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IMPLEMENTATION COMPLETION REPORT
(TF-26341 IDA-40090)

ON A

CREDIT

IN THE AMOUNT OF SDR 27.4 MILLION
(US$40 MILLION EQUIVALENT)

TO THE

REPUBLIC OF ZAMBIA

FOR AN

ECONOMIC MANAGEMENT AND GROWTH CREDIT

December 28, 2006

AFTP1
Africa region

CURRENCY EQUIVALENTS

(Exchange Rate Effective as of December 29)

Currency Unit = Kwacha
US$ 1.00 = K 4,406

FISCAL YEAR
January 1 - December 31

ABBREVIATIONS AND ACRONYMS

ABB	Activity Based Budgeting
APAS	Annual Performance Appraisal System
CAE	Country Assistance Evaluation
CAS	Country Assistance Strategy
CEM	Country Economic Memorandum
BoZ	Bank of Zambia
BFS	Banking Financial Services
DFID	Department of International Development (UK)
DBZ	Development Bank of Zambia
EMGC	Economic Management and Growth Credit
EPZ	Export Processing Zone
ERB	Energy Regulatory Board
GDP	Gross Domestic Product
GRZ	Government of the Republic of Zambia
FSDP	Financial Sector Development Program
FIAS	Foreign Investment Advisory Service
HIV/AIDS	Acquired Immunodeficiency and Human Immunodeficiency Virus
HIPC	Heavily Indebted Poor Countries
IDA	International Development Agency
IFAD	International Fund for Agricultural Development
IMF	International Monetary Fund
LASF	Local Authorities Superannuation Fund
LDP	Letter of Development Policy
MoFNP	Ministry of Finance and National Planning
MoU	Memorandum of Understanding
MTEF	Medium-Term Expenditure Framework
NAPSA	National Pension Scheme Authority
NBFIs	Non-Bank Financial Institutions
NSCB	National Savings and Credit Bank
OAG	Office of Auditor General
OPE	Operations Evaluations Department
PMEC	Payroll Management and Establishment Control
PEMFAR	Public Expenditure Management and Financial Accountability Review
PIA	Pension and Insurance Authority
PPI	Private Participation and Infrastructure
PRSP	Poverty Reduction Strategy Paper
PSD	Public Service Development
PSMD	Public Sector Management Division
PSPF	Public Service Pension Fund
RFP	Request for Proposal
TNDP	Transitional National Development Plan

ZAMTEL	Zambia Telecommunications Company
ZANACO	The Zambia National Commercial Bank
ZESCO	Zambia Electricity Supply Corporation
ZEPZA	Zambia Export Processing Zones Authority
ZIC	Zambia Investment Centre
ZNBC	Zambia National Broadcasting Corporation
ZPA	Zambia Privatization Agency
ZRA	Zambia Revenue Authority
ZDA	Zambia Development Agency

Vice President:	Hartwig Schafer
Country Director	Michael Baxter
Sector Manager	Emmanuel Akpa
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ZAMBIA
ZM-Econ Mgmt & Growth Credit (FY05)

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Project ID: P040631	*Project Name:* ZM-Econ Mgmt & Growth Credit (FY05)
Team Leader: Jos Verbeek	*TL Unit:* AFTP1
ICR Type: Core ICR	*Report Date: December 29, 2006*

1. Project Data

Name:	ZM-Econ Mgmt & Growth Credit (FY05)	*L/C/TF Number:*	TF-26341; IDA-40090
Country/Department:	ZAMBIA	*Region:*	Africa Regional Office

Sector/subsector: Central government administration (45%); General finance sector (20%); Compulsory pension and unemployment insurance (15%); General energy sector (10%); Telecommunications (10%)

Theme: Macroeconomic management (P); Public expenditure, financial management and procurement (P); Regulation and competition policy (P); State enterprise/bank restructuring and privatization (S); Corporate governance (S)

KEY DATES			*Original*	*Revised/Actual*
PCD:	04/17/2004	*Effective:*	12/21/2004	
Appraisal:	07/08/2004	*MTR:*		
Approval:	12/14/2004	*Closing:*	12/31/2005	

Borrower/Implementing Agency: The Republic of Zambia/Ministry of Finance and National Planning

Other Partners: Ministries of: Energy and Water Development; Transport and Telecommunications, Environment, Tourism and Natural Resources, Commerce Trade and Industry. Cabinet Office (PSMD). Pension Funds and Bank of Zambia.

STAFF	Current	At Appraisal
Vice President:	Hartwig Schafer	Gobind Nankani
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Sector Manager:	Emmanuel Akpa	Emmanuel Akpa
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2. Principal Performance Ratings

(HS=Highly Satisfactory, S=Satisfactory, U=Unsatisfactory, HL=Highly Likely, L=Likely, UN=Unlikely, HUN=Highly Unlikely, HU=Highly Unsatisfactory, H=High, SU=Substantial, M=Modest, N=Negligible)

Outcome:	S
Sustainability:	L
Institutional Development Impact:	M
Bank Performance:	S
Borrower Performance:	S

	QAG (if available)	ICR
Quality at Entry:		S
Project at Risk at Any Time:		

Note that the ICR was written using the older system format which does not allow for the 6 level ratings system to be used. However, guidelines permit and expect the text to use the 6 level rating system to be used. This is the *case for this ICR.*

3. Assessment of Development Objective and Design, and of Quality at Entry

3.1 Original Objective:

Backgroun d and Context

During the 1990s the Government of the Republic of Zambia embarked on a sweeping program of liberalization and deregulation with the objective to reform the economy, to eliminate major market distortions, and to ensure a rapid transition to an open market system. However, the Government commitment to reform weakened when macroeconomic situation deteriorated and led to economic contraction in the mid-to- late 1990s. Since 2000, the economy has experienced some remarkable success. The sustainability of these successes, however, will depend on the Government's ability to remove the remaining distortion from the economy, to develop capacity to deal with new constraints, and to prevent the fiscal and current account deficits from increasing their share of GDP in the future.

With the preparation and launching of its first Poverty Reduction Strategy Paper (PRSP) in July 2002, the Government developed a more comprehensive program to reduce the high income inequality and to sustain structural reforms. Most notably, the PRSP focused on the following three main objectives to reduce poverty: (i) promoting economic growth and diversification of production and exports; (ii) improving access and quality in the provision of social services; and (iii) mainstreaming the crosscutting issues of infrastructure, governance, HIV/AIDS, gender, and the environment. To broaden the scope of the PRSP, the Government also prepared the Transitional National Development Plan (TNDP) covering the period 2002-2005. The TNDP, which was launched in December 2002, brought in additional areas of the economy that were not included in the PRSP.

To support the implementation of the PRSP and TNDP, the Bank prepared a Country Assistance Strategy (CAS) (Report No. 27654-ZA), which was discussed by Board in March 2004. The CAS was explicitly rooted in a results framework, which linked the overall goals of the PRSP and TNDP to specific strategic objectives, which were measured by long term outcomes and monitored by intermediate progress indicators that were directly affected by IDA interventions. In line with the objectives of the CAS, the Economic Management and Growth Credit (EMGC) was prepared to support implementation of the PRSP and given the alignment of the CAS with the PRSP, the policy and institutional reform agenda of the CAS. In addition, the EMGC draw upon sectoral strategies prepared by GRZ, e.g. Zambia's Financial Sector Development Plan, to select its milestones for tranche release.

The EMGC was also built on the past achievements in the areas of macroeconomic management and structural reforms, which were supported by a three Tranche Fiscal Sustainability Credit (US$170 million), approved by the Board in May 2001 and fully disbursed in June 2002. EMGC was, therefore, a continuation of the reform efforts that had been initiated by the previous adjustment operations in Zambia and was seen as an instrument to provide an umbrella of support for other operations in Zambia. Other inputs for the preparation of this operation were provided through the Public Service Capacity Building Project approved in February 2000 and through a variety of economic and sector work, which included the Public Expenditure Management and Financial Accountability Review (PEMFAR, Report no. 26 162-ZA), Financial Sector Assessment (FSAP, Report no. 27289-ZA), Country Economic Memorandum (CEM, Report no. 28069-ZA), Investment Climate Assessment (ICA, Report no.29741-ZA), and Foreign Investment Advisory Services report on Administrative Barriers to Investment.

Objectives

The EMGC (US $40 million) was the first (of the two) structural adjustment operation designed to support policy and institutional reforms as outlined in the 2004 base-case lending scenario of the CAS. The EMGC was designed to assists the Government in achieving four interrelated development objectives: (a) correct macro imbalances; (b) improve financial sector performance; (c) enhance the public sector management; and (d) improve business environment.

The achievement of these objectives in turn depended on the implementation of specific reforms in the areas of: (i) pensions and payment culture among Government agencies; (ii) state- owned non-bank financial institutions; (iii) public expenditure management, debt management, and civil service reform; and (iv) private sector development including regulation for public utilities and private business.

3.2 Revised Objective:

The EMGC objectives and components were not revised and remained relevant to the circumstances of Zambia throughout the EMGC implementation.

3.3 Original Components:

The components of the EMGC aimed at four main reform areas consistent with the objectives described above:

- Returning to a macro-economic framework conducive to robust growth, with emphasis on: (i) correcting macro imbalances; and, (ii) improving the financial sustainability of the pension system;
- Strengthening the role of the financial sector by: (i) resolution of state-owned non-bank financial institutions; (ii) building a better governance structure for the Bank of Zambia; and (iii) promoting a better credit culture for timely servicing of financial obligations;
- Strengthening the credibility and institutional capacity of the public sector through: (i) upgrading Government's debt management capacity to support fiscal sustainability; (ii) improving public expenditure management and financial accountability practices; and (iii) streamlining ministerial structures and improving incentives for service delivery; and,
- Rationalizing the interaction between the public and the private sectors by: (i) enhancing private sector development through improved business environment; and, (ii) strengthening the legal and regulatory environment for network utilities.

The components chosen were in line with the Government development strategy and supportive of the Bank policy dialogue with the Government. The range of reforms covered by the EMGC program was broad, but appropriate for Zambia's economic situation at that time.

The reforms and the supporting policy measures under each component were described in the Letter of Development Policy (LDP). They were also sequenced in the Policy Reform Program Matrix, with specific core measures critical for the reform program highlighted separately. The details of EMGC achievements and the outputs/outcomes of its components are presented in Annex 1 and described in section 4.2 below.

3.4 Revised Components:

The original components remained unchanged.

3.5 Quality at Entry:

There was no quality at entry review carried out by the Quality Assurance Group (QAG) on this operation.

The ICR finds the quality at entry to be satisfactory. This assessment is based on the following considerations. The EMGC had clear strengths:

- *Link to Country Priorities.* The objectives of the EMGC were well linked with the development priorities of Zambia. They included policy measures, which placed the deepening of the reforms, particularly in the public sector, at the top of the Government's reform agenda. These priority reforms had also been identified in the 2004 CAS, which had explicitly linked the overall goals of the PRSP and TNDP to specific strategic priorities of the Government. Table 2 and Annex 5 of the EMGC Program Document identified how the key areas of reform were linked to the results matrix of the CAS and which CAS outcome was impacted by the EMGC measures. The CAS had envisaged the EMGC to be prepared if Zambia operates in the base-case lending scenario. However, at the time of the preparation of the EMGC Zambia was judged to be in the low case scenario. Moving to the base-case lending required achieving specific milestones in the following five areas: maintenance of good portfolio performance; satisfactory implementation of the PRSP; maintenance of a sound macroeconomic framework; progress in public sector reform; and satisfactory performance in the Education and Health sectors. By the time of the Board presentation of the EMGC, the Government had reached these milestones and was in compliance with all the base-case triggers of the CAS.

