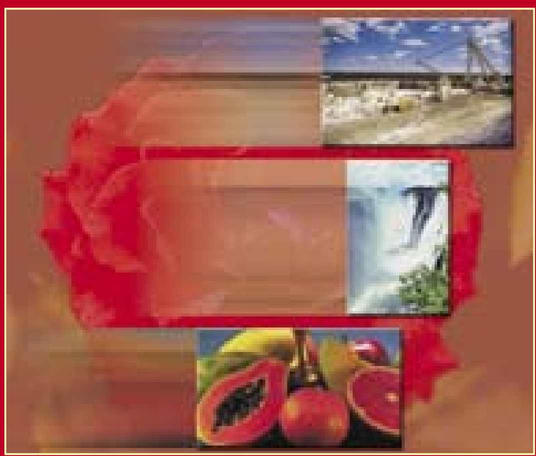
UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

INVESTMENT POLICY REVIEW

ZAMBIA



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United Nations Conference on Trade and Development

Investment Policy Review
Zambia

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PREFACE

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

The Investment Policy Review of Zambia was initiated at the request of the Government of Zambia and was financed by the Governments of Germany, Italy and Norway. In preparing the review, UNCTAD received the full support and cooperation of the Ministry of Commerce, Trade and Industry, the designated cooperating agency, and other ministries and government agencies, including the Zambian Investment Centre. The mission also had the benefit of the views of the private sector, foreign and domestic, civil society, as well as the resident international community, particularly bilateral donors and development agencies. The Investment Policy Review was presented to a national stakeholders' workshop on 22 August 2005.

This report was prepared by Shuvojit Banerjee, Lena Chia, John Gara, Arvind Radhakrishna, Ian Richards, Oliver Saasa, Taffere Tesfachew, and Zbigniew Zimny under the direction of Khalil Hamdani. Violeta Mitova, Erich Supper and Andrea Zazzarelli also provided inputs. Lang Dinh provided research assistance, Essie Saint-Clair, Elisabeth Anodeau-Mareschal and Deborah Wolde-Berhan provided production support.

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

Geneva, November 2006

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ABBREVIATIONS

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

ZAMBIA

Zambia has been a republic since independence from the United Kingdom in 1964. It is landlocked and shares borders with eight countries. Lusaka is the capital and the other main cities are Ndola and Kitwe in the Copperbelt, and Livingstone in the Southern Province. Copper wealth has made Zambia one of Africa's most highly urbanized countries. Multi-party parliamentary democracy has been in practice since 1991, with the legislature consisting of a 150 member National Assembly. The President is elected through direct vote. The country obtains 65% of its export earnings from mining, mainly copper and cobalt. The country is notable in the region for its social and political stability. Governments since 1991 have enacted comprehensive market liberalization policies

MAIN ECONOMIC AND SOCIAL INDICATORS

INDICATOR	2000	2001	2002	2003	2004
Population (million)	10.7	10.9	11.1	11.3	11.5
GDP at market prices (billion of current dollars)	3.2	3.6	3.7	4.3	5.4
Annual GDP growth (percentage)	3.6	4.9	3.3	5.1	4.6
Inflation (percentage)	26.0	21.4	22.2	21.4	18.0
GDP per capita (dollars)	317.1	349.5	352.4	413.2	470.6
GDP by sector (percentage):					
• Agriculture	22.3	22.1	22.2	19.3	20.9
• Industry	25.3	25.6	26.1	29.7	26.9
- Manufacturing	11.4	11.1	11.6	11.3	12.1
- Mining[a]	4.1	3.9	3.5	7.8	..
• Services	52.4	52.3	51.7	51.1	52.2
FDI inflows (millions of dollars)	121.7	71.7	82.0	172.0	334.0
Total exports (fob) (US$ millions)	746.0	887.0	920.0	1,137.0	1,067.2
Copper as percent of total exports[b]	60.3	63.5	61.9	58.0	52.1
Exports of goods and services (percent of GDP)	21.1	27.1	28.6	30.6	19.8
Imports of goods and services (percent of GDP)	31.4	37.3	42.0	41.8	27.1
Gross capital formation (percent of GDP)	18.7	20.0	17.4	16.0	26.0
Population living below the national poverty line (%), 1987-2000	72.9	72.9	72.9	72.9	..
Human development rank[c]	153	153	163	166	..
Adult illiteracy rate (percent of people aged 15 and above)	21.8	21.0	20.1	..	..

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

Notes:
a Economist Intelligence Unit, Country Profile.
b Comtrade.
c Total countries ranked: 177.

INTRODUCTION

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

With the opening up of the Zambian economy in the 1990s, FDI inflows increased considerably reaching $334 million in 2004. This was largely explained by the implementation of an ambitious privatization programme (1994-2001), investments in copper and cobalt extraction, and greenfield investments in the agricultural sector, in particular horticulture and floriculture production, and in tourism. The immediate challenge for Zambia will be to increase and sustain FDI inflows beyond recent levels, and to reap greater benefits from FDI for diversification, industrialization and development.

Recent FDI inflows have contributed modestly to the much-needed diversification of the economic base and exports. There is also some evidence to indicate that it has contributed to skill and technology transfer. But the assessment of this report is that given its resource potential, Zambia is under-performing and should have done better in attracting FDI. Based on Zambia's recent record and the level of foreign investment moving into other countries in the region, this report estimates that Zambia should be able to attract on average about $400 million a year.

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

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

Chapter II reviews Zambia's investment policy and regulatory framework and provides recommendations that could help improve the framework. It shows that key elements of the investment code should be reviewed and that a number of impediments remain. The lack of coherence in government policies creates obstacles for investors. The need to screen investments, the issuance of work and residence permits, and the fiscal framework are generally weak spots, which should be quickly tackled.

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

Chapter IV summarizes the main conclusions and recommendations.

I. FOREIGN DIRECT INVESTMENT IN ZAMBIA: TRENDS AND IMPACT

A. Economic Backdrop

Until three decades ago, Zambia was one of the most prosperous countries in sub-Saharan Africa. Today it ranks as one of Africa's least developed. At independence in 1964, the country's rich mineral resources were well developed and during the first ten years, world market conditions were generally favourable. However, the country's fortunes were adversely affected in the early 1970s by the rise in oil prices and the drop in copper prices. This was compounded by the nationalization of major industries, including copper mines, which formed the backbone of the economy and generated 90 percent of export revenues. The wider economy suffered severe difficulties and by 1975, Zambia was faced with a sharp decline in government revenue as well as an escalation in the balance of payments and budget deficits.

