provided tends to be narrow and specific to the enterprise;

- In general, foreign firms in Zambia see training and the broadening of skills base to be the responsibility of the Government, as is the case elsewhere. However, as indicated above, rather than using low quality skills, foreign firms conduct their own training, catering to their own narrow and specific needs.

The low skills capability of local producers is one of the principal causes of weak linkages between local and foreign enterprises, the other being the cost of finance. There are, however, exceptions as seen in the horticulture and floriculture industries. But, the mining sector, which has a great potential to become a major magnet for the establishment of supplier industries, is largely stand-alone with only basic inputs being supplied locally. There is little downstream processing of raw agricultural produce. For example, local cotton is not consumed within the country due to the small production of textiles.

Recommendations to increase skills capability and linkages are:

- Establish a joint public-private sector one-stop centre, where entrepreneurs have access to business development services and inputs (i.e. entrepreneurship training, information, finance, quality control, networking, and business counselling). Such programmes, for example EMPRETEC and Enterprise Africa, are already in operation in some African countries, and should be introduced in Zambia.

- The government should set up a linkage-promotion programme to identify and upgrade local enterprises that have the potential to supply to, and learn from, foreign affiliates and subsequently perhaps even become exporters on their own right. Such programmes have produced successful results in a number of emerging economies. The Irish National Linkage Programme, Singapore Local Industry Upgrading Program (LIUP) and the Malaysian Penang Skills Development Centre (PSDC) are best practice examples of such effective initiatives. Zambia should explore the possibility of introducing such a programme with technical and financial support of donors.

- At present, the issue of linkages between local firms and foreign affiliates does not feature in the incentive schemes offered to foreign investors. Incentives provided to foreign affiliates should incorporate provisions that encourage such firms to use local supplies and provide skills and technical know-how as appropriate.

- The potential contribution of firm-level learning and training for skills development is not yet fully understood in Zambia, despite recent efforts to take it into account in policy formulation. The option of tax incentives for enterprises providing verifiable technical training should be seriously considered. This approach will generate more effective results than the option being considered by the Government at present, which is to raise education levy from the private sector.

5. Investment promotion

Investment promotion has become an indispensable part of developing countries' efforts to attract FDI and benefit from it. It is important, in particular, for countries that are

less known among global investors, such as Zambia, but that have resources, locational advantages and policies that are attractive to potential investors.

Investment promotion in Zambia is relatively new. The Zambian investment Centre (ZIC), which was established in 1992, has been given the mandate of administrating, monitoring and promoting investment.[41] Initially, ZIC, chronically under-funded and understaffed (during 2003, for example, ZIC's budget was only $380,000 and its staff 40, out of which only half were professionals), focussed on the implementation of the Investment Act of 1993, with little resources left for investment promotion. Thus, ZIC's primary responsibilities have been the evaluation of applications for investment and the issuing of Investment Certificates for both foreign and domestic investors. ZIC also assists foreign investors with the processing of non-citizen employment permits.

After twelve years of existence, by now, ZIC should have emerged as a best practice and innovative multi-role organisation. It should have been the champion that leads the investment promotion drive of the country. As a multi-service provider, it should have offered quality extension services to core clients: advisory, diagnostic, information provision and dissemination. As a business matchmaker, it would have promoted strategic business alliances. As a development catalyst, it should have been leading the drive to establish fruitful dialogue between the public and private sectors, so essential for creating an enabling investment climate. As the investment promotion strategy formulator, it should have by now been armed with appropriate investor targeting/investment marketing strategies, founded on in-depth research and ongoing analysis of comparative/ competitive advantages.

The reality today is different. One instead observes an institution struggling to justify its very existence despite much rhetoric about its role as one-stop-shop. The strategy pursued, the structure in place, the interaction with other relevant organisations, the promotional tools and methods used, the skill mix point to significant gaps and deficiencies.

ZIC faces a number of challenges in transforming itself into an effective marketing entity. Its greatest internal constraint is a severe lack of funding, so much so that it finds itself compelled to limit its role to that of a weak facilitator rather than that of a development catalyst. At present the Agency receives an annual funding of less than $400,000 from the Government, the bulk of which is drained by administrative expenses, with hardly anything left for actual promotion. A good degree of staff time is devoted to securing additional funding from donors, paid consultancy services and the issue of licenses.