- *Lessons from Previous Operations.* To incorporate lessons learned from the previous IDA operations in Zambia, the EMGC preparation took particular note of the recommendations of the 2002 Country Assistance Evaluation (CAE) carried out by Independent Evaluation Group. The key CAE recommendations focused on three areas: (a) providing a clear link between objectives and conditions in the design of structural adjustment lending; (b) strengthening donor coordination; and (c) giving priority to public expenditure management, governance, investment climate, energy reform, and HIV/AIDS. In line with the above, the team paid particular attention to include these recommendations in the design of the EMGC. In addition, the team also ensured that the EMGC complemented the IMF macroeconomic program in Zambia and supported the mutual objective of maintaining macroeconomic stability. The explicit links to the CAS and CAE, which the team demonstrated at the concept stage, were also viewed by the reviewers as one of the positive feature of this operation.

- *Analytical Base.* The design of EMGC and its components were mainly driven by the need for deeper structural reforms to sustain growth and to reduce poverty in line with the overall objectives of the PRSP. These reforms were mostly underpinned by both the previous Bank's operations and the solid analytical work in Zambia including: Fiscal Sustainability Credit; Public Service Capacity Building Project; Public Expenditure Management and Financial Accountability Review; Financial Sector Assessment; Country Economic Memorandum; Investment Climate Assessment, as well as a number of private sector related analytical reports such as the Challenge of Competitiveness and Diversification; Privatization Review-Facts and Assessment; Financial Sector Assessment; Agribusiness Sector Development; and, Investment Climate Assessment and the Administrative Barriers to Investment Study.

- *Design and Focus of the Program* The EMGC design was comprehensive and included a broad range of policy measures dealing with key structural issues. These measures were of high priority and in harmony with the country needs. The EMGC content included areas of critical importance such as improved functioning of the financial sector and increased credibility of the budget process and of the public sector. The EMGC also aimed at enhancing the role of the private sector through improved business environment and strengthened regulatory framework for utilities. These were all appropriate and critical to the success of the PRSP and TNDP policy measures in Zambia.

Compared to the above-mentioned strengths, there were also few shortcomings in the design of the EMGC.

- First, some measures required more fundamental institutional changes (e.g. constitutional amendment) than were foreseen in designing the EMGC. Others required complementary institutional change or changes in the procedures and methods of operation. Line ministries were weak at the outset and needed further strengthening to allow them to timely implement EMGC supported policy measures. This became clear when by the time of the originally scheduled second Tranche, 8 out of 10 core conditions had not been met and the Government requested more time to fulfill the second Tranche core conditions. As a result there was a six-month delay in release of the second Tranche compared to the original schedule. This need for capacity building was also mentioned during the concept review meeting as some reviewers noted the possibility of a TA operation to accompany the EMGC. Even though in the areas of public sector management and financial sector development the Bank and donors made financial resources available for technical assistance this did not become fully available within the time frame needed to assist the Government with the implementation of the supported reforms.

- Second, the issues covered by EMGC required intensive engagement over an extended period of time, which went beyond a traditional one-year quick disbursing adjustment operation and warranted a programmatic operation, with a 3-4 years time frame. Such instrument of lending would have fit more appropriately with the task team intention, which was to help the Government to stay on track with its own development strategy and institutional reform agenda. Although the task team opted for a quick disbursing operation to help initiate the implementation of key reforms, the programmatic instrument would have provided more flexibility in sequencing of important reforms in a medium term framework and would have allowed more time for the Government to begin the process of implementation of the needed institutional reforms.

- Third, in view of the importance of fiduciary issues in enhancing public sector transparency and accountability, the operation could have included some key policy measures in the area of public financial management.

4. Achievement of Objective and Outputs

4.1 Outcome/achievement of objective:

The achievement of objectives and outcomes of the EMGC is <u>rated moderately satisfactory</u>.

The details of the achievement and outcomes under EMGC are discussed in section 4.2 and in Annex 1 below. As a whole, the operation substantially achieved its outcomes identified in the Program Document. The key goal of the first component was to contribute to a *stable macroeconomic environment* as a basis for sustainable growth. This was achieved by improving economic management and continuing movement toward a financially sustainable pension system (see Component A below) and was further strengthened by the reforms undertaken under the third component. On the second component, the objective was *to strengthen the role of the financial sector*. This was substantially achieved by developing the Financial Sector Development Program (FSDP) and changing the legal setting of the state-owned non-bank financial institutions (see component B below). The reform objectives under the third component focused on *strengthening the credibility and institutional capacity of the public sector*. This was substantially achieved through clearer delineation of responsibilities on debt management, adopting measures to improve public expenditure management, financial accountability practices, and strengthening Government's capacity to manage its payroll (details in Component C below). On the fourth component, the objective was to *rationalize the interaction between the public and the private sector.* This was substantially achieved as evidenced by the business environment and revised policy documents governing network utilities (component D below).

4.2 Outputs by components:

The details of the Government reform program supported by the EMGC and its components are discussed in the Program Document (No. 29294-ZA). Drawing on that document, this Section describes major accomplishments under each of the EMGC components.

Component A: Returning to a Macroeconomic Framework Conducive to Robust Growth

This component is rated as satisfactory. This rating reflects success of the Government in implementing EMGC's core and non-core policy conditions related to this component and in achieving the main objectives of: (i) correcting the macroeconomic imbalances; and (ii) implementing actions to improve financial viability of the pension system. The latter was critical to maintaining fiscal and macroeconomic stability.

The macro economic program of the Government needed to focus on sustaining macro stability to provide a firm basis for implementing the structural reform agenda outlined in PRSP and TNDP. For this purpose the Government maintained a satisfactory macroeconomic framework in agreement with the IMF. Performance under the IMF program has been broadly satisfactory (see recent economic developments below).This was confirmed by a positive second and third review under the PRGF arrangement, which were concluded in April 2005 and January 2006 respectively.

An important step in sustaining macroeconomic stability was the initiation of actions to improve financial viability of the pension system as current and the progressively increasing pension shortfalls in the coming years would need to be compensated for by direct transfers from the budget. The Zambia's pension schemes remain in financial imbalance, burdening the fiscal resources and threatening macro-fiscal stability. Three major public institutions provide pensions to retirees: the national -level public service pensions fund (PSPF); the Local Authorities Superannuation Fund (LASF); and the National Pension Scheme (NAPSA). The PSPF, whose benefit levels are protected by the constitution, was insolvent. LASF was on the brink of insolvency. Both PSPF and LASF held considerable arrears. NAPSA has enrolled all new civil servants after February 2000.

The other related issue on macro-fiscal stability was the need to eliminate the build up of budgetary arrears and arrears by state-owned enterprises with the utilities. These arrears not only had put at risk the financial viability of the utilities themselves, but also required budgetary transfers to settle them.

To address these issues, the Government of Zambia with support of EMGC undertook the following actions, though with considerable delays in the case of the second Tranche measures.

- ***Corrected macroeconomic imbalances.*** The Cabinet issued a decision to empower utilities and insurance companies to treat government institutions as any other client. The utilities and the insurance companies were expected to discontinue their services to the Government institutions in similar fashion as any other customer. In addition the Accountant General instructed accounting officers to pay their utility and insurance bills on time. The Secretary of the Treasury also issued a letter to the utilities and insurance companies reiterating the decision made by the Cabinet. In addition, the MoFNP adopted a time bound restructuring plan for payment of the Government's arrears to the utility and insurance companies. The Government made separate arrangements with each of the relevant utility and insurance companies to dismantle the stock of arrears in a time bound manner. In addition, to strengthen oversight and control over the utility payments and insurance premiums, the MoFNP decided to pay all utility bills and insurance premiums directly from the Treasury and debit the transfers it made to the government agencies that were billed by the utilities and the insurance companies.

- ***Improved financial sustainability of the pension system.*** To improve financial viability in the short run, the PSPF completed a draft three-year implementation plan to reduce administrative expenses to 12 percent of 2003 annual accrued contributions as approved by the board. The PSPF also negotiated a plan with the Government to retire a small percentage of its arrears and installed computer equipment to produce monthly reports on benefits and to improve its projection of cash needs. Given the fact that putting the PSPF on a financial sound footing would not be possible without a constitutional amendment and in view of the fact that a general review of the constitution had been initiated, the Cabinet approved a proposal to the constitutional review commission to change the provisions of article 124 to enable PSPF reform to be applicable to existing participants in PSPF. To strengthen its position, LASF negotiated a debt/equity swap to retire a part of the central government arrears. It also negotiated a separate payment schedule with each local government authority to improve cash flows and begin retiring arrears in this area. Negotiations with the major utilities that participate in LASF reduced their arrears. In the case of NAPSA since most of the issues facing this institution were operational rather than financial, NAPSA drafted an operation manual on its corporate governance. A revised investment policy was also adopted by NAPSA's Board that allowed NAPSA to invest in assets externally in 2005. This required the appointments of a global custodian and pension fund manager. However, the appointment of a global custodian, and selection of a pension fund manager faced delays (due to the tendering process) and did not take place in time for release of the second Tranche. Subsequently, NAPSA completed the bidding process and is negotiating with two potential global custodians. For potential investment managers, expressions of interest have been evaluated and an RFP drafted. These are critical long-term relationships and, once established, are costly to change. NAPSA's own inexperience, and the lack of local experience in these matters generally, has lead NAPSA to proceed thoughtfully and with caution, which seems appropriate.

- ***Strengthened the capacity of the Pension and Insurance Authority.*** Ambiguities in the Pension Scheme Regulation Act prevented effective supervision and monitoring of pensions. Moreover, the Pension and Insurance Authority (PIA), which regulates employer-sponsored private sector schemes and the two public sector schemes, had neither the capacity nor adequate resources to tackle enforcement and compliance with the law. With support of EMGC, the Government made the PIA an autonomous institution. It also amended the Pension Scheme Regulation Act to give the PIA the authority over all pension schemes. The PIA in turn prepared an action plan for its operation, backed by budgetary and human resource needs.

Progress on output/outcomes indicators. The medium term outcomes indicators for budgetary arrears called for: (i) reduced arrears of the Government from an estimated 2.7 percent of GDP in 2004 to zero by 2007; and, (ii) reduced domestic borrowing requirements from an estimated 3 percent of GDP in

2003 to less than 1 percent of GDP by 2006. At end 2005, the domestic borrowing had dropped to 1.9 percent of GDP and the Government arrears had been reduced to 1.2 percent of GDP. Further reductions in these ratios are expected in 2006 as part of the program agreed with the IMF. The outcomes indicators for pension reform stated the need to bring public service pension scheme in financial balance to ensure sustainability of the overall pension system. In November 2005, the Cabinet approved reform proposals of PSPF, including amending the constitution to allow PSPF, to undertake reforms in order to achieve and remain on a sound financial footing. This was a major step, though its ultimate impact on financial viability of the pension system may take some time to be realized. LASF has strengthened its financial position through retiring arrears, completed its first actuarial valuation since 1998 and collected data for analysis of various policy reform options.

With respect to macroeconomic outcomes, policy measures implemented under the PRGF, particularly those aimed at reduction of budgetary arrears and domestic borrowing, contributed to improved macroeconomic environment. The measures supported by EMGC aimed at improving the payment culture by Government agencies and the utilities such that a re-emergence of arrears would be stopped and help in time improve the fiscal balance. However, these improvements will take time to show their impact on the fiscal balance and therefore it is still too early to draw concrete conclusions regarding the impact of the program supported.

The recent economic developments show growth has been robust and broad based in the recent years in contrast to the 1990s. The growth rate of real GDP averaged 5.4 percent a year during the 2003-2006 period, exceeding the 5 percent growth rate projected under the EMGC (Table 1).