The situation declined through the next two decades, made worse by increasing government debt and an inability to maintain investment in the copper industry. External factors, in particular the declining terms of trade for commodity producers, compounded Zambia's problems. GDP growth averaged 1.5 percent in the 1970s, 1.4 percent in the 1980s and 0.3 percent in the 1990s. In the 1980s, Zambia's economic growth was second lowest in Southern African Development Community (SADC) after Mozambique, a country that was experiencing civil strife. In the 1990s, it was well below the SADC average of one percent and the Sub-Saharan African average of 2.4 percent.

The Zambian Government made various attempts at stabilization. Although begun in the late 1980s, serious reforms did not take place until 1991, when, under close guidance from the IMF and World Bank, the Government introduced tough reforms resting on three main policy planes: removal of subsidies; economic liberalization and stabilization; and privatization of public sector enterprises. Price controls were removed, the exchange rate was unified and became market-determined, capital controls were abolished, interest rates on loans were liberalized, and regular auctions of treasury bills were initiated. Agriculture input and output markets were also opened up to private sector entry, and import controls were abolished with very few exceptions. The privatization process moved faster and by 2002, almost all the parastatal companies were privatized. However, it is noteworthy that the largest companies in vital economic sectors such as utilities, oil and finance are still state-owned.[1]

Backed by more recent development plans, increasing commodity prices, qualification for debt cancellation under HIPC and expansion in mining, construction, manufacturing, wholesale and retail trades, and services, the overall effort is starting to pay off. Real GDP growth reached 5.4 percent in 2004 and 5.1 percent in 2005. This marked a significant improvement over the annual average of 2.4 percent GDP growth in the preceding four years and signaled a reversal of the economic stagnation of the 1990s.

At the same time, FDI increased by 11.7 percent in 2004 to $334 million,[2] helped by expanding market demand and stronger investor and donor confidence. The rise in foreign exchange inflows strengthened the Kwacha and brought inflation down to 17 percent at the end of 2005. The boom in the mining sector has been a particularly strong driver in the country's recent growth and increased FDI inflows. Firstly,

[1] These included the Zambia Telecommunication Company (ZAMTEL); Zambia Electricity Supply Corporation (ZESCO); Indeni Oil Refinery; INDENI Oil Refinery, Zambia National Oil Company; National Airports Corporation; and Zambia National Commercial Bank (ZANACO).

[2] UNCTAD, World Investment Report 2005.

privatization has been followed by recapitalization. Secondly, copper mines have benefited from increased prices in the global commodity market. Supporting this trend, Table I.1 shows the annual GDP growth in recent years, broken down by sector.

Table I.1. Annual GDP Growth Rates by Sector, 1998-2004
(Constant 1994 prices)

	1998-2001 Average	2002 Actual	2003 Actual	2004 Actual
CONSTANT 1994 PRICES				
Primary sector	2.3	3.8	4.5	7.5
Agriculture, forestry and fishing	1.0	-1.7	5.1	4.2
Mining and quarrying	6.7	16.4	3.4	13.9
Secondary sector	4.7	7.2	10.9	9.1
Manufacturing	3.5	5.7	7.6	4.7
Electricity, gas, and water	4.2	-5.2	0.6	-1.9
Construction	8.2	17.4	21.6	20.5
Tertiary sector	4.0	1.9	3.4	3.2
Wholesale and retail trade	4.0	5	6.1	5
Restaurants and hotels	8.3	4.8	6.8	6.4
Transport, storage, and communications	3.8	1.8	5	6.2
Financial intermediation and insurance	0.5	3.5	3.4	3.5
Real estate and business services	11.9	4.4	4	4
Community, social, and personal services	2.3	1.6	1.5	0.6
Other	1.0	-13.8	-7.8	-7.6
GDP at market prices	2.4	3.3	5.1	5.4

Source: Central Statistical Office and Ministry of Finance and National Planning

B. FDI Trends

1. FDI Growth

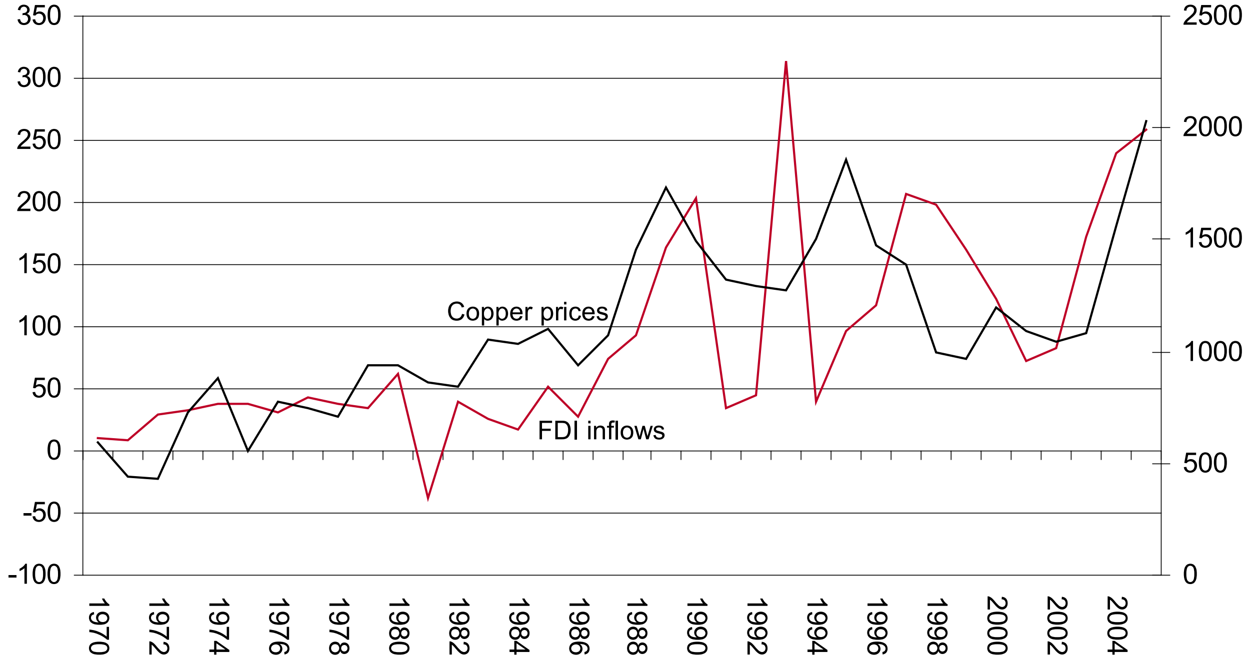
Overall, Zambia's FDI inflows have not changed significantly in the last twenty years, especially when measured relative to population and size of economy. This compares poorly with its peers, who have made stronger efforts to improve their investment climate and implement economic reforms.