During field visits to Zambia, serious weaknesses were noted at both organisational and operational levels. Unless these are addressed in the immediate future, it is hard to imagine how the ZIC can effectively execute its mandate in line with national objectives and implement an investment promotion strategy, which would bring desired results. At the organizational level, the main constraints observed are:

- Unclear mission, unrealistic mandate beyond current capacity, poor corporate and strategic planning.

[41] Specifically, ZIC's mandate was to promote investment, co-ordinate government policies, regulate and monitor investments, render one-stop shop facility and support investors in Zambia. The predecessor of ZIC, the Investment Co-ordinating Committee, established under the Investment Act of 1986, only reviewed foreign investment applications.

- Inadequate funding, in particular in relation to its broad mandate. Scarcity of resources has compelled the Agency to sideline its core business, which is investment promotion.
- Lack of clear organizational structure and a proper co-ordination of roles and assignments among divisions. For instance, the Monitoring Division could not provide information on actual investment flows and the number of employment created as a result. In the last four years, the Agency was able to conduct only a limited number of promotional missions abroad. Similarly, the Research Division lacks the resources and other capacity to conduct much needed in-depth research/analysis on competitive/comparative advantages, target markets, competitor strengths/weaknesses etc..
- Absence of a comprehensive investor targeting strategy based on careful research and analysis.
- Absence of a well defined marketing strategy.
- Absence of a comprehensive information database which is vital in the implementation of an effective investment promotion strategy. The Zambia Investment Centre does not have any information on actual FDI flows into the country. ZIC could only provide information on investment pledges/commitments.
- Absence of a well-integrated and co-ordinated approach towards investment promotion and facilitation among key institutions and government departments.
- No effective investor tracking system.
- Lack of in-house expertise in priority sectors earmarked for promotion.
- Poor overseas representation.
- No benchmarking of results.

In light of the above, it is clear that ZIC cannot aspire to effectively execute its mandate and seriously fulil its role as one-stop-shop. The Agency must undergo substantial change, as in its present form it does not match the profile of a best practice agency. This objective can only be realized when the serious weaknesses identified above are addressed in a holistic manner, as a piece meal approach will simply not work. Only when properly constituted and empowered can ZIC serve effectively as a promotion agency.

However, all is not lost. In spite of its constraints and the heavy burden of administering the Investment Act, ZIC has been able to develop or initiate some investment promotion activities. These include:

- Image building, that is advertising Zambia as friendly and attractive to investors, the Agency has created the web site, issues regularly newsletters and a quarterly magazine. It has also prepared an informative investment guide.

- ZIC has also moved to investment facilitation by undertaking efforts to develop one-stop-shop function and by supporting investment missions visiting Zambia and providing information to inquires of investors.

- Over two years ago, ZIC initiated the programme of identifying investment opportunities in 72 districts, a prerequisite to investment targeting.

- ZIC has also coordinated a public-private sectors dialogue, including both foreign and domestic investors, instituted recently by the Government within the Zambia Business

Advisory Council and the Business Forum. Both are placed under the President's Office.

- Preparing its Strategic Plan for 2002-2005, ZIC has attempted to put its work on a more systematic and predictable basis.

The key message of this report is that investment promotion should be seen as part of an overall FDI strategy. Thus the Government should issue a clear statement on the objectives of FDI, which should be realistic, based on Zambia's investment potential, clarifying the role of FDI in the economy and identifying also the role of private domestic investment. The specific role of individual Government departments/agencies and other key actors should be clearly spelled out to bring about a unified approach to the implementation of FDI policy, including investment promotion and facilitation.

A "Clients Charter" which provides services to investors should be created in ZIC and other major government agencies that are involved in providing services to investors. The charter should be a mission statement and should include time limits on issuing approvals or providing services. It should be made public and serve as a benchmark by which government departments and the public could measure performance in promoting investment. This will promote a mindset on client orientation and contribute towards a more efficient delivery of one-stop-shop service by ZIC.

ZIC should be considerably strengthened. In the short term, this means providing it with sufficient resources that will enable it to re-organize itself and build capabilities in developing the following activities:

- Introducing an investor tracking system, which will serve as a tool for planning and monitoring support to new and existing investors;

- Building capabilities to undertake in-depth analysis of direct investment flows into priority areas, research on investment potential and to identify measures that help realize the potential; prepare project profiles; monitor external competition to enable successful positioning; formulate/revise strategy on investment promotion, including internal evaluation of the costs and benefits of different techniques of investment promotion; and benchmarking of results.