Table 1: Key macroeconomic outcomes compared to EMGC projections

	2003	**2004**	**2005**	**2006**
Real GDP growth, % (pr)	5.1	4.6	5.0	5.0
Real GDP growth, % (ac)	**5.1**	**5.4**	**5.0**	**6.0**
CPI growth, % (pr)	17.2	20.0	15.0	10.0
CPI growth, % (ac)	**17.2**	**17.5**	**15.9**	**9.0**
Domestic Investment, % of GDP (pr)	26.2	23.3	21.8	22.0
Domestic Investment, % of GDP (ac)	**24.3**	**24.3**	**23.0**	**23.5**
Current Account Balance, % GDP (pr)	-7.5	-6.4	-4.1	-3.8
Current Account Balance, % GDP(ac)	**-9.31**	**-5.5**	**-3.8**	**-3.8**
Fiscal Balance, % of GDP (pr)	-6.0	-3.0	-2.7	-3.1
Fiscal Balance, % of GDP (ac)	**-6.0**	**-2.9**	**-2.7**	**-2.4**
Net Present Value Debt, % of Exports (ac)	**192**	**164**	**132**	**45**
Reserves as Months of Imports (ac)	**1.3**	**1.1**	**1.3**	**1.5**

Discrepancies are due to revisions by the Central Statistical Office and Ministry of Finance and National Planning of the actual outcomes.

pr = projected at appraisal
ac = actual for 2003 and 2004 and current estimates for 2005 and 2006
Source: World Bank (EMGC President's Reports); Zambian authorities.

The positive growth developments are driven to a large extent by favorable external developments. Zambia's terms of trade improved by 21.9 percent in 2004 and by 5.5 percent in 2005. This, combined with strong performance of non-traditional exports and a resurgence of copper prices and production, have led to a decline in its current account deficit from 9.3 percent of GDP in 2003 to a projected 3.8 percent in 2006. In addition, reaching the HIPC Completion point in early 2005 wiped out approximately US$4 billion of Zambia's external debt stock and with the Multilateral Debt Relief

Initiative external debt will have been further reduced to approximately US$0.6 billion. This greatly improved Zambia's external creditworthiness. Copper prices rose by approximately 100 percent between 2003 and 2005, and overall export levels measured in US$ in 2005 are estimated to amount to US$2.4 billion, almost three times the level of exports in 2000. The positive improvements in the external account have resulted in build up of international reserves, which now stand at about 1.5 months of imports. The favorable external developments have also impacted the domestic currency, which has been appreciating in real terms by approximately 8 percent annually during 2003-2004, and by over 30 percent during 2005, putting at risks some of the favorable export diversification results achieved.

In terms of other macro variables, fiscal policy has been put on a sustainable basis and has become more predictable through the introduction of the MTEF. Fiscal deficit has declined from 6.6 percent of GDP in 2003 to a projected 2.4 percent in 2006. After years of weak fiscal policy implementation, the authorities have improved budget execution and reduced its domestic financing needs drastically. Domestic borrowing was reduced from 5.1 percent in 2003, to less than 1 percent in 2005. Complementing fiscal developments, the monetary policy itself has become tighter with growth in broad money falling from 60 percent in 2000 to an estimated 14.6 percent in 2006. Tight monetary policy and reduced budgetary deficit have reduced inflation from a stubbornly high 20 percent for most of the beginning of the millennium to 8.6 percent for the year ending May 2006. The Government has realized that through improved economic management, it would be in a better position to direct its expenditure programs to provide the poor with a better opportunity to reap the benefits of the current growth momentum in Zambia.

The details of achievements in these areas are mentioned in Section A of Annex 1.

Component B. Strengthening the Role of the Financial Sector.

On balance, this component is rated as moderately satisfactory. This rating reflects the fact that while all the core conditions and major non-core conditions were met, actions under this component took longer to implement than anticipated, and that moderate progress was achieved towards medium term outcome indicators.

The Government's intention in this area was to remove weaknesses in the state-owned financial institutions, including low intermediation; limited supervision; and insolvent public non-bank financial institutions (including Zambia National Building Society, Development Bank of Zambia, and National Savings and Credit Bank). To address these concerns financial sector stakeholders in collaboration with the BoZ prepared the Financial Sector Development Program (FSDP). The FSDP was broad and did not go beyond identification of financing needs in the areas of housing, rural, and investment finance. However, despite its shortcomings, the FSDP provided for a systematic action to resolve many issues related financial institutions. The restructuring of the state owned non-bank financial institutions is to set the stage for improved intermediation for long term development finance and access to financial services by the urban and rural poor. An important step was to ensure proper oversight by the Bank of Zambia.

To begin addressing issues related to the state-owned non-bank institutions the Government of Zambia under the EMGC undertook the following actions:

- ***Consolidated the legal framework of NBFIs***. The Government undertook a number of measures to consolidate the legal framework governing state-owned non-bank financial institutions (NBFIs). In the mean time and as a means to control further demise of the state owned NBFIs, a Memorandum of Understanding (MoU) was signed for each of the three insolvent NBFIs, the Zambian National Building Societies (ZNBS), the National Savings and Credit Bank (NSCB), and the Development Bank of Zambia (DBZ), to impose operating restrictions and to delegate the supervisory authority with the Bank of Zambia. The necessary changes to the legal acts of the state-owned NBFIs with the objective to bring each of them under the Banking and Financial Services (BFS) Act such that all supervisory powers are with the Bank of Zambia (BoZ) was adopted by Parliament and was signed into Law by the President in October 2005. The next step, which is to incorporate them under the company's act is progressing and the amendments to the acts in question would be presented to the Cabinet for adoption in 2006.

- ***Strengthened accountability and financial discipline.*** To improve financial discipline the MoU's for NSCB, ZNBS and DBZ with the Government and BoZ ensured that: (a) no public funds will be used with respect to these institutions without a business plan; (b) operations restrictions on DBZ shall remain in effect until at least 75 percent of its equity is committed by a private entity; and (c) DBZ shall neither accept deposits nor should raise any loan requiring government guarantee. In the case of DBZ the agreed restrictions have been fully adhered to. The MoU between BoZ, MoFNP and NSCB management provides adequate guarantees that NSCB will not engage in activities that will negatively affect its financial situation. In addition, the International Fund for Agricultural Development (IFAD) is providing technical assistance to improve management of NSCB as well as project financing to assist the rural farming communities in Zambia. The operational restrictions on ZNBS have not led to a recovery of its balance sheet as both NSCB and ZNBC had remained insolvent for more than a decade. In principle NSCB should develop a business plan to serve the rural areas and not to become another main stream commercial bank for the urban centers. ZNBC is expected to close down as there are currently no viable solutions for its continuation.

- ***Improved governance structure.*** The Government wants to further improve the governance structure of BoZ through embedding its independence in the proposed constitution, which will change the procedures by which the Governor will be appointed as well as its board of directors. Also, the BoZ has undertaken an evaluation of the available options and business model for setting up a credit bureau. This is important in developing a credit culture, which so far has been undermined by non timely servicing of financial obligations.

Progress in medium term output/outcomes. The CAS outcome indicators to which the EMGC policy actions contribute stated resolution of state-owned financial institutions as a medium term outcome. The EMGC policy actions correctly focused on the state-owned NBFIs as at the time of preparation the privatization of the last remaining state owned commercial bank, ZANACO, was part of the HIPC program. At the time the state-owned NBFIs were highly insolvent and pursuing business opportunities that directly competed with commercial banks without proper oversight. The financial sector development program has identified Zambia's financial sector gaps mainly in two areas: (i) provision of investment finance and (ii) provision of financial services for the poor. In order to fill these gaps, DBZ and NSCB need to be restructured to provide the public with these essential services. The NBFIs have been brought under the supervision of BoZ through signing memorandum of understanding (MoU). The MoUs also cover the implementation framework and business plan for each of the three state-owned NBFIs. These MoUs were signed by the BoZ, MoFNP and management of each of the three state-owned NBFIs. The MoUs designate the BoZ as the implementing agency for the restructuring process.

The Cabinet has reviewed and agreed in principle to the proposed changes. The MoUs will remain in place until legal changes are adopted. So far, progress has been slow and moderate on these fronts. Therefore, the risks that specialized NBFIs remain by and large ineffective and distortionary institutions within the landscape of Zambian financial sector remain in the medium term. Specifically, NSCB could diverge from the goal of a becoming a specialized financial institution that targets rural and urban poor and proceed with functioning as a State-owned commercial bank. Such a development could also wipe out any gains from privatization of ZANACO. Similarly, keeping ZNBS operating would undermine credibility of financial supervision and not help the broader issue of housing finance. These risks are currently being mitigated by way of MoUs that target implementation of specific business plans consistent with FSDP and EMGC objectives, between MOF, BOZ and the NBFIs. However, delays in definition of appropriate business plans and implementation thereof could render these MoUs ineffective.

The details of achievements in these areas are mentioned in Section B of Annex 1.

Component C. **Strengthening the Credibility and Institutional Capacity of the Public Sector**

This component is rated as moderately satisfactory. This rating reflects the fact that the Government fulfilled policy conditions of EMGC with considerable delays, and that progress in reaching the outcome was slower than expected. Under this component the Government achieved its three primary objectives: (i) to upgrade Government's debt management capacity to support fiscal sustainability; (ii) to improve public expenditure management and financial accountability practices; and (iii) to streamline ministerial structures and improve incentives for service delivery.

In the area of *public debt*, the issues before the EMGC pertained mainly to institutional arrangements for its monitoring and evaluation, which had made it difficult to formulate a consolidated debt strategy because of the mixed responsibilities between MoFNP and BoZ. In the area of *public expenditure management* despite the introduction of the MTEF in association with Activity Based Budgeting and other improvements in budget management process, several problems remained, which undermined Government's credibility with regard to the budget process. For one, actual spending differed considerably from the planned amounts. This reflected the liberal use of supplemental appropriations as a way to make major shifts in the budget during the year from one ministry to another or from one subhead to another, with supplementary budgets presented to Parliament after spending had already occurred. Also, information on past expenditures were not used effectively as cash release to ministries and expenditure reporting continued to rely on the old system. Budget was approved by the Parliament *after* the start of the fiscal year, and expenditure data from the previous year were not included with an estimate for the current year to enable comparison with the proposed budget estimates. Also, the Office of Auditor General (OAG) had resource constraint and poor staffing and its regulations limited its ability to operate effectively.

On *incentives for service delivery*, the main issues before the EMGC were related to payroll data base and consolidation of allowances. Zambia's civil servants had not increased significantly during the last decade while payroll had been rising significantly. However, payroll data base was completely separate from the Cabinet Office that managed the civil service and Cabinet Office was unaware of the recruited staff for unauthorized positions. Also, Zambia's civil service regulations had allowed for over 50 allowances and many received allowances that were not directly related to their job specifications. This created significant distortions in the pay system, which needed to be based on job responsibility and educational background. The system also included dozens of fixed amount allowances, which had lost value over the years. These distortions had contributed to an unsustainable growth in the wage bill from 5.3 percent of GDP in 2000 to 8.4 percent in 2003, crowding out the ability of the Government to effectively implement its PRSP and threatened macroeconomic stability.

To address these issues, with the support of EMGC, the Government of Zambia:

- ***Consolidated responsibilities between MoFNP and BoZ on debt management.*** MoFNP took several actions in this regard including: establishing a task force to reconcile the debt database covering domestic and foreign direct debt; establishing procedures for updating and maintaining the database to produce regular reports; formulating a strategy for debt management post - HIPC completion point with a particular focus on the distribution between foreign and domestic borrowing and preparing a framework within which MoFNP can act as decision maker on domestic debt issues with BoZ acting as agent. Further comprehensive debt management reforms continue to be undertaken under the Public Expenditure Management and Financial Accountability reform program.