Zambia's FDI performance is strongly based on the performance of its mining industry, for which FDI has been a vital source of capital, technical inputs and managerial know-how. Figure I.1 shows the degree to which Zambia's FDI inflows and world copper prices have historically been linked. Nevertheless, other factors also explain FDI performance. These include the nationalization programme, which saw an initial divestment of around $300 million, and from 1992, the privatization programme.

At the start of the privatization programme, over 80 percent of companies in Zambia were state-owned, ranging from mines, utilities and financial services to hotels and supermarkets. Privatization began with the divestment of smaller companies, often to local investors, and its impact was minimal until larger firms started to be sold off in 1995. Between 1995 and 2000, average FDI inflows increased to $161 million, peaking at $207 million in 1997.

Figure I.1. FDI inflows into Zambia, 1970 - 2004

(FDI inflows in millions of dollars on left axis and copper prices in pounds sterling per tonne on right axis)



Source: UNCTAD.

The pick-up in FDI since 2003 is mainly explained by the recent commodity price boom, which saw copper prices increase by 80 percent from $1,560 per metric ton in 2002 to $2,816 in 2004.[3] Two new large mines (the Kansanshi mine by First Quantum Minerals from Canada and the Lumwana Mine by Equinox Minerals from Australia) have started operations. Others are being rehabilitated and expanded by new foreign owners after a period of decline, notably the Ramcoz mine and Konkola Copper Mines (KCM), the largest producer in Zambia. As a result of this, copper production was projected to increase to over 500,000 tons in 2006 from 398,000 in 2004 and a low of 228,000 in 1998.

2. Distribution by sector and industry

Systematic data on FDI inflows by sector, industry or country of origin are not available. On the whole, FDI has been concentrated in the mining sector, both in terms of stocks and flows, since the mid-1990s. It is estimated that the mining sector attracted more than half the FDI inflows during this period, a time when many large foreign mining companies entered the country for the production and exploration of copper and other minerals such as cobalt. However, this should be put into context. These companies are relatively small when compared to sector leaders such BHP Billiton, which has a market capitalisation of $123 billion. The TNCs entering Zambia included Avmin (Australia, with a market capitalisation $563 million), America Mineral (USA, $241 million), Metorex (South Africa,

[3] IMF, *International Financial Statistics*, September 2004, p. 1080.

Table I.2. Zambia's FDI performance compared to that of selected other countries, 1986-2004

(US$ and percentage)

Country	ABSOLUTE PERFORMANCE					RELATIVE PERFORMANCE													
	FDI inflows per year				FDI stock	FDI inflows												FDI stock	
	Millions of dollars				Dollars	Per capita (dollars)				Per $1,000 GDP (dollars)				As percentage of GFCF				Per capita (dollars)	% GDP
	Average (1986-1990)	Average (1991- 1995)	Average (1996- 2000)	Average (2001-2004)	2004	Average (1986-1990)	Average (1991-1995)	Average (1996-2000)	Average (2001-2004)	Average (1986-1990)	Average (1991-1995)	Average (1996-2000)	Average (2001-2004)	Average (1986-1990)	Average (1991-1995)	Average (1996-2000)	Average (2001-2004)	2004	2004
Zambia	**112.5**	**106.1**	**161.4**	**164.9**	**3,019.3**	**14.0**	**11.6**	**15.8**	**14.6**	**35.5**	**31.9**	**47.9**	**35.9**	**37.4**	**24.3**	**23.6**	**16.1**	**263.0**	**55.8**
Botswana	72.4	-48.2	72.3	225.0	1,382.0	53.8	-31.6	42.6	127.1	31.1	-13.3	15.4	37.5	15.5	-4.5	6.0	15.4	781.2	15.1
Ghana	8.8	101.4	133.4	106.0	1917.4	0.6	5.9	7.0	5.0	1.6	17.3	20.5	15.2	1.3	8.1	9.3	6.6	88.5	21.7
Lesotho	11.7	19.2	30.1	37.3	478.9	7.5	11.6	17.2	20.7	22.7	23.0	32.6	37.5	4.9	3.9	6.5	10.4	266.3	31.6
Mozambique	5.0	32.0	178.5	267.9	2,165.7	0.4	2.1	10.3	14.3	2.1	14.8	47.8	69.5	0.7	6.7	22.5	35.6	111.5	39.0
Namibia	7.3	109.0	99.2	245.3	1526.8	5.4	70.2	55.0	124.8	3.2	36.0	28.5	68.0	2.0	18.9	13.8	35.0	759.9	32.6
South Africa	-72.7	376.5	1,517.3	2,212.5	4,6282.7	-2.1	9.2	34.4	47.8	-0.8	2.6	10.8	18.4	-0.4	1.7	6.6	11.8	980.4	21.7
Uganda	0.3	46.4	260.4	473.4	5203.3	0.0	1.5	7.7	12.9	0.1	10.3	31.5	47.4	0.1	4.4	19.8	25.6	138.3	48.0
United Republic of Tanzania	-1.0	54.2	110.7	200.5	1,612.9	-0.1	2.7	4.8	7.6	-0.3	11.1	18.3	32.1	-0.2	6.9	9.9	15.4	58.0	23.6
SADC	283.2	1174.2	3,718.2	6,470.9	8,3484.6	1.9	6.6	18.8	30.3	2.2	6.4	19.7	33.0	1.2	3.8	10.9	18.7	378.5	28.5
SADC without South Africa	355.9	797.7	2,200.8	4,258.5	3,7201.9	3.1	5.9	14.4	25.4	8.1	17.4	42.0	67.2	4.8	8.8	18.6	30.0	214.6	46.6
LDCs	1,0702.1	634.2	1,586.5	3,885.3	7,1952.5	14.4	1.4	2.8	6.0	36.3	4.5	9.3	20.1	20.8	2.1	6.0	10.4	97.0	24.4

Source: UNCTAD, World Investment Report 2005.

$405 million), First Quantum (Canada, $3 billion) and, more recently, Equinox Minerals (Australia, $593 million), J&W Investments (Switzerland), which acquired the closed Ramcoz mine, and Vedanta Resources (United Kingdom, $8 billion), which acquired Konkola Copper Mines.