- Training to ZIC's staff on investment promotion strategy and techniques.

ZIC should also expand image building activities to include media relations and press tours and participation in international conferences/seminars. For investment generating activities, targeted approach in overseas promotion should be employed. There should also be greater participation in investment fora, greater use of direct mail, telemarketing, one-on-one meetings with potential investors, and matching prospective investors with local partners.

ZIC should also pay equal attention to after care services.

ZIC should take a lead in policy advocacy and should involve the private sector in developing FDI promotion campaigns.

Marketing the country and investment opportunities abroad should be coordinated among various agencies and with ZIC, from the stage of project identification to mounting the promotional campaign. Promotional missions abroad must be adequately prepared and have promotional materials and project profiles for distribution.

IV. MAIN CONCLUSIONS AND RECOMMENDATIONS

Since the introduction of major economic policy reforms in the early 1990's, private investment, including FDI, has been playing a greater role in Zambia's economy. FDI inflows during this period were considerably higher than the previous two decades and its share in total national investment increased pushing the investment rate of the entire economy to levels not seen for many years. More importantly, FDI has been instrumental in rehabilitating the declining copper industry, initially through takeovers of state-owned mines and more recently through greenfield investment in new mines and post-privatization investment in acquired mines. As a result, the production and exports of copper – the key earner of export revenues for Zambia – started growing again. So did employment after initial reductions related to privatization and the restructuring of the mines. Prospects are good as world demand for copper and prices increased considerably in 2004 and are expected to stay at a higher level for some time due to increasing demand for copper from growing economies such as china.

FDI has also contributed significantly to the long-term policy objective of Zambia, which is to diversify its production and export base from mining to other products and services such as agro-based products (e.g., flowers and vegetables), manufacturing products and the service sector, in particular tourism. As shown in this report, the recent rapid growth in non-traditional exports is attributed to FDI. There is also some evidence to suggest that new technologies and skills have been transferred to Zambia as the result of recent FDI inflows. Their impact on the local economy, however, has not been significant. This is partly because of weak linkages between foreign affiliates and local enterprises and partly because of the absence of targeted policies and incentives to encourage technology and skill diffusion. To date, the performance of the Zambian private sector has been poor due largely to the high cost of capital and business inputs, which make sustaining competitiveness in an open economy practically difficult. That said though, the immediate prospects for both domestic and foreign investment are encouraging as Zambia is still far from exploiting its considerable investment potential, which exists in many industries and activities. It is still rich in copper deposits, in spite of its long exploitation. It has hardly been tapped in other mining activities, in particular gemstones, which, according to industry sources, have the potential to contribute more to exports than copper and cobalt put together. FDI potential extends also to services – notably tourism, financial and infrastructure services – agriculture (including agro-processing) and manufacturing, including copper products. In the latter two sectors it is greatly enhanced by Zambia's privileged market access in the region and large markets in developed countries, including the EU, United States and Japan.

But to sustain progress and to exploit fully its investment potential, Zambia has to do much more. This review pinpoints to several weaknesses in the investment policy and the cost of doing business that Zambia must urgently address in order to attract the quantity and quality of FDI needed to better meet its development goals. These are:

1. Further improvements in the investment policy and regulatory framework

Over the last decade, Zambia has made significant progress in opening its economy and introducing a liberal investment framework. However, Zambia's operating conditions have not improved in tandem with its liberalization policies. While Zambia's Investment Act

generally provides for a liberal environment, business related laws and regulations still create too many administrative hurdles and give too much discretionary power to government officials. Operating conditions relating to licensing and administration of regulations as well as taxation, land and commercial justice require an immediate attention. Amendments to the Investment Code are currently under consideration. This report recommends that some of the proposed changes require serious rethinking, as they are likely to have a negative impact on FDI flows. More specifically:

- The proposal to introduce investment approval procedure through compulsory registration of all investors and traders could lead to unnecessary bureaucratic hurdles. This review recommends that registration be limited to collection of information on investment flows only and not for obtaining investment approval. The best judge of the business plan is the investor that takes the risks. The role of the investment Centre should be to give guidance on the country's investment priorities and ensure that the investor confirms to regulatory requirements.