- ***Increased the credibility of the budget process.*** The Government met all the 5 core and 3 non core conditions of EMGC related to expenditure management and financial accountability mechanisms. Among the early actions taken to increase the credibility of the budget process, the Ministry of Finance and National Planning (MoFNP) submitted recommendations to the constitutional review committee to enable the budget to be approved by parliament before start of the fiscal year and to restrict approval of supplementary appropriations. The office of the Auditor General also submitted its recommendations to constitutional review committee to further enhance its autonomy and expand its duties. MoFNP also submitted a Green Paper to the Cabinet with three-year indicative budget ceiling for each ministry, inclusive of ceilings for personal emoluments. The 2006 ABB format Yellow (Budget) book includes a section which provides information on codes, priorities, rules on varying budget provisions, adoption of quarterly funding, non-varying of poverty reduction programs expenditures, and the sanction that would be applied to those agencies that do not submit expenditure returns on time. In addition, The Cabinet approved a revised Finance Act that strengthened financial management and accountability mainly by strengthening the role of internal audit. The Finance Act has been approved by Parliament and the MoFNP is in the process of finalizing the financial regulations. Other actions to further strengthen the credibility of the budget process included: (i) the MoFNP tabled in the legislature the annual budget for the year 2005 including an annex which compared the estimated expenditures for the year 2005 with the budget releases for the years 2004 and 2003; (ii) the Cabinet approved the new structure of OAG, which include authority to fill vacant auditor positions. Also, the FMS software was installed in all ministries, and the Accountant General's Department generated a report from FMS on actual expenditure by ministry for the first 6 months of 2004.

- ***Improved incentives for service delivery and restructured ministries.*** The Government consolidated some allowances into base salary and reduced the overall ratio of allowances to base salary. To further increase incentives for service delivery, the MoFNP: (a) transferred the payroll to the Payroll Management and Establishment Control (PMEC) system; (b) trained users of the system in all central ministries; (c) based Personal Emoluments releases on PMEC; (d) matched each public servant to a specific post on the establishment; and (e) ceased to pay public servants whose post is not on the establishment, except those identified for retrenchment, but not yet paid their terminal benefits. In addition, Payroll Management and Establishment Control (PMEC) system was installed at a few central ministries with funding from DFID. Also, the new annual performance appraisal system was implemented for all management positions. The annual salary increments will no longer be automatic but instead will be based on employee performance. To complete the initial restructuring of ministries and remove the excess staff from the payroll, the Cabinet approved the new structure for the three of the four remaining ministries i.e. Ministry of Sport Youth and Child Development, Ministry of Community Development and Social Services and Ministry of Communication and Transport. Cabinet is expected to approve the restructuring of the Ministry of Home Affairs shortly.

Progress in medium term output/outcomes. The stated CAS medium term outcomes refer to several outcomes: (i) variations between planned budget and actual expenditures at sector level no greater than 10 percent; (ii) budget presentation reflects summary of the proposed budget alongside with actual expenditures in the previous years; (iii) allowances are consolidated into base salary; (iv) All Permanent Secretaries and staff in functions above the level of the PSs are on a performance pay contract; and (v) composition of staffing shifts toward support of service delivery functions. Moderate progress has been made in these areas. As a result of public expenditure management reforms, for the first time, the 2005 budget document included a summary table that compared the estimated expenditures for 2005 with the actual (and planned) budget for 2004 and the actual budget for 2003. Expenditures have stayed within the appropriations, which are validated through audited reports. Supplemental appropriations have not been approved by Parliament ex-ante, but no supplemental appropriation takes place without cabinet approval as well as identification of savings needed to pay for additional expenditures. The outcome indicators also called for streamlining the civil service and rationalizing its remuneration scheme in a manner to reduce the overall ratio of allowances to base salary. In 2005, Government consolidated 14 general allowances into base pay for civil servants and froze the nominal amounts for those allowances independent of the recipient's base pay. This has indeed resulted in a decline of the overall ratio of allowances to base salary. Had the wage negotiations in 2005 been successful a further and more substantive decline in the ratio of allowances to base salary could have taken place.

On rationalization of the remuneration schemes, the transfer of the payroll to the new PMEC system was completed in October 2005 and the payment of salaries and benefits from November is now based on that system. The Government trained all users of the system in each central ministry before moving their specific payroll to the new PMEC system. In those cases where the transfer involved decentralized staff, the government agency responsible for the roll out also trained staff in the districts and provinces. Each civil servant transferred from the old payroll system to PEMC system has been matched to a specific post on the establishment. Approximately 5,000 civil servants out of a total of 115,000 could not be matched to a post on the establishment. Before deciding on retrenchment of those servants whose post is not on the establishment, the public service management division in the Cabinet Office would evaluate the qualifications of this group to see if they can be allocated a post on the establishment that has remained vacant. Once this process has come to an end the Government is committed to retrenching the remainder of this group of civil servants in 2006. A budgetary allocation has been made for this exercise in the draft 2006 budget.

The details of achievements in these areas are mentioned in Section C of Annex 1.

D. Rationalizing the Interaction between the Public and the Private Sector

<u>Implementation of this component is rated as moderately satisfactory</u>. This rating reflect the fact that all the Credit conditions were substantially fulfilled though with some delays and that there was a moderate progress towards reaching the Government's two-pronged objectives of: (i) improving Zambia's business environment; and (ii) improving the legal and regulatory environment for network utilities, designed to increase the efficiency of the energy and telecom sectors.

Zambia's weak business environment prevented the development of a strong and broad based private sector to generate growth and employment. To build consensus among key stakeholders to design a program to address key bottlenecks facing the private sector, the Government in collaboration with IDA, organized a private sector development forum. The forum identified several areas for immediate action, including consolidation of the many public sector agencies involved in private sector development into one; removing administrative barriers to business entry, and improving the regulatory framework for network utilities. In the *energy* sector, the main policy and institutional issues were identified as: (i) the absence of a comprehensive document of Policy Statement for the energy sector that clearly articulated the Government's vision for the development of the sector over the medium to long-term; (ii) weak regulatory capacity and independence of the Energy Regulatory Board (ERB); and (iii) the need to revamp electricity tariff policy to ensure viability of the sector entities. In the *telecommunication* sector the issues were also similar to the ones on the energy sector, namely: (i) absence of a comprehensive document of Policy Statement for the sector; (ii) the need to separate policy and regulatory functions and strengthening regulator in issues of licensing and price setting; and (iii) the need to separate mobile operations from fixed line services. Enterprises (ZESCO and ZAMTEL), in both sectors were inefficient and unreliable and needed appropriate oversight by a strong and independent regulator to attract large-scale investments in these sectors.

To address these bottlenecks, with the support of EMGC, the Government of Zambia:

- ***Improved Zambia's business environment.*** The Cabinet reaffirmed its commitment to market based policies for private sector development by undertaking several measures including: (i) adopting PSD Reform Action Plan and its implementation framework; (ii) creating a single Zambia Development Agency; (iii) preparing and submitting to Parliament the Investment Act; (iv) and amending the legislation on Export Processing Zone to establish regulatory framework.

- ***Improved the legal and regulatory environment for network utilities.*** The Government adopted a Policy Statement for the Energy that clearly articulated the Government's vision and provided the basis for adopting the required legislation and regulation in the sector over medium to long term. The Government also prepared amendments to strengthen the ERB and made satisfactory progress in improving ERB capacity and in implementing commercialization of ZESCO. Similar actions were also followed in the case of telecommunications. The Cabinet adopted a comprehensive Policy Statement for the telecommunication sector that articulated the Government's objective for the development of the sector over the medium to long term. It also developed the new telecommunication law to ensure autonomy of regulator and separation of its policy and regulatory functions. Progress was also made in the commercialization of ZAMTEL to ensure effective management and regulation of its operation, and to prevent its anti-competitive behavior.

Progress on output/outcomes indicators. The outcomes indicator in this component referred to the need for a comprehensive and consistent approach to private sector development and the need for a revision of Zambia's energy and telecomm sector policies in light of market developments. Priorities have been identified to strengthen an enabling environment for private sector led growth. Satisfactory progress has also been made in adopting the PSD Action Plan and in adopting a comprehensive Policy Statements on the energy and telecom sectors. Progress has also been made in consolidating the functions of various agencies dealing with PSD issues. The CAS outcome indicators also stated improved domestic investment climate as key factors for attracting domestic and foreign investors and for enhancing private activities in the economy. Private investment increased from an average 13 percent of GDP in 2003 to a projected 14.8 percent in 2006. Net private capital flows also rose from US$263 million to US$477 million or 0.5 percent of GDP between 2003 and 2005.

The details of achievements in these areas are mentioned in Section D of Annex 1.

4.3 Net Present Value/Economic rate of return:

Not Applicable. This was a policy-based operation.

4.4 Financial rate of return:

Not Applicable. This was a policy-based operation.

4.5 Institutional development impact:

The EMGC was a fast disbursing operation and was not expected to have significant institutional development impact. That impact has been assesses as modest as is described below:

In the area of *macroeconomic management*, eliminating budgetary arrears as well as arrears by state-owned enterprises improved predictability of the budget and the financial position of the utilities themselves; measures implemented to improve financial sustainability of the pension system began to improve the financial situation of the NAPSA. In addition, the PIA was made an autonomous institution and the amendments to the Pension Scheme Regulation Guide gave the PIA the authority over all pension schemes.

In *strengthening the role of the financial sector* institutional development impact included: approving the Financial Sector Development Program to undertake a systematic restructuring of NBFI; bringing the non-bank state-owned financial institutions under the Banking and Financial Services Act; incorporating NSCB and DBZ under the Company's Act; establishing supervisory powers of BoZ over non-bank financial institutions; preparing restructuring plan for DBZ and NSCB; and begin improving governance of BoZ through changing the procedures by which its Governor and the board of directors are appointed.

In *strengthening the credibility and institutional capacity of the public sector* the institutional arrangements between MoFNP and BoZ on debt management was strengthened to improve monitoring and evaluation of public debt; MoFNP formulated a strategy on debt management post HIPC completion point; the autonomy and duties of Auditor General were expanded; FMS software was installed in all ministries to improve financial reporting system; and in the area of the civil service the payroll management system installed in central ministries, and a system was put in place to match each public servant to specific post in the establishment.

In the area of *the private sector development* the Government: made progress in consolidating functions of many public sector entities involved in private sector development; established an implementation framework for private sector development Reform Action Plan; adopted a comprehensive Policy Statement for Energy and Telecommunication sectors; and, began improving regulatory framework of the Energy Regulatory Board, and made this institution more independent.

The above mentioned institutional developments were anchored to the Government's own strategy for increased capacity building in the economy. They also complemented other parallel TAs, which were provided to the Government to further strengthen the institutional capacity in the public sector.

5. Major Factors Affecting Implementation and Outcome

5.1 Factors outside the control of government or implementing agency:

An important factor outside the control of the government was the constitutional amendments required for the implementation of some key EMGC policy measures, particularly in the areas of pension and public expenditure management. Most important of which included amendment changing provisions of public pension fund, amendment to enable the budget to be approved before start of the fiscal year, and amendment restricting approval of supplementary appropriations. The office of Auditor General also required constitutional amendment to enhance its autonomy and expand its duties. Although the revisions to the constitution was meant to be a total revision and not just for the above mentioned amendments, the approval of the constitution and of these amendments is clearly beyond the control of the Government, and would potentially put at risk the timely implementation of the recommended policy actions in case such approvals are delayed.

Another factor beyond control of the Government was the increase in energy prices. However, despite the significant increases in oil prices, inflation and current account deficit have remained below the projected levels at appraisal.

5.2 Factors generally subject to government control:

Although ownership and commitment of the Government to the reform agenda was strong, the implementation of certain reforms faced delays. This delay was particularly in the two important areas of public expenditure management and civil service reform. These plus other delays in meeting the core conditions effectively postponed release of the second Tranche by almost 6 months from its originally targeted release date of June 2005.