The second largest sector for FDI is the services sector, more specifically banking, communications and tourism. There are six international banks operating in Zambia, including Barclays, Standard Chartered, Stanbic and Citibank. FDI in telecommunications services is more recent and concentrated in mobile telephony, with licenses granted to Telecel (which was acquired by MTN in late 2005) and Celtel, which was acquired by Kuwait's MTC Group in 2005. The tourism industry has also attracted more foreign investors in recent years, especially in the development of game parks and in sites around the Victoria Falls area. The latter saw the opening of the Sun International resort in 2001 built at an estimated cost of $45.6 million on 46 hectares. Foreign investors are also present in the country's three big international hotel chains, namely, Intercontinental, Taj Group of hotels and Holiday Inn, which were acquired through privatization.

In recent years, agriculture has been attracting FDI directed mainly at the production of fruit, flowers, horticultural products, cotton, maize, tobacco and sugar. Foreign involvement in this sector ranges from such large companies as South African listed Illovo Sugar and medium-sized foreign companies like Enviroflor (joint venture with Netherlands and individual farmers from Zimbabwe).

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

3. Types of FDI

Recent FDI to Zambia has been boosted by the acquisitions of existing assets by foreign investors under the government's privatization programme that, as was noted earlier, began in 1992, initially selling smaller enterprises, followed later by the larger copper mining companies. By April 2002, 257 state enterprises had been privatized from a total of 284. Of the privatized companies, 65 percent were sold to Zambian individuals, 29 percent to foreigners while 6 percent were wound up.

Although only 29 percent of privatized companies were acquired by FDI, in value terms, foreign investment dominated the privatization programme, mainly through joint ventures. The total value of privatization receipts amounted to around $450 million, thus indicating the small size of many projects. Foreign investors were involved mainly in the purchase of a number of larger mining, energy, manufacturing and agro-business companies (Table I.3). The largest participation came through the purchase of government mining holdings. The main foreign investors purchasing privatized assets came from the UK and South Africa. Some of these investors, such as CDC and Lonrho had already had a long-standing presence in Zambia and were expanding their shareholdings in these companies.[4]

[4] African Development Bank (1998).

A new round of privatization took place in 2005. Three companies (Monarch Zambia Limited, Zambia Seed Company and Kafue Textiles of Zambia) were sold that year, bringing the total number of companies and units privatized, leased or concessioned since the programme began to 262. Firms identified for privatization but still in public ownership, apart from ZAMTEL (telecommunications) and ZESCO (power) (discussed in Chapter III), include the Indeni Oil Refinery; Zambia National Oil Company, the National Airports Corporation and Zambia National Commercial Bank (ZANACO).

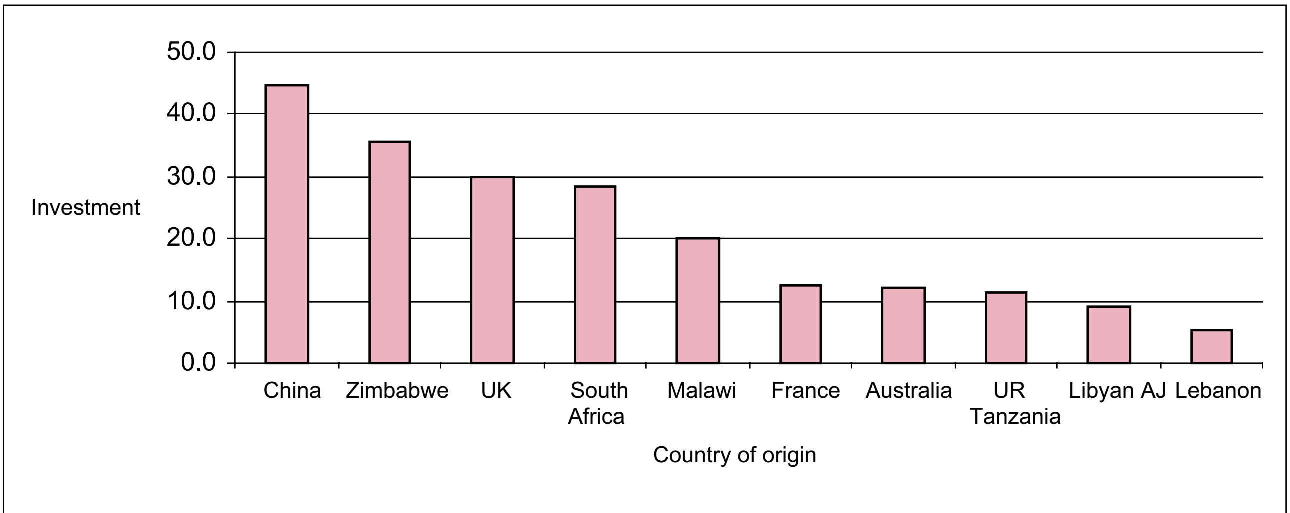
As described earlier, there has recently been significant FDI in greenfield projects in mining, the exploration of new copper deposits and in agriculture. In the latter category, new investment has come through the purchase of land for large-scale farms by Zimbabwean investors, especially in tobacco and maize. The Zambia Investment Centre records 61 farmers as having entered between 2002 and October 2004, with investments estimated at $51 million. The Sun Resort International Hotel is also a recent example of greenfield investment, supporting the Government's objective to develop the Victoria Falls area as a prime tourist destination.

4. Countries of origin

Although companies from the United Kingdom and South Africa have traditionally been the main foreign investors in Zambia, countries of origin are being increasingly diversified. Data on investment approvals in the years 2000-2002 provide some insight. Amongst developing country investors, Chinese investors are playing a prominent role, primarily in the manufacturing and construction sectors. Zimbabwe has also been a source of recent investment, in agriculture and tourism. However, this is due more to Zimbabwe's worsening business climate than Zambia's attractiveness as an investment destination.

Outside mining, British investment is present in tourism, services, and manufacturing. South African investors have displayed most interest in recent years in services, particularly in tourism, retail trade and banking. Figure I.2 shows the country of origin of approved investments between 2000 and 2002.