- The proposal to impose a minimum size threshold for FDI in order to attract "quality investment" is a questionable policy. Large investments are not always the most efficient and the most beneficial for the domestic economy. The quality of investment should be judged not by the size of investment but the knowledge, experience, networks and marketing and management skills that it brings. For example, most investments to Africa in the areas of information and communications technology (ICT), gemstone mining and the service sector tend to be small- and medium-scale. It would be unfortunate if Zambia discourages small-scale investment in these areas because of minimum size threshold regulations.

- The proposal to reserve some business sectors for Zambian nationals and residents is understandable but this review suggests that it should not be through a blanket exclusion clause, but by introducing a "reserved list" of business sectors.

- The proposals for new incentives need re-examination, as they do not seem to be based on a critical analysis of inadequacies in the current incentive schemes. Furthermore, they should take into account the existing sectoral incentives and include a post-investment audit.

Other key recommendations regarding the investment policy and regulatory framework are:

- Improving the administration of VAT, in particular as regards to delays in VAT refunding, the high thresholds for making claims, cumbersome forms and frequent audits following the submission of claims.

- Introducing guidelines on work permits for expatriates, clarifying non-citizen employment provisions of the 1993 Investment Act, implemented in a discretionary manner by Immigration Department. The Department should be required to give reasons for negative decisions and conduct a training programme on FDI policy for immigration officials.

- Developing more transparent land acquisition procedures targeting initially areas suited to investment in agriculture and tourism. Land tenure system and fees for land

registration/acquisition should be included among priorities for reform. As a short- to medium-term solution, the government should explore establishing commercially operated industrial zones with a view to providing access to serviced industrial and commercial land. In the long term, creating a market for land should be considered.

- Improving the commercial justice system through: (a) a case backlog clearance programme and an efficient case administration system; (b) reviewing the civil procedure rules and bringing them into line with modern norms; and (c) initiating the overhaul of outdated commercial laws.

- Streamlining regulations for business licensing and the administration through: (a) introducing a single business identification number that combines the company's registration, taxpayer and industry licenses identification numbers; (b) eliminating the duplication of information requirements by various government agencies; (c) establishing deadlines for procedural authorizations and a system for *de facto* approvals of applications that are not administratively approved within an established timeframe; (d) simplifying forms, including information requirements, for business licenses; and (e) consolidating forms of individual agencies into a single application form.

2. Consolidation of recent improvements in macroeconomic policy

Although the macroeconomic policy climate of Zambia has improved in recent years, the progress made has not been sufficient enough to provide business confidence and create a stable policy environment. Relatively high interest rates and, as a result, prohibitive cost of capital, have been a major stumbling block to domestic enterprise development as well as to FDI in non-traditional activities where many investors are small- to medium-scale operators. The latter have often to rely on domestic credit for working capital. Therefore, the government must continue to consolidate recent success in macroeconomic policies.

The key to achieving macroeconomic stability and, with it, a much better investment climate, is further reduction in the fiscal deficit of the central Government, which has been the main trigger of macroeconomic volatility. This is also a condition, along with progress in privatization plans, for reaching the Completion Point under HIPC initiative, which would result in a significant reduction of the external debt burden. Less external debt payment obligations would provide additional relief to government finances and could generate foreign exchange savings, which could be used to create better conditions for private investment in priority areas.

3. Increasing the availability and competitiveness of infrastructure services

The cost and availability of essential services necessary for production and exports are among the main constraints to investment in Zambia. Transportation, energy and telecommunication services are not available in many areas of the country with significant investment potential. Where they are available, they are often of poor quality, unreliable and very expensive, typically several times more expensive than in the countries competing with Zambia for FDI. If the competitiveness of *all* these services does not improve drastically across the board, Zambia will never exploit fully its investment potential and benefit from its wide access to international markets. Progress has been recently achieved in railway transportation, with the successful concessioning of one of the two railways with the help of

SIDA. The road network is being upgraded and extended, with the help of donors, but not as fast as planned in 1988 by the National Road Board in its investment programme.

The primary policy objective towards infrastructure services should be to create efficient and well-managed enterprises that provide high-quality services at competitive rates. The emergence of such enterprises will encourage domestic investment, attract FDI, create employment, generate sustained flow of revenue for the government and generally benefit society as a whole. At a time when the government resources are stretched and additional public investment on infrastructure services is not forthcoming, a viable option is to seek private sector participation in revitalizing such services. After the initial push on the privatization programme, Zambia's plan to privatize energy and fixed-line telecommunication services has stalled and, instead, their commercialization is being envisaged. If properly prepared and executed, taking into account the need for regulatory mechanism, privatization could serve as a more viable means to achieving the key policy objective in these services: a significant improvement of their availability, reliability and, most importantly, price competitiveness. Therefore, the plans for privatization of infrastructure services should be given urgent attention.