A notable delay subject to Government control was the consolidation of allowances into base salary, which needed more time as it faced substantial resistance from the Public Sector Unions. The underestimation of this resistance was a weak element in the operation. Perhaps a more in-depth analysis of the political economy covering such points of resistance and developing specific strategies to deal with them might have helped setting a more realistic timeframe for the implementation of conditions of this nature.

Other areas where more timely actions by the Government may have resulted in a better outcome included transfer the payroll to the PMEC system, and measures related to business environment and regulatory framework for network utilities.

5.3 Factors generally subject to implementing agency control:

See Section 5.2

5.4 Costs and financing:

There were no changes in the costs or financing of EMGC. The Credit was in the amount of US$40 million on standard IDA terms with 40 years maturity and a grace period of 10 years. EMCG was a two Tranche operation with core prior actions for Board presentation. The Credit was approved on December 14, 2004, became effective on December 21, 2004 and the first Tranche was released on December 26, 2004. The second Tranche of EMGC was released on December 12, 2005.

6. Sustainability

6.1 Rationale for sustainability rating:

Sustainability is rated as likely. This is mainly because the EMGC components and reform measures were explicitly anchored to the Government's own reform program in the PRSP and TNDP as well as sectoral strategies. First, the macro targets were linked to the IMF's PRGF. Zambia has maintained macroeconomic stability since 2000. This is a good track record, which is expected to continue and to help sustain economic growth. Second, with release of the second Tranche, the reform has not slowed down and is continuing in line with the PRSP and TNDP policy priorities. For example, progress with the implementation of the financial sector reform has continued in tandem with the FSDP and necessary capacity in the bank of Zambia is being developed to move to a fully risk-based approach in 2007 of bank and non bank supervision as well as through the adoption of regulations governing microfinance institutions.

Third, the reform programs in the public sector have provided further support to Government's own program in the areas of public financial management and civil service reform. In the area of public expenditure management, the financial regulations necessary to operationalize the revised Finance Act were prepared and are expected to be finalized by June 2006. In the area of debt management, the MOFNP has also begun the process of developing a comprehensive debt data base, which includes data on contingent liabilities and the debts of the remaining parastatals. Fourth, most of the EMGC policy measures on financial accountability practices, pension reform, public expenditures, and debt management, have been included into the regular operations of the Government, or into the legal and regulatory framework, and are unlikely to be reversed. Finally, the follow on IDA operations are essentially build on the continuation of the EMGC supported measures such as the recently approved public sector management project and the proposed water sector improvement project to be presented to the Board in FY07.

6.2 Transition arrangement to regular operations:

In line with the CAS, IDA is in the process of preparing the second development policy lending to Zambia as a successive operation to EMGC. The proposed second operation will build on EMGC achievements and will deepen the reforms in the areas of public expenditure management, private sector development, public sector reform, business environment, and regulatory framework. The core conditionality will be more weighed towards private sector development to ensure greater opportunities for employment and income growth and to make sure that growth can have maximum impact on poverty reduction. Agriculture will also be added to the operation to accelerate the development of the rural economy and to further encourage a private sector led growth.

7. Bank and Borrower Performance

Bank

7.1 Lending:

The Bank's performance is rated moderately satisfactory. The reasons for this rating include: consistency with the CAS, timeliness of the operation, quick response of the Bank; focus of the reform measures, and the project design which took into consideration experience gained from the previous operations in Zambia. EMGC was consistent with the Government's development strategy, in particular the PRSP and TNDP. Its design covered several highly important requirements for rapid transition to an open market system. It was prepared with a full knowledge of the economy and Zambia's obstacles to structural reforms. Some considerable analytical work, such as those on public expenditure review, debt management, private sector development, and a FIAS study on regulations and administrative barriers to investment in Zambia, were all helpful in the preparation of this operation. The prior actions for Board presentation were critical to the operation and were considerably sharpened during the concept review meeting and the preparation missions.

The project team consisted of seasoned professionals with relevant technical expertise in the areas of public sector reform and financial sector. The Bank team was also well managed by an experienced team leader. The fact that the team members continued their involvement in the operation and were managed by the same task manager benefited greatly the implementation progress of the operation. The presence of the Bank office in Zambia greatly facilitated monitoring the implementation of the EMGC. Close consultation was also carried out with the IMF.

Although the project was appraised thoroughly, but the capacity of the Government to timely implement the second Tranche policy measures was overestimated. This was partly a reflection of the authorities own perception and optimism, particularly during the appraisal, to proceed quickly with the identified reform measures. Also, as mentioned before, the operation had some shortcomings as reflected in the underestimation of implementation and political risks as well as in putting as Tranche release conditions amendments to constitution, the approval of which was beyond control of the Government. Also, the decision on lending could have been made on a programmatic type operation such as PRSC, though as mentioned before this would happen if Zambia moves to the CAS high case scenario.

7.2 Supervision:

Supervision quality is rated satisfactory. As a two Tranche operation EMGC did not require the multitude of supervisions associated with multi -Tranche programmatic operations. The team reviewed progress in achieving the milestones described in the LDP and the Program Document. The involvement of many team members that designed the EMGC in its implementation was important factor in keeping the supervision quality high. The supervision team established a good working relationship with the Government counterparts and was able to resolve many of the implementation problems. The aide-memoires of the missions were informative and well organized, with a clear summary of essential issues, agreed actions, and next steps. There was also a good follow up on the issues and agreed actions.

7.3 Overall Bank performance:

The overall Bank performance is rated moderately satisfactory in view of the rating for lending and the quality of supervision.

Borrower

7.4 Preparation:

Borrower preparation is rated satisfactory. The preparation of EMGC started on a solid base with strong support of the Government and the implementing agencies. To facilitate coordination of activities, the Government during the preparation and appraisal appointed an inter-ministerial steering committee responsible for preparing the EMGC. The design and preparation of each component and sub-component was discussed and agreed on with each implementing agency during the appraisal. The Government and IDA had full understanding on the elements of EMGC as highlighted in the LDP. The Government participated in the Bank's Project Concept review. This helped create ownership of the programs and policies under the EMGC.

7.5 Government implementation performance:

The overall implementation performance of the Government is assessed as moderately satisfactory. As discussed in section 4, the Government was effective in maintaining macroeconomic stability, which greatly helped implementation of other reforms. The MoFNP and the steering committee also facilitated the policy dialogue and coordination of the activities of the numerous agencies involved in this operation. Although the Government was fully involved in the design stage and timely met the Board (first Tranche) conditions, its delays in the implementation of the second Tranche policy measures, particularly in the areas of public expenditure management and civil service reform, contributed to delays in the release of the second Tranche.

7.6 Implementing Agency:
See section 7.5

7.7 Overall Borrower performance:
In view of moderately satisfactory implementation, the overall performance of the Borrower is rated as moderately satisfactory.

8. Lessons Learned

Operations with deep institutional reform require longer time horizon than a one year quick disbursing loan. Institutional reforms are inherently difficult and time consuming to implement as changes will normally happen at slow speed and over a number of years. The EMGC supported institutional measures required intensive engagement over an extended period of time, and well beyond the one-year time horizon of that operation. In hindsight, given the long term nature of the reform measures supported by EMGC, and in view of the fact that the team was helping the Government to stay on track with its own program of reform considering its limited capacity, a programmatic adjustment operation, with a 3-4 years time frame, would probably have been a more appropriate alternative. Such instrument of lending would have provided more flexibility in sequencing of important reforms in a medium term framework, with a more appropriate time line for the implementation of the required policy measures.

Uncertainty on the timing of policy implementation increases by requiring amendments to the constitution, which are beyond control of the Government. Although in special circumstances the reforms cannot proceed without such amendments (like the case of PSPF), adjustment operations should stay away, to the extent possible, from putting the amendments to constitutions or passage of legislation as Tranche release conditions. These requirements would potentially put at risk the timely implementation of policy measures and the follow up actions in case the approval of such amendments or legislation is delayed or does not materialize for political and other reasons.

Continuity of policy dialogue on broad based operations calls for experienced staff with good knowledge of the country. The familiarity of the Bank staff with the circumstances of Zambia and their involvement in working closely with their counterparts proved to be an effective way in designing the program and in creating a genuine ownership for the reform agenda. Such ownership is essential both at the preparation and at the implementation stage. This experience also highlights the importance of involving staff throughout the life of the project. Although few staffs were changed during the EMGC program, maturity and experience of team members helped maintain continuity of policy dialogue on important issues and allowed fine tuning of the operations when needed. Involvement of the field staff in project supervision was also proved to be important in regular follow up on policy actions by the Government.

Operations involving comprehensive reforms require quality supervision. Operations that are broad based and have strong policy and institutional implications would need adequate supervision staff and resources as they necessitate continuous dialogue with the Government and other stakeholders. The broad scope of the EMGC had important consequences for supervision as it required considerable range of skills and experience. Involvement of the many team members that designed the EMGC during its implementation was critical in keeping the supervision quality high and in building understandings of the reform agenda when there were changes at the level of Cabinet, or in counterparts.

Expectations should be realistic in the case of one-year adjustment operations. The lessons drawn from EMGC exercise indicate that it is important to be realistic regarding how quickly it is possible to transform activities that were state operated into market based approach and on commercial basis. It usually takes quite some time before a state-owned bank, or an enterprise, can grow into institutions that can truly and independently operate on commercial terms. These institutions may remain dependent on Government support for many years to come before they can operate completely on their own.

9. Partner Comments

(a) Borrower/implementing agency:

Ministry of Finance and National Planning

Implementation Completion report

(ZM-PE-P040631)

ON A CREDIT IN THE AMOUNT OF

SDR 27.4 MILLION (US$40 MILLION EQUIVALENT)

TO THE

REPUBLIC OF ZAMBIA

FOR AN

ECONOMIC MANAGEMENT AND GROWTH CREDIT

SUMMARY OF PROJECT DATA

Country: Zambia

Program Name: Economic Management and Growth Credit (EMGC)

Loan Number: 4009 ZA

Sector/sub sector: Public sector (60%), Financial Sector (25%); Private sector (15%)

Theme: Public Sector Administration (P); other accountability/anti-corruption (P); other financial and private sector development (S)

Borrower/Implementing Agency: Ministry of Finance and National Planning

Other Partners: Ministries of: Energy and Water Development, Transport and telecommunication Environment, Tourism and Natural Resources, Commerce Trade and Industry, Cabinet Office (PSMD), Pension Funds and Bank of Zambia

Key Dates

PCD: April 2004

Appraisal: July 2004

Approval: December 14, 2004

Effective: December 21, 2004

Closing: December 31, 2005

Introduction

During the 1990s, the Government of Zambia embarked on a policy reform program of liberalisation and deregulation aimed at eliminating major market distortions to ensure a rapid transition to an open market system. However, with the deterioration of the macroeconomic situation and the contraction of the economy in the mid to late 1990s, Governments commitment to the reform program weakened.

In July 2002, Government prepared and launched its first Poverty Reduction Strategy Paper (PRSP), which, focused on reducing the high income inequalities through promotion of economic growth and diversification and sustaining structural reforms by improving access and quality in the provision of social services while mainstreaming the cross cutting issues. In addition, Government expanded the scope of the PRSP to include areas of the economy not include in the PRSP by preparing and launching the Transitional National Development Plan (TNDP) in December 2002.

On December 14, 2004, the Bank approved the Economic Management and Growth Credit (EMGC) of US$ 40 million as continuation of support to the reform efforts initiated earlier. It was built on the past achievements in the areas of macroeconomic management and structural reforms supported by a three Tranche Fiscal Sustainability Credit of US$ 170 million. The EMGC was effective on December 21, 2004 and scheduled to close on December 31, 2005. The first tranche of the credit was disbursed on December 28, 2004. This credit was designed to support public sector reform program, financial sector reform and the private sector reform.