Figure I.2. Investment approvals by country of origin, 2000 - 2002
(US$ million)



Source: Zambia Investment Centre

Table I.3. Profile of major privatizations with foreign participation
(As of 31 March 2003)

Name of the acquired enterprise	Date privatized	Investor	Foreign participation ($ million)[a]	% share of equity
Mining				
ZCCM Luanshya/Baluba complex	Jun 97	Binani Inds (UK & India)	35	85
ZCCM Chibuluma Mine	Sep 97	Metorex (RSA), Miranda Mines (RSA), Crew Devt Corp (Can) & Genbel (Aust)	18	85
ZCCM Power Division	Nov 97	National Grid Co (UK) & Midlands Power Intl (UK)	50	80
ZCCM Chambishi Copper Mine	Jun 98	China Non-Ferrous Metal Inds Corp (PRC) [a]	20	85
ZCCM Chambishi Cobalt Plant	Sep 98	Avmin (RSA)	50	90
ZCCM Nkana Mine, Concentrator & Cobalt Plant, & Mufulira Division	Feb 00	First Quantum Minerals (Can) and Glencore Intl (Switz) [b]	43	90
ZCCM Nchanga Division, Konkola Division, Chingola Refractory Ore Dumps & Nampundwe Pyrite Mine	Mar 00	Anglo American Corp (RSA), IFC & CDC (UK) [c]	30	80
Subtotal			246	
Manufacturing				
Chilanga Cement	Jun 94	CDC (UK)	5.4	26
Zambia Breweries Central Division	Aug 94	Zamanglo (RSA-owned by Anglo-American Corp and Indol Intl.).	14	100
Northern Breweries	Jul 96	Lonrho (UK)	9	100
Subtotal			28.4	
Agriculture				
Zambia Sugar Company	Jul 94	Tate & Lyle (UK) and CDC (UK)	37	70
Mukumpu Ipumbu Farm & Mukumpu Kampemba Ranch	Dec 95	CDC (UK)	7	100
Lusaka & Gwembe cotton ginneries	Jan 96	Lonrho Zambia (UK)	6	100
Subtotal			50	
Tourism				
Intercontinental Hotel, Lusaka	Mar 98	Marasa Holdings (Uganda)	9	100
Intercontinental Hotel, Livingstone	Mar 98	Sun Intl (South Africa)	7	100
Subtotal			16	
TOTAL			**340.4**	

Source: Zambia Privatization Agency, (2003).

Notes: [a] Privatization values of greater than $5 million.
[b] Value of cash at close of $20 million and $23 million deferred.
[c] Purchase allows extra conditional/deferred cash of $60 million.

C. Impact of FDI

1. Technology and Skills Transfer

In addition to capital, FDI inflows in the past decade have brought some technology and know-how. FDI has also contributed modestly to diversifying exports and modernizing services, notably in telecommunications and tourism. However, FDI has yet to contribute significantly to the development of stronger business relationships with domestic enterprises, which is an essential condition for sustained transfer of skills and technological capability.

FDI's strongest impact has been in transferring skills and knowledge in the horticulture and tourism sectors. In horticulture, foreign investors have introduced new varieties of flowers, and vegetables, and made local farmers more familiar with the use of new pest control methods and irrigation. Many Zambians occupy managerial positions and are continually trained in quality control and agricultural science, essential for fruits, flowers and vegetables grown for export. Non-managerial staff receive training at agricultural colleges.

The Natural Resource Development College/Zambia Export Growers' Association (NRDC/ZEGA) Training Institute was set up by exporters – most of them foreign firms - in partnership with the Government of Zambia. This trust educates farmers on the safe use of agricultural chemicals, pesticides and herbicides, and on personal and consumer safety. There is particular emphasis on environmental and social aspects of production. Box I.1 provides an example.

In the hospitality business, the entry of a number of international hotel groups brought with it an increase in services and quality in hotel management. Employees have been retrained since the takeover and are now performing at international standards. They also benefit from ongoing staff training programmes and the use of modern reservations systems and marketing techniques.

2. Employment and linkages

The most important contribution of FDI to employment has been in mining and related industries, but the overall direct impact has not been large because of the low labour-intensity of this sector. In 2002, mining employed fewer than ten percent of formal sector workers. However, there have been spillovers and indirect employment creation for suppliers of goods and services to the mining sector.

Privatization-linked FDI in mining was initially associated with a negative impact on employment as new foreign owners rationalized operations. One mine was closed, causing widespread concerns about privatization. Employment in mining declined from over 52,000 in 1995 to 35,000 in 2002. But with post-privatization and greenfield FDI taking off, it rapidly increased, reaching 54,000 in 2003.

There has also been greenfield FDI in other industries, providing employment opportunities. These industries are labour-intensive and include tourism, horticulture, and the growing of sugar, coffee and tobacco. Jobs in the tourism sector, for example, doubled from 5,909 in 1995 to 11,892 in 2000.[5] By the end of 2003, they had reached 16,000.[6]

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

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

Box I.1. Promoting sustainable knowledge and skills

Established in 1995, Enviroflor Ltd. is a Dutch-Zambian joint venture that grows roses for export. The present Dutch management acquired a share of the business previously held by the§Dutch Department of Development Cooperation. The company acquired 106 hectares of land. Enviroflor grows mainly medium-sized roses, which are exported to the Netherlands and sold through auction to global markets. The company exports over 18 million roses per year and growth is estimated at around 10 to 15 percent per annum.

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

Source: Investor interview.

Business relationships between foreign affiliates and local companies are limited. The mining industry is linked to some support sectors that provide maintenance and basic machinery. In the case of machinery, however, the supporting companies are also often foreign affiliates who only have a marketing presence in Zambia, importing their products from abroad. Agriculture has provided more links with local producers, such as in the cotton and horticulture sectors. Linkages have been established with the local population through the use of outgrower schemes where cotton and flower supply arrangements have been made with small individual farmers. Dunavant, a US TNC, buys approximately 57 percent of the national cotton crop, and has 100,000 outgrowers with holdings averaging 1.3 hectares. In 2002, it approved another scheme for an additional 40,000 outgrowers on over 20,000 hectares.[7]