4. Develop and strengthen domestic private sector

Underdeveloped domestic private sector significantly reduces potential benefits from FDI through linkages and spillover effects. In fact, building a strong and competitive domestic enterprise sector by itself is an effective FDI promotion strategy as it demonstrates an economic climate conducive to investment. In Zambia, the domestic private sector is still in its earlier stages of development despite recent changes in policy-orientation favouring the private sector. Even more worrying is the negative opinion among local investors about the current policy environment, which is regarded as unfriendly to domestic investors. Efforts must be made to correct this misperception, as the investment policy of Zambia does not discriminate between national and international investors. The public-private sector dialogue and partnership which has been proposed in the new Private Sector Development Plan will help in addressing this problem. Falling interest rates resulting from prudent macroeconomic policy are a basic pre-condition to domestic enterprise development. The positive movements observed since 2003 in this respect are encouraging and must be maintained. It should be noted, however, that falling interest rates do not automatically lead to greater credit availability to local investors, in particular SMEs. Banks may still consider lending to such enterprises too risky. Therefore additional measures are needed facilitating lending to SMEs such as mobilizing the support of bilateral and multilateral agencies, introducing venture capital financing and creating a special financial institution assuming the role of an investment partner in new local investment projects.

The Government has restructured the educational and training programmes with a view to creating a national system that meets the requirements of the market economy. These efforts should be strengthened as many skills are still lacking and investors, especially foreign investors, have to resort to importing skills, in particular management and specialized technical skills. Work permits should not be used to limit this practice. A better option would be to introduce incentives encouraging in-house training and skill development. The Government should also set-up a linkage promotion programme to identify and upgrade local

enterprises that have the potential to supply to foreign affiliates. Incentives to foreign affiliates to use local suppliers could be part of such a programme.

5. Policy coherence and investment promotion

The Government should explain clearly its vision and objectives concerning the role of FDI and the long-term benefits of attracting FDI. This would help rectify the prevailing misconception, in particular among domestic investors and the public at large, about FDI and avoid possible backlash against policies that are perceived to be more favourable to foreign investors. The role of individual government departments/agencies in attracting investment should be clearly spelled out to bring about a unified approach to the implementation of FDI policy, including investment promotion. So far there have been many examples of uncoordinated efforts in investment promotion as well as counterproductive actions by individual institutions thereby frustrating government efforts to attract FDI and benefit from it.

The Ministry of Commerce, Trade and Industry (MCTI) has the lead role for investment-related matters, which shows the importance that the government attaches to investment policy as MCTI is one of the most important mainline ministries. MCTI should play policy-coordinating role ensuring synergy in investment-related policies and activities pursued by different government departments. However, in line with established best practices, the primary responsibility of investment promotion and facilitation should rest in a single institution, which in the Zambian case would be the Zambian Investment Centre (ZIC).[43] ZIC should be strengthened in all respects: staffing, funding, skills and positioning vis-à-vis other government departments to allow it to fulfill its mandate, that is, promoting investment, rendering one-stop shop facility, supporting existing investors and benchmarking Zambia's investment policies and promotion efforts with competitor countries. Some of these functions have never been undertaken by ZIC, others are at a very rudimentary stage. Two other typical functions of a modern Investment Promotion Agency – targeting foreign investors and policy advocacy – are currently outside the scope of ZIC's activities but as Zambia advances with its diversification strategy, targeting investors may be necessary and should be part of the promotion strategy.

Targeting potential investors would be greatly facilitated by a document that provides an overview of Zambia as a location for investment. UNCTAD has a joint project with the International Chamber of Commerce that produces precisely such overviews, in the form of investment guides, for LDCs. ZIC has already made a request to UNCTAD to be included in this project. This matter should be pursued with some urgency. A reliable and professional investment guide that carries the credibility of two independent international organizations would be a very useful tool for raising awareness abroad of Zambia as an investment location.

[43] A proposal to establish a department within MCTI namely, Zambia Development Agency (ZDA), to oversee among other things, the investment promotion functions previously performed by ZIC has been recently approved by the Cabinet. The discussion referring to ZIC in this report will, therefore, apply to ZDA.

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