Objectives

The EMGC was designed to support policy and institutional reforms by assisting the Government in achieving four major development objectives of: (a) correcting macro imbalances; (b) improving financial sector performance; (c) enhance the public sector management and (d) improving business environment.

Specific reforms were to be implemented in the following areas to achieve the above objectives: (i) Reforms to improve the Pension and payment culture among Government agencies especially to utility and insurance companies; (ii) Reforms aimed at recuperating the financial viability and stability of state-owned non-bank financial institutions; (iii) reforms focused on improving public expenditure management, debt management, and civil service reform so as to reduce the fiscal burden of government; and (iv) reforms focusing on the investment climate so as to achieve private sector development including regulation for public utilities and private business.

Programme Components

As indicated above, the programme consisted of four reform components as follows: Macro-economic reforms; financial management reforms; public sector management reforms; and private Sector reforms.

Macro-economic Reforms

This component of the program aimed at maintaining an appropriate macroeconomic framework conducive for strong economic growth with emphasis on (i) correcting macro imbalances; and (ii) improving the financial sustainability of the pension systems. This component involves implementation of reforms that would lead to the reduction and elimination of the build up of budgetary areas and arrears by parastatals with utilities. In addition, the component looked at improving the financial stability of the public service pension schemes that were increasingly becoming a fiscal drain on government.

Financial Management

The reforms in this area involved strengthening the financial management framework and improve the functioning of the financial sector by (i) resolution of state-owned non-bank financial institutions; (ii) building a better governance structure for the Bank of Zambia; and (iii) promoting a better credit culture for timely servicing of financial obligations.

Public sector Management

The reforms in this area were aimed at strengthening the credibility and institutional capacity of the public sector through: (i) upgrading government's debt management capacity to support fiscal sustainability; (ii) improving public expenditure management and financial accountability practices and (iii) streamlining ministerial structures and improving incentives for service delivery. This involved improving the institutional arrangements for monitoring and evaluation of government debt, building the credibility of the budget preparation and execution as well as improving the general management of the civil service so as to improve the service delivery in the public sector.

Private Sector Development

This involved the rationalisation of the relations between the public sector and the private sector by (i) improving business environment to enhance private sector development; and (ii) strengthening the legal and regulatory frameworks and environment for network utilities of energy and telecommunications. This involved removing the inconsistencies in government policies towards private sector, strengthening the public service agencies serving the private sector, removing the existing contradictions between the Investment act and other related legislation, reviewing the restrictive labor laws relating to retirement, retrenchment and expatriate work permits, reducing the cost of establishing and operating business by streamlining the number of licences required to establish a business, developing a comprehensive policy document for the energy sector and developing a comprehensive policy document for the telecommunications sector.

Achievement of Objectives and Outputs

Objectives

The objectives and outcomes of the EMGC were to a large extent achieved. Though some delays were experienced in the implementation of some components of the programme, generally, the objectives as a whole have been achieved. One key objective of the programme was the achievement of a stable macroeconomic environment. This was achieved as a result of the interactions between the different components of the program.

Outputs by Component

Component A. correcting macroeconomic imbalances

This component was adequately implemented as reflected in the success of implementing the EMGC's core and non-core policy reforms related to this component and in achieving its main objectives of a stable macroeconomic environment as reflected in the table of selected macroeconomic variables below.

Table 1: Selected Macroeconomic Variables, 2003-2005

	2003	2004	2005 Target	2005 Outturn
Real GDP Growth rate	5.1	5.4	6.0	5.1
Domestic Financing of fiscal deficit (% of GDP)	5.1	1.9	1.6	1.8
Money Supply Gowth (Annual Percent Change)	23.4	30.3	13.0	0.4
Inflation (end period)	17.2	17.5	15.0	15.9
Interest rates (December vales)	37.2	29.8		27.4
Current Account deficit (% of GDP, excl. grants)	(16.2)	(10.7)		(11.9)
Gross international reserves(month of import cover)	1.3	1.2	1.3	1.8

Within this component, Government needed to correct the macroeconomic imbalances and maintain a conducive macroeconomic framework focusing on sustaining macroeconomic stability as a basis for a successful implementation of structural reforms outlined in the PRSP and TNDP. To this effect, a stable macroeconomic framework agreed with the IMF under the PRGF arrangement was maintained.

To achieve a stable macroeconomic environment, Government needed to improve the financial viability and sustainability of the pension systems. To improve the viability of the system, government was to make transfers to pension companies serving the public service retirees: Public Service Pension Fund; the Local Authorities Superannuation Fund (LASF); and the National Pension Scheme (NAPSA), directly from the budget. However, the sustainability of the pension systems has not been satisfactory because these pension funds still depend on fiscal resources for their sustainability

To achieve further fiscal stability, Government needed to eliminate the build up of budgetary arrears and the arrears by state-owned enterprises with the utility companies. This would reduce the budgetary pressure on the government to settle these arrears. Specifically, the following actions were under taken:

- *Reduction of Arrears***:** The Ministry of Finance and National Planning (MoFNP) adopted a time bound restructuring plan for payment of the Government's arrears to utility and insurance companies**.** The Secretary to the Treasury issued instructions to the utility and insurance companies to treat government agencies on commercial terms and the Accountant General instructed controlling officers to ensure prompt payments of utility and insurance bills. Even if these measures were undertaken, it has not yet led to the changes in payment behaviour that were envisaged. A multi-year plan for the dismantling of all audited domestic arrears was prepared and is being implemented.

- *Improvement of financial sustainability of the Pensions systems:* Cabinet approved a proposal to the constitutional review commission to change the provisions of article 124 to enable PSPF reforms to be applicable to existing participants in Public Service Pension Fund (PSPF). To improve financial viability in the short term, the PSPF completed a draft three-year implementation plan to reduce administrative expenses to 12 percent of 2003 annual accrued contributions as approved by the board. In addition, The PSPF also negotiated a plan with Government to retire a small percentage of its arrears. Computer equipment were installed to produce monthly reports on benefits and to improve its projections of cash needs.

The Local Authorities Superannuation Fund (LASF) negotiated a debt/equity swap to retire a part of the central government arrears. It also negotiated a separate payment schedule with each local government authority to improve cash flows and begin retiring arrears in this area. As for National Pension Scheme (NAPSA), to improve its operational problems, an operational manual was drafted on its corporate governance, a revised investment policy was adopted which, required the appointment of a global custodian and selection of a pension fund manager. However the appointment of the global custodian and selection of the fund manager were delayed due to the tendering process. In addition, a program for training trustees was developed.

- *Strengthening the capacity of the Pension and Insurance Authority*: Pension and Insurance Authority (PIA) was made an autonomous institution in line with the FSDP recommendations to strengthen its capacity to tackle the issues of enforcement and compliance with the law. The Pension Scheme Regulation Act was also amended to give the PIA the authority over all pension schemes. In return, PIA prepared an overall vision paper backed by operating action plans and budgetary and Human Resource needs.

Progress on Output/Outcomes Indicators

Overall Policy measures implemented under the PRGF programme supported by the IMF in particular those relating to reduction of budgetary arrears and domestic borrowing contributed to improvement in macroeconomic environment. Measuring success of the actions supported by EMGC aimed at improving the payment culture by Government agencies and state owned companies in meeting their obligations towards payment of utilities to prevent a re-emergence of arrears can only be observed on a long term basis and thus its impact would not be felt in a short term. Therefore, it would be too early to draw any concrete conclusions regarding the impact of the programme on this output.

Component B. Strengthening the Financial System

All the core conditions and major non-core conditions were met, although this component took longer than anticipated to implement. The intention of Government in this area was to remove weaknesses in the state owned institutions including low intermediation; limited supervision; and insolvent public non-bank financial institutions, such as Zambia National Building Society, Development Bank of Zambia, and National savings and Credit Bank. To address these concerns, A Financial Sector Development Plan was prepared by the Bank of Zambia in collaboration with financial sector stakeholders. This plan among other things outlines the necessary action to resolve the issues surrounding the non-bank financial institutions, National Savings and Credit Bank (NSCB), Zambia Development Bank of Zambia (DBZ), and the Zambia National Building Society (ZNBS).

To address issues related to the state owned non bank institutions, Government undertook the following actions under the EMGC.

- *Consolidation of the legal framework of NBFIs*: progress was made in the process of adopting and consolidating the necessary legal changes to the Building Societies Act, the National Savings and Credit Bank Act, and the Development Bank of Zambia Act. The necessary changes to the legal framework of the state-owned NBFIs with the aim of bringing them under the Banking and Financial Services Act (BFSA) so that all supervisory powers are with the BOZ were adopted by parliament. Additionally, the Bank of Zambia, MoFNP, and the Development Bank of Zambia signed a Memorandum of Understanding, which specifies the supervisory role of the Bank of Zambia and the MoFNP with regard to the Development Bank of Zambia until DBZ falls under the BFS Act.

- *Strengthened accountability and financial discipline*: Government commenced the implementation of its Financial Sector Development Plan pertaining to the reform of state-owned NBFIs including NSCB, ZNBS, and DBZ, to ensure that no public funds are used without a business plan, and DBZ would neither accept deposits nor raise any loan requiring Government guarantee. In addition, operations restriction on DBZ would remain in effect until at least 75 percent of its equity is committed by a private entity. The restrictions on DBZ have been fully adhered to while the MoU signed between BoZ, MoFNP and NSCB management provide guarantee that NSCB would not engage in activities that would negatively affect its financial situation.

- *Improved Governance Structure*: Governments aim is to improve the Governance arrangement of the BoZ so as to guarantee its independence and independent execution of monetary policy. So far the appointment of the Bank governor by the president is ratified by parliament. Furthermore, BoZ undertook a comprehensive evaluation of available options with regard to which business model of a credit bureau before setting up a credit bureau. This is essential in developing a credit culture.

Component C: Strengthening the Credibility and Institutional Capacity of the Public Sector

The aim of this component was to strengthen the current weak institutional arrangements for monitoring and evaluation of Government debt that make it difficult to formulate a consolidated strategy since responsibilities are split between MoFNP and BoZ. Government under the EMGC managed to upgrade governments' debt management capacity to support fiscal sustainability; improve public expenditure management and financial accountability practices and to streamline ministerial structures and improved incentives for service delivery.

With the support of the EMGC, Government achieved the following:

- *Consolidation of responsibilities between MoFNP and BoZ on debt management*: the following actions were undertaken to improve debt management institutional arrangement as well monitoring and evaluation of debt: establishment of a Task Force with the objective of reconciling the debt database covering domestic and foreign direct debt, as well as on-lending; establishment of procedures for updating and maintaining the debt database, regular reports on outstanding debt were produced for internal use by MoFNP and BoZ, and work was initiated on establishing clear procedures for updating and maintaining the debt database; a strategy for debt management post-HIPC completion point with a particular focus on the distribution between foreign and domestic borrowing was prepared in broad terms and a framework within which the MoFNP can act as decision maker on issues regarding domestic debt with BoZ acting as agent was prepared.

- *Expenditure management and financial accountability to increase credibility of the budget process*: All the core and non-core conditions of the EMGC relating to expenditure management and financial accountability were met though with some delays. Among the actions taken to increase budget process credibility are: the submission by MoFNP recommendations to the constitutional review committee that would enable the budget to be approved by Parliament before the start of the fiscal year and enhance accountability for public expenditure by restricting retroactive approval of supplementary appropriations; the submission by the Office of the Auditor General its recommendations to the CRC on enhancing its autonomy and expanding its duties; approval by Cabinet and Parliament of a revised Finance Act that strengthens financial management and accountability, including provisions that:· define the role and functions of the Treasury; strengthen the role of internal audit through establishment of audit committees; define the responsibilities of the Accountant General's Department; enhance provisions for oversight of statutory corporations, and prohibits expenditures from being incurred that exceed the appropriation.