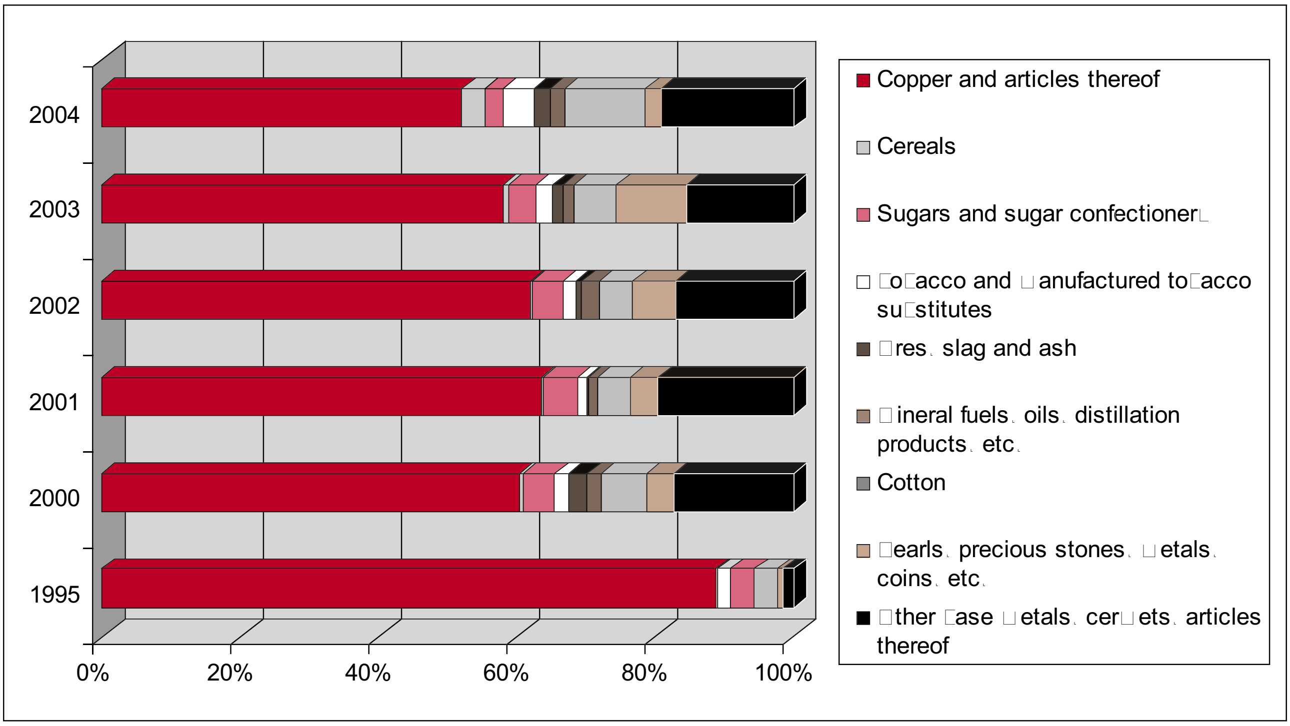
D. Export diversification

Zambia's commodity exports are dominated by copper, although that dominance is gradually being reduced (see Figure I.3). Nevertheless, natural resource commodities still accounted for 73 percent of Zambia's main commodity exports in 2004, compared to 79 percent in 2000 and 94 percent in 1995.

In recent years, FDI has contributed to the growth of non-traditional export products (i.e. non-natural resources) and an overall diversification. Cotton and tobacco have emerged as expanding export sectors (17 percent of exports in 2004 compared to 8 percent in 2000) and metal manufactures (mainly base metals, including copper waste and scrap) saw an important increase, largely due to FDI, rising from 1 per cent in 1995 to 7 percent in 2000 and 4 percent in 2004.

[7] IDL Group, (2002).

Figure I.3. Composition of Zambia's main commodity exports, 1995 - 2004
(Percent based on trade value)



Source: UNCTAD Comtrade.

A closer examination of the cotton sector shows that in the 1980s, exports consisted mainly of ginned cotton. But as from the late 1990s, exports diversified towards a wide range of manufactures, namely, textile yarn, men and women non-knit outwear, outer and under knitted garments, textile clothing accessories and various textile articles. Zambian Mulungushi Garments, a Chinese joint venture was the leader in this. Total exports of cotton and other textiles have increased from $7.6 million in 1990 to $143 million in 2004.

The production of gemstones revived in the late 1990s with the arrival of several foreign SME operators. Exports doubled from $11 million in 1990 to $23 million in 2002, although they decreased in 2003 and 2004, mainly because of poor infrastructure (see Chapter III).[8]

Export revenues from tourism have been rising sharply, from $47 million in 1995 to $149 million in 2003. The government estimates that these revenues grew by 12.1 percent year-on-year in 2005 and 6.4 percent in 2004. Key to this has been the rapid expansion of facilities such as lodges, guesthouses and camping sites, including the opening of two luxury hotels in the region of Victoria Falls, the rehabilitation of Livingstone airport and the opening of the Tourism Development Credit Facility in 2004.

Zambia benefits from widespread preferential market access. Chilanga Cement, is a good example of a company that has capitalized on Zambia's regional market access in order to sell to neighbouring countries (see Box I.2).

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

Box I.2. Tapping export opportunities in the region

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

The company has significant linkages to domestic companies: for example, it is a major client of Zambia Railways and of the largest domestic colliery, Maamba Collieries, which is the biggest employer in the Southern Province.

Apart from maintaining 80 percent share of the domestic market, the company also exports a significant share of its production regionally - 23% in 2002. Exports are divided fairly evenly between the United Republic of Tanzania (31%), Malawi (21%), Burundi (25%), and the Democratic Republic of Congo (23%). Zambia's principal competitor in this industry is South Africa and Zimbabwe. Cement exports from Zambia grew nearly six-fold from 1990 to 2001.

Zambia has a overall cost advantage compared to South Africa in selling to these regional markets due to the smaller distances involved, compensating for Zambia's higher operating costs. Chilanga's main export focus is on the Democratic Republic of Congo, due to the distance advantage of its plant in Ndola.

Source: Investor interview.

E. Conclusions

Despite signs of export diversification, FDI has yet to play a significant role in the economy. Zambia's FDI story to date is mainly marked by privatizations and commodity price fluctuations.

Yet this needn't be so. The country has a record of relative political stability, privileged access to international markets, an educated workforce and relatively good governance, as measured by conventional indicators. It has also implemented a liberalization programme that on the whole has been well-received.

However, Zambia's reform programme needs to go further. Chapter II evaluates the investment framework and notes a number of challenges introduced by the new Zambia Development Agency Act. Chapter III notes the country's investment potential but highlights the importance of macroeconomic stability and good infrastructure for that potential to be fulfilled.