To further strengthen the credibility of the budgeting process, the following actions were undertaken: MoFNP submitted a Green Paper to Cabinet in the third quarter of 2004 with three-year indicative budget ceilings for each ministry, inclusive of ceilings for personal emoluments (PE's). New Financial Management System (FMS) software was installed in all ministries that would permit reporting by ABB format; Accountant General's Office generated a report from the FMS on actual expenditure by ministry for the first six months of 2004 under the ABB classification; Cabinet approved the new structure for the OAG, which includes authority to fill vacant auditor positions. MoFNP tabled in the Borrower's legislature the annual budget for 2005 including an annex, which compared the estimated expenditures for the year 2005 with the budget releases for the years 2004 and 2003. The presentation of the annex together with the annual budget for 2005 was however delayed because of procedural problems in government regarding sending annexes together with the budget.

- *Improved incentives for service delivery and restructured ministries*: government consolidated most allowances into base salary and reduced the overall ratio of allowances to base salary. Further, Government transferred the payroll to the Payroll Management and Establishment Control (PMEC) system; trained users for all central ministries; based Personal Emoluments releases on PMEC; matched each public servant to a specific post on the establishment; and ceased to pay public servants whose post is not on the establishment except those identified for retrenchment but not yet paid off.

To complete the restructuring process, Cabinet approved the new structures for three remaining ministries and any excess staffs removed from the payroll. The new annual performance appraisal system (APAS) was implemented for all public service positions and a circular issued that annual salary increments are no longer automatic but instead will be based on employee performance.

Component D: Improving Zambia's Business environment

The objective of this component was to improve the business environment to enhance private sector development and strengthen the legal and regulatory frameworks and environment for network utilities. This component was well implemented but with some delays. Government achieved the following under the EMCG:

- *Improved Zambia's business environment*: Government reaffirmed its commitment to market-based policies for private sector development by adopting the PSD Reform Action Plan and established an implementation framework for the PSD Reform Action Plan. In addition and in an effort to further improve the investment climate, the process of establishing a "one stop shop" for investor the Zambia Investment Agency began. Further more, a revised draft Investment Act was finalized and circulated to the private sector.

- *Improvement of the legal and regulatory environment for network utilities*: In the energy sector, interim point actions for commercialisation of ZESCO were met while the preparation of a comprehensive energy policy document began. In the telecommunications sector, Government adopted a comprehensive Policy Statement for the sector that clearly articulates the Government's vision for the development of the sector over the medium to long-term.

Major Factors Affecting Implementation and Outcome

The program implementation was affected by factors both within and out side the control of government:

- Policy measures that delayed the release of the second tranche of the funds arising for the government side were mainly in the areas of public expenditure management.

- Most policy measures especially those related to budget preparation and public expenditure management as well as areas around the pension schemes and enhancement of the autonomy of the office of the Auditor General required amendments to the constitution which was beyond government control.

- The consolidation of allowances into base salary was also a delay not entirely within government control as it could not be fully implemented without agreement with public service unions. In setting up the timeframe for the implementation of this measure, the resistance from the unions was underestimated and thus its implementation was affected.

Conclusions, Lessons Learnt and Recommendations

- Need for reduction on the number of milestones to be met and remain realistic in the case of such short –term adjustment programmes.

- There is need for mechanisms to be put in place for ensured adequate and timely communication between line ministries, departments and lending institutions for smooth implementation of activities.

- Similarly, there is need for mechanisms to ensure adequate and timely communication between the Bank and the Government authorities.

- Considering the difficulties associated with implementation of measures and reforms affecting institutional arrangements and the time it takes for such measures to show results, such measures should not be implemented under a short loan arrangement.

- Policy based conditions should not be used as a condition for tranche release of funds as such policies are influenced by other factors beyond government control.

(b) Cofinanciers:

(c) Other partners (NGOs/private sector):

10. Additional Information

Annex 1. Key Performance Indicators/Log Frame Matrix

Reform Measures		Outcomes and outputs
Board: December 2004	**Second Tranche: December 2005**	
A. Returning to a Macroeconomic Framework Conducive to Robust Growth		
Maintenance of an appropriate macroeconomic framework	***Maintenance of an appropriate macroeconomic framework***	Government maintained a satisfactory macroeconomic framework in agreement with the IMF. Performance under the program has been broadly satisfactory. This was confirmed by a positive second and third review under the PRGF arrangement, which were concluded in April 2005 and January 2006 respectively The growth rate of real GDP has averaged 5.4 percent a year during the 2003-2006 period, exceeding the 5 percent growth rate projected under the EMGC. The positive growth developments were driven to a large extent by favorable external developments. Fiscal policy has been put on a sustainable basis and monetary policy has become tight.
A.1 Correcting macroeconomic imbalances		
Cabinet has issued a decision to empower utilities and insurance companies to treat government institutions as any other client including that the utilities and insurance companies would be expected to discontinue their services to Government institutions in similar fashion as any other customer; ***The Accountant General has instructed accounting officers to pay their utility and insurance bills on time;*** ***The Secretary of the Treasury has issued a letter to the utilities and insurance companies reiterating the decision made by Cabinet.***	***The MoFNP has adopted a time bound restructuring plan for payment of the Government's arrears to utility and insurance companies.***	The Cabinet issued a decision to empower utilities and insurance companies to treat government institutions as any other client. The Government made separate arrangements with each of the relevant utility and insurance companies to dismantle the stock of arrears in a time bound manner. At end 2005, the domestic borrowing had dropped to 1.9 percent of GDP and the Government arrears had been reduced to 1.2 percent of GDP. Further reductions in these ratios are expected in 2006. Accountant General instructed accounting officers to pay their utility and insurance bills on time.

		MoFNP adopted a time bound restructuring plan for payment of the Government's arrears to the utility and insurance companies.
A.2. Working towards a financially sustainable pension system		
PSPF Board has approved amendments to reform pensions including the benefit formula, commutation factors, and contribution rates for new PSPF members since the year 2005 and PSPF has completed a draft three year implementation plan to reduce administrative expenses to 12 percent of 2003 annual accrued contributions as approved by its board.	***Cabinet has approved (i) a proposal to the constitutional review commission to change the provisions of article 124 to enable PSPF reforms to be applicable to existing participants in PSPF and (ii) a reform program that ensures the financial sustainability of the fund*** ***The National Pension Scheme Authority (NAPSA) has (i) adopted a revised investment policy, appointed a global custodian, and selected a pension fund manager; (ii) drafted an operations manual on corporate governance; and (iii) developed a program for training trustees.***	In November 2005, the Cabinet approved reform proposals of PSPF, including amending the constitutional to allow PSPF, to undertake reforms in order to achieve and remain on a sound financial footing. LASF has strengthened its financial position through retiring arrears, completed its first actuarial valuation since 1998 and collected data for analysis of various policy reform options. PSPF completed a draft three-year implementation plan to reduce administrative expenses. The PSPF negotiated a plan with the Government to retire a small percentage of its arrears. LASF negotiated a debt/equity swap to retire a part of the central government arrears. NAPSA drafted an operation manual on its corporate governance. A revised investment policy was also adopted by NAPSA's Board that allowed NAPSA to invest in assets externally in 2005.
B. Strengthening the Role of the Financial Sector		
B.1. Resolution of state-owned non-bank financial institutions		
Cabinet has approved the Financial Sector Development Program, which stipulates the repeal of those sections of the Building Societies Act, the National Savings and Credit Bank (NSCB) Act, and the Development Bank of Zambia (DBZ), such that (i) these institutions can be incorporated under the Company's Act, (ii) inconsistencies with the BFSA are removed; and (iii) supervisory powers over NBFIs by the Bank of Zambia are strengthened. ***The Bank of Zambia, MoFNP, and***	***The Borrower has made progress in the process of adopting the necessary legal changes to the Building Societies Act, the National Savings and Credit Bank Act, and the Development Bank of Zambia Act*** ***The Borrower has commenced implementing its Financial Sector Development Program pertaining to the reform of state-owned NBFIs including NSCB, ZNBS, and DBZ, to ensure that no public funds will be used without a business plan acceptable to IDA.***	The financial sector development program has identified Zambia's financial sector gaps mainly in two areas: (i) provision of investment finance and (ii) provision of financial services for the poor. The NBFIs have been brought under the supervision of BoZ through signing memorandum of understanding (MoU). The MoUs also cover the implementation framework and business plan for each of the three state-owned NBFIs. The MoUs were signed by the BoZ,

the Development Bank of Zambia have signed a Memorandum of Understanding, which specifies the supervisory role of the Bank of Zambia and the MoFNP with regard to the Development Bank of Zambia until DBZ falls under the BFS Act.	***DBZ shall not (i) accept deposits and (ii) raise any loan requiring Government guarantee.***	MoFNP and management of each of the three state-owned NBFIs. The MoUs designate the BoZ as the implementing agency for the restructuring process. The Cabinet has reviewed and agreed in principle to the proposed changes. The MoUs will remain in place until legal changes are adopted. The necessary changes were made to the legal acts of the state-owned NBFIs with the objective to bring each of them under the Banking and Financial Services (BFS) Act. The MoU between BoZ, MoFNP and NSCB management provides adequate guarantees that NSCB will not engage in activities that will negatively affect its financial situation. International Fund for Agricultural Development (IFAD) is providing technical assistance to improve management of NSCB.
C. Strengthening the Credibility and Institutional Capacity of the Public Sector		
C.2. Improving Public Expenditure management and financial accountability practices		
The MoFNP has submitted recommendations to the constitutional review committee that would (i) enable the budget to be approved by parliament before the start of the fiscal year; (ii) enhance accountability for public expenditure by restricting retroactive approval of supplementary appropriations; and (iii) the Office of the Auditor General has submitted its recommendations to the CRC on enhancing its autonomy and expanding its duties. ***Cabinet has approved for submission to Parliament a revised Finance Act that strengthens financial management and accountability, including provisions that:·(i) Define the role and functions of The Treasury; (ii) Strengthen the role of internal audit through establishment***	***MoFNP has tabled in the Borrower's legislature the annual budget for 2005 including an annex, which compares the estimated expenditures for the year 2005 with the budget releases for the years 2004 and2003. This would be presented in summary table aggregated by budget head, showing the PE and non-PE spending from GRZ resources.***	The 2006 ABB format Yellow (Budget) book includes a section which provides information on codes, priorities, rules on varying budget provisions, Government adopted quarterly funding, non-varying of poverty reduction programs expenditures, and the sanction that would be applied to those agencies that do not submit expenditure returns on time. The MoFNP compared the estimated expenditures for the year 2005 with the budget releases for the years 2004 and 2003. The Cabinet approved the new structure of OAG, which include authority to fill vacant auditor positions.

of audit committees; (iii) Define the responsibilities of the Accountant General's Department; (iv) Enhance provisions for oversight of statutory corporations, and (v) prohibits expenditures from being incurred that exceed the appropriation. ***Cabinet has agreed that it will approve any supplemental to the budget, if any, prior to the spending occurring and that such supplemental would show not only where spending will increase, but also where it will be reduced as a result.*** ***MoFNP has submitted a Green Paper to Cabinet in the third quarter of 2004 with three-year indicative budget ceilings for each ministry, inclusive of ceilings for personal emoluments (PE's).***		FMS software was installed in all ministries, and The Accountant General's Department generated a report from FMS on actual expenditure by ministry for the first 6 months of 2004. Payroll Management and Establishment Control (PMEC) system was installed at a few central ministries with funding from DFID. MoFNP submitted a Green Paper to the Cabinet with three-year indicative budget ceiling for each ministry. Cabinet approved the new structure of OAG, which include authority to fill vacant auditor positions. The Revised Finance Act was approved in 2005 and implementation regulation has been prepared. The MoFNP submitted a proposal to the CRC for chances to the constitution that would allow the requested improvements
C.3. streamlining ministerial structures and improving incentives for service delivery		
	PSMD in the Cabinet office has consolidated most allowances into base salary and reduced the overall ratio of allowances to base salary subject to negotiations with Public Service Unions and the identification of their fiscal implications. ***MoFNP has (i) transferred the payroll to the PMEC system; (ii) trained users for all central ministries; (iii) based Personal Emoluments releases on PMEC; (iv) matched each public servant to a specific post on the establishment; and (v) ceased to pay public servants whose post is not on the establishment except those identified for retrenchment but not yet paid off.*** .	Government consolidated 14 general allowances into base pay for civil servants and froze the nominal amounts for those allowances independent of the recipient's base pay. This has indeed resulted in a decline of the overall ratio of allowances to base salary. MoFNP matched each public servant to a specific post on the establishment; MoFNP ceased to pay public servants whose post is not on the establishment, except those identified for retrenchment, but not yet paid their terminal benefits. The Government trained all users of the system in each central ministry before moving their specific payroll to the new PMEC system. Each civil servant which has been

		transferred from the old payroll system to PEMC system has been matched to a specific post on the establishment. Approximately 5,000 civil servants out of a total of 115,000 could not be matched to a post on the establishment and are awaiting re-assignment or retrenchment.
D. Rationalizing the Interaction between the Public and the Private Sector		
Note that in this area no credit release milestones were identified.		