II. THE INVESTMENT FRAMEWORK

A. Introduction

For more than a decade Zambia has affirmed its commitment to fostering private sector development and welcoming FDI. This is a change from the more statist approach adopted in the 1970s, which included nationalizations and a burgeoning role for state enterprises in business. This changed approach resulted in some complementary reforms including the 1993 Investment Act with liberal provisions for FDI. Nevertheless, there remain significant legal and administrative impediments to investment. FDI issues will henceforth be governed by the 2006 Zambia Development Agency (ZDA) Act, which has replaced the Investment Act. The ZDA Act marks a departure from its predecessor's more liberal stance, introducing compulsory licensing and screening of new investors, restricting the scope for incentives and making it more difficult to employ foreign workers and obtain land. This act does not distinguish between treatment for domestic and foreign investors. But it introduces new investment regulations. The ZDA is not yet operational as an agency.[9]

This chapter considers the specific measures within the investment framework that concern only foreign investors followed by the general conditions for all business that are also of importance to foreign investors.

B. Specific FDI measures

1. Entry and Establishment

Under the ZDA Act, passed in May 2006, foreign investors may invest in any activity open to the private sector. The only activities potentially closed to the private sector are arms production, security printing and the manufacture of dangerous substances, for which case-by-case investment approval is needed.

However, all investors, foreign or domestic, are required to apply to the ZDA for approval to invest, for which they must undergo a screening process. This not only includes activities for which special conditions may apply (such as development or operations in a multi-facility zone) but seemingly for all investors. In the 1993 Act, approval (in the form of an investment certificate) was not required although it was a de facto requirement to avail of protections and incentives. The principal form of approval under the ZDA Act is the grant of an investment licence.

For a foreign investor, an investment licence means that guarantees in the ZDA Act on important matters such as funds transfer, due process in expropriation and recourse to adequate dispute settlement will apply (see Section B.4). Larger investors may also be eligible for privileges under certain conditions in relation to taxes and expatriate recruitment.

Applicants for an investment licence must satisfy the ZDA Board that the investment will have developmental benefits and will not harm the environment. These requirements are in addition to regulatory requirements in the activity concerned. For example, manufacturing enterprises need to obtain licences from city, municipal or district councils.

[9] Since this review was completed, the Government established the Zambia Development Agency. Nevertheless, the recommendations made throughout this review remain valid and should be seen as pertinent to the development of this new agency.

If the screening process is similar to that pertaining to the non-mandatory investment certificate under the previous Investment Act, that screening process will be burdensome to the investor. Under the Investment Act, the process required a number of documents, market studies and risk assessments. Investors also had to furnish proof that they had the necessary investment capital on hand.

The ZDA Act obliges the Agency to decide whether or not to grant an investment licence within fourteen days of application. Applicants may appeal against ZDA's decisions in case of rejection. As the ZDA is not yet operational as an agency, it is not yet possible to assess the efficiency of the application procedure. However, under the previous regime of voluntary investment certificates, the practice was for certificates to be granted by the former Zambia Investment Centre within thirty days, therefore faster than the stipulated six weeks. Screening was assessed to be routine and non-discriminatory.

The proposed investment licence is valid for only ten years and is subject to renewal. It is not transferable without the ZDA's approval. These processes all increase uncertainty for investors.

ZDA approvals should apply only for the grant of special conditions or incentives to qualified investors. The ZDA Act involves the Government in judging whether every proposed investment is worthwhile on a number of broad criteria of promoting economic development, employment, exports and transfer of technology. This entails what could be interpreted as a subjective public intervention in business activity and will occupy unnecessary time for the ZDA. For business it will involve unnecessary time and risk. Taking care of the public interest in investment should continue to reside only in ensuring that the activity meets the necessary laws and regulations.

2. Treatment and Protection of FDI

The ZDA Act has no provisions specific to foreign investors on standards of treatment. The Act does have provisions on the protection of foreign investors' interests with respect to compulsory acquisition of property, the transfer of funds and dispute settlement.

a. Treatment Standards

The ZDA Act applies to both domestic and foreign investors. It therefore does not mention national treatment for foreign investors. However, additional guarantees for foreigners are contained in the BITs. Those recently signed by Zambia accord standards of fair and equitable treatment, national treatment and most favoured nation treatment to foreign investors (see Box II.1). However, of those recently signed, only one, Switzerland, has been ratified.[10] At the same time, Zambia's BITs take account of its membership of various regional agreements under which it has committed to provide preferential treatment for investors from regional countries. Thus, Zambia's BITs make an exception from these treatment standards of special advantages to nationals of third states by virtue of agreements establishing customs unions, economic unions, monetary unions or similar institutions.

[10] The only other BIT to have been ratified was with Germany. This BIT was signed in 1966 and therefore, unlike Switzerland, does not accord standards of fair and equitable treatment, national treatment and MFN treatment.

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

Article 3: Protection of Investments

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

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

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

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

Article 4: Exception

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

b. Protection

During the 1970s, Zambia pursued a nationalization policy that entailed extensive expropriation of foreign investment. Today, these policies have taken an about-turn. Zambia is a member of the Multilateral Investment Guarantee Agency (MIGA). That is a positive signal to foreign investors. In international practice there are four conditions for expropriation: public interest, due process, non-discrimination and prompt, adequate and effective compensation.

Zambia's constitution (article 16) provides only for compensation. The ZDA Act provides for public interest, due process and compensation. Investments may only be expropriated by an Act of Parliament relating to the specific property and compensation must be at market value. Article 19 of the ZDA Act says:

- An investor's property shall not be compulsorily acquired nor shall any interest in or right over such property be compulsorily acquired except for public purposes under an Act of Parliament relating to the compulsory acquisition of property which provides for payment of compensation for such acquisition.
- Any compensation payable under this section shall be made promptly at the market value and shall be fully transferable at the applicable exchange rate in the currency in which the investment was originally made, without deductions for taxes, levies and other duties, except where those are due.

Non-discrimination remains noticeably absent from Zambia's legislation. Only the BITs (except that signed with Germany) provide for all four conditions and, as mentioned earlier, only one of these has been ratified. It can be said that any reticence that investors may have should be placed against Zambia's clear change of direction from the nationalizations of the 1970s and its membership of MIGA. However, it is the norm elsewhere for investors to be covered by all four conditions. Non-discrimination should be made a condition of Article 19 of the ZDA Act or could be integrated into the proposed new investment code.

Should clear provisions on discrimination not be forthcoming, Zambia will need to ratify the nine non-operational BITs it has signed, and expand its BITs network, taking into account best practices elsewhere with respect to provisions on treatment and protection issues.

c. Repatriation and Convertibility Rights

The ZDA Act provides guarantees for rights of repatriation with respect to profits, debt service, fees, royalties and disinvestment proceeds.

3. Foreign exchange control and trade permits

The Foreign Exchange Control Act was repealed in 1994. There are therefore no controls on the transfer of capital in or out of Zambia.