Annex 2. Project Costs and Financing

Project Cost by Component (in US$ million equivalent)

Component	Appraisal Estimate US$ million	Actual/Latest Estimate US$ million	Percentage of Appraisal
	40.00	40.00	100
Total Baseline Cost	40.00	40.00	
Total Project Costs	40.00		
Total Financing Required	40.00	40.00	

Project Costs by Procurement Arrangements (Appraisal Estimate) (US$ million equivalent)

Expenditure Category	Procurement Method[1]				Total Cost
	ICB	NCB	Other[2]	N.B.F.	
1. Works	0.00 (0.00)	0.00 (0.00)	0.00 (0.00)	0.00 (0.00)	0.00 (0.00)
2. Goods	0.00 (0.00)	0.00 (0.00)	0.00 (0.00)	0.00 (0.00)	0.00 (0.00)
3. Services	0.00 (0.00)	0.00 (0.00)	0.00 (0.00)	0.00 (0.00)	0.00 (0.00)
4. Miscellaneous	0.00 (0.00)	0.00 (0.00)	0.00 (0.00)	0.00 (0.00)	0.00 (0.00)
5. Miscellaneous	0.00 (0.00)	0.00 (0.00)	0.00 (0.00)	0.00 (0.00)	0.00 (0.00)
6. Miscellaneous	0.00 (0.00)	0.00 (0.00)	0.00 (0.00)	0.00 (0.00)	0.00 (0.00)
Total	0.00 (0.00)	0.00 (0.00)	0.00 (0.00)	0.00 (0.00)	0.00 (0.00)

Project Costs by Procurement Arrangements (Actual/Latest Estimate) (US$ million equivalent)

Expenditure Category	Procurement Method[1]				Total Cost
	ICB	NCB	Other[2]	N.B.F.	
1. Works	0.00 (0.00)	0.00 (0.00)	0.00 (0.00)	0.00 (0.00)	0.00 (0.00)
2. Goods	0.00 (0.00)	0.00 (0.00)	0.00 (0.00)	0.00 (0.00)	0.00 (0.00)
3. Services	0.00 (0.00)	0.00 (0.00)	0.00 (0.00)	0.00 (0.00)	0.00 (0.00)
4. Miscellaneous	0.00 (0.00)	0.00 (0.00)	0.00 (0.00)	0.00 (0.00)	0.00 (0.00)
5. Miscellaneous	0.00 (0.00)	0.00 (0.00)	0.00 (0.00)	0.00 (0.00)	0.00 (0.00)
6. Miscellaneous	0.00 (0.00)	0.00 (0.00)	0.00 (0.00)	0.00 (0.00)	0.00 (0.00)

Total	0.00 (0.00)	0.00 (0.00)	0.00 (0.00)	0.00 (0.00)	0.00 (0.00)

[1/] Figures in parenthesis are the amounts to be financed by the Bank Loan. All costs include contingencies.

[2/] Includes civil works and goods to be procured through national shopping, consulting services, services of contracted staff of the project management office, training, technical assistance services, and incremental operating costs related to (i) managing the project, and (ii) re-lending project funds to local government units.

Project Financing by Component (in US$ million equivalent)

Component	Appraisal Estimate			Actual/Latest Estimate			Percentage of Appraisal		
	Bank	Govt.	CoF.	Bank	Govt.	CoF.	Bank	Govt.	CoF.

Annex 3. Economic Costs and Benefits

Not Applicable

Annex 4. Bank Inputs

(a) Missions:

Stage of Project Cycle	No. of Persons and Specialty (e.g. 2 Economists, 1 FMS, etc.)		Performance Rating	
Month/Year	Count	Specialty	Implementation Progress	Development Objective
Identification/Preparation				
February - 03	*8*	1 team leader; 1 economist; 1 pension specialist; 3 consultants; 1 sector manager; 1 advisor		
April - 04	*13*	1 team leader; 2 economists; 3 public sector specialists; 1 financial sector specialist; 2 energy sector specialist; 2 private sector specialist; 1 pension specialist; and 1consultant		
Appraisal/Negotiation				
June/July - 04	*12*	1 team leader; 1 economists; 2 public sector specialists; 1 financial sector specialist; 2 energy sector specialist; 2 private sector specialist; 1 pension specialist; 1 results specialist; and 1consultant.		
Supervision				
May/June - 05	*8*	1 team leader; 1 economists; 1 public sector specialists; 1 financial sector specialist; 1 energy sector specialist; 2 private sector specialist; and 1consultant	S	S
October/Nov - 05	*4*	1 team leader; 1 economists; 1 public sector specialists; and 1 private sector specialist	S	S
ICR				
June - 06	*2*	1 team leader; 1 consultant		

Note that ISR rated implementation progress Moderately Satisfactory after both supervision missions and rated performance with regard to the development objective after the first supervision mission Moderately Satisfactor and after the second supervision mission Satisfactory using the new rating system under the ISR system.

(b) Staff:

Stage of Project Cycle	Actual/Latest Estimate	
	No. Staff weeks	US$ ('000)
Identification/Preparation	92.5	547.0
Appraisal/Negotiation	35.2	161.2

Supervision	32.5	182.0
ICR	4.0	32.0
Total	164.2	951.2

Note that services of short term consultants are included in the US$ numbers but are included in the No. of staff weeks. Note that the cost of the initial preparation which was abandoned in FY03 accounted for a total of 63 staff weeks and US$326.9 thousand of total expenditures. Hence, the preparation which led to the approved lending operation amounted to 29.5 staff weeks and US$247.1 thousand of total expenditures

Annex 5. Ratings for Achievement of Objectives/Outputs of Components

(H=High, SU=Substantial, M=Modest, N=Negligible, NA=Not Applicable)

	Rating
☐ *Macro policies*	◯ *H* ◯ *SU* ◯ *M* ◯ *N* ◯ *NA*
☐ *Sector Policies*	◯ *H* ◯ *SU* ◯ *M* ◯ *N* ◯ *NA*
☐ *Physical*	◯ *H* ◯ *SU* ◯ *M* ◯ *N* ◯ *NA*
☐ *Financial*	◯ *H* ◯ *SU* ◯ *M* ◯ *N* ◯ *NA*
☐ *Institutional Development*	◯ *H* ◯ *SU* ◯ *M* ◯ *N* ◯ *NA*
☐ *Environmental*	◯ *H* ◯ *SU* ◯ *M* ◯ *N* ◯ *NA*
Social	
☐ *Poverty Reduction*	◯ *H* ◯ *SU* ◯ *M* ◯ *N* ◯ *NA*
☐ *Gender*	◯ *H* ◯ *SU* ◯ *M* ◯ *N* ◯ *NA*
☐ *Other (Please specify)*	◯ *H* ◯ *SU* ◯ *M* ◯ *N* ◯ *NA*
☐ *Private sector development*	◯ *H* ◯ *SU* ◯ *M* ◯ *N* ◯ *NA*
☐ *Public sector management*	◯ *H* ◯ *SU* ◯ *M* ◯ *N* ◯ *NA*
☐ *Other (Please specify)*	◯ *H* ◯ *SU* ◯ *M* ◯ *N* ◯ *NA*

(S=Satisfactory, MS=Moderately SatisfactorySU=Substantial, M=Modest, N=Negligible, NA=Not Applicable)

	Rating
Macro Policies	*S*
Sector Policies	*MS*
physical	*NA*
Financial	*NA*
Institutional Development	*M*
Environmental	*NA*
Social	
Poverty	*NA*
Gender	*NA*
Other	*NA*
Private Sector Development	*MS*
Public Sector Development	*MS*
Other (specify)	*NA*

Annex 6. Ratings of Bank and Borrower Performance

(HS=Highly Satisfactory, S=Satisfactory, U=Unsatisfactory, HU=Highly Unsatisfactory)

6.1 Bank performance	*Rating*
☐ *Lending*	◯ *HS* ◯ *S* ◯ *U* ◯ *HU*
☐ *Supervision*	◯ *HS* ◯ *S* ◯ *U* ◯ *HU*
☐ *Overall*	◯ *HS* ◯ *S* ◯ *U* ◯ *HU*

6.2 Borrower performance	*Rating*
☐ *Preparation*	◯ *HS* ◯ *S* ◯ *U* ◯ *HU*
☐ *Government implementation performance*	◯ *HS* ◯ *S* ◯ *U* ◯ *HU*
☐ *Implementation agency performance*	◯ *HS* ◯ *S* ◯ *U* ◯ *HU*
☐ *Overall*	◯ *HS* ◯ *S* ◯ *U* ◯ *HU*

(HS=Highly Satisfactory, S=Satisfactory, MS=Moderately Satisfactory, S=Satisfactory, U=Unsatisfactory, HU=Highly Unsatisfactory)

6.1 Bank performance	*Rating*
Lending	*MS*
Supervision	*S*
Overall	*MS*

6.2 Borrower performance	*Rating*
Preparation	*S*
Government Implementation performance	*MS*
Agency Implementation Performance	*MS*
Overall	*MS*

Annex 7. List of Supporting Documents

1. Economic Management and Growth Credit, Program Document, Report No.29294 ZA
2. Zambia: Poverty Reduction Strategy Paper, 2002.
3. Zambia: Transitional National Development Plan, 2002-2005.
4. Zambia: Country Assistance Strategy, Report No. 27654 ZA, 2004
5. Financial Management and Financial Accountability Review, Report no. 26262 ZA.
6. Financial Sector Assessment, Report No. 27289 ZA.
7. Country Economic Memorandum, Report No. 28069 ZA.
8. Zambia: Public Expenditure Review
9. Investment Climate Assessment, Report No. 29741 ZA.
10. FIAS Report on Administrative Barriers to Investment.
11. Economic Management and Growth Credit, Release of Second Tranche, Dec. 2005.
12. Development Credit Agreement, Credit Number 4009 ZA, Dec. 2004
13. Minutes of ROC meeting and Concept Review Meeting, July 20, 2004ay 19, 2004.
14. Agreed Minutes of Negotiations, October 2004.
15. Supervision Mission Documents, *Aide-memoires, Back to office reports, Implementation Status Reports.*