Export permits are no longer required.

4. Dispute settlement

Zambia has a chequered history of investment disputes dating back to the period of nationalisation. However, the situation has improved since 1991. International arbitration is a right for investors covered by BITs. Otherwise, and if both parties agree, investors may resort to international arbitration, under the 2000 Arbitration Act. Zambia is a signatory to the 1958 New York Convention, has signed the UNCITRAL model law and is a member of the International Centre for the Settlement of Investment Disputes (ICSID). This means that where international arbitration is used, the resulting arbitral award is binding and must be enforced in Zambia.

The 2000 Arbitration Act also provides for domestic arbitration, which was used successfully in the case of private mobile phone provider Telecel versus state-owned ZAMTEL. The dispute was settled in seven months. The results of domestic arbitration are also legally binding. USAID and the Law Association of Zambia are currently in the process of reviewing the legal and institutional framework in favour of strengthening national arbitration.

5. Regional and international investment agreements

Zambia is a member of several multilateral agreements on investment, notably, the Washington Convention, which put in place ICSID (since 1970), and MIGA (since 1988). The country has signed 12 BITs, with Belgium, China, Croatia, Cuba, Egypt, France, Germany, Ghana, Italy, Luxemburg, the Netherlands and Switzerland, of which only the BITs with Germany and Switzerland have been ratified. Thus the BIT network is thin and important investors, such as the United Kingdom and South Africa, are not represented.

Zambia is a signatory to other international agreements, which touch on investment. This includes the agreement establishing the WTO, of which the country is a founding member and 19 double taxation treaties (DTTs). COMESA, of which Zambia is a member, is working on proposals for a common investment area, headed by a regional investment agency. However, plans for the investment area are still at an early stage, although work is underway on coordinating competition policy.

Zambia is also a signatory of the African Caribbean and Pacific (ACP) countries and the European Union Co-operation Agreement, dating back to 1975 when the first Lomé convention was signed. Zambia ratified the Cotonou Agreement in April 2002. The latter provides for investment and private sector development matters, calling on its signatories to improve their investment climates.

6. Overall assessment of specific measures

The Government of Zambia has stated its commitment to encouraging FDI and has undertaken a number of reforms to create a more liberal environment. However, the ZDA Act has in many ways made the environment more restrictive for investors.

The strongest example of this is the introduction of compulsory licensing of investors, which may in part be designed to give the ZDA power to first approve every foreign investor prior to investment. The reasoning behind this provision may be partly premised on a belief that an investment promotion centre should in the first place determine whether an investor's business plan is a good one and thereafter, monitor operations to ensure compliance with the plan. The best judge of the business plan is the investor that provides the finance. Government officials should confine themselves to ensuring that the investor conforms to regulatory requirements (e.g. environmental or competition issues) or, where applicable, incentive requirements. In sectors that do require prior authorizations such as infrastructure, mining and hotel construction within national parks, ZDA's role should be to assist the investor in obtaining the necessary approval.

Therefore, it is recommended to limit registration to the purpose of collecting information and not of policing investments. Only investors applying for incentives should need to go through an approval process. In registering for information purposes, it is proposed that only information directly relevant to monitoring FDI statistics should be requested.

Zambia should ratify its outstanding BITs as they send a signal to investors of its commitment to provide a stable, transparent and predictable investment climate. They would also compensate for the absence of non-discrimination in Zambia's legislation. BITs should be negotiated with the United Kingdom and South Africa, two of Zambia's largest investing countries.

C. General investment measures and conditions

This section reviews those areas of the policy and operational framework that affect all investors.

1. Private Sector Facilitation

In order to improve the business climate, the government established the private sector development (PSD) programme and the financial sector development plan. The PSD programme's action plan covers over 80 measures. These can be grouped into policy environment and institutions, trade expansion, infrastructure, citizens' empowerment, business facilitation and economic diversification, and laws and regulation. Many of the measures in the action plan are still in early stages of implementation with initial studies still to be commissioned. However, one concrete manifestation is the forthcoming creation of the Zambia Development Agency, examined in Chapter III. Action plans have also been approved for the Ministry of Tourism, Environment and Natural Resources to streamline licensing requirements and for the Ministry of Commerce, Trade and Industry to tackle administrative barriers. Reference is made to pertinent PSD measures in the discussion below.

2. Taxation

The Income Tax Act the Customs and Excise Act and the Value Added Tax Act are the basic laws that cover Zambia's tax system.

The general corporate tax rate is 35 percent. However, there have been a number of longstanding preferential rates and generous allowances for sectors that the Government has wished to promote. For example, the agriculture sector enjoys a rate of 15 percent and successor mining companies to ZCCM pay a concessionary rate of 25 percent. Companies listed on the Lusaka Stock Exchange pay 33 percent to promote 'financial deepening'.[11] Commercial banks are taxed at 45 percent of their profits above 250 million kwacha ($83,500).

In 2006, the ZDA Act brought in a new set of incentives applicable only to investments that are over $500,000, are licensed by the Zambia Development Agency and are operating within a sector designated as a priority by the Minister of Commerce, Trade and Industry,[12] the list of which can be amended by statutory instrument. The incentives themselves are specified in the 2006 budget and stipulate that for the first five years of operation: corporate tax should be calculated on 50 percent of profits; dividends should be exempt from tax and that capital expenditure on the improvement or upgrading of infrastructure should qualify for an improvement allowance of 100 percent. In addition, imported machinery and equipment is exempt from customs duty.

The ZDA Act also introduced Multi-Facility Economic Zones (MFEZs), for which developers, operators and tenants would benefit from a number of fiscal and non-fiscal allowances. These are described in the next section.

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

[12] Sectors currently include the production of: machinery; iron and steel products; electrical and electronic products; chemicals and petrochemicals; pharmaceuticals; wood products; sand and clay based products; palm oil products; pulp, paper and paper board; textiles; transport equipment; plastics; medical and scientific equipment; rubber and leather products; and packaging and printing materials. Also included is the processing of: agricultural products; forest products; non-ferrous metals; and gemstones.

However, as it stands, there appears to be some confusion among government officials over whether the condition of eligibility for incentives set by the minimum investment threshold of $500,000 also applies to the grant of incentives in MFEZs and in the longstanding incentive schemes (such as in agriculture and mining) introduced prior to the ZDA Act. It is expected that the matter will be clarified in the coming months.

A **value added tax** (VAT) of 17.5 percent was introduced in 1995. Statutory registration applies to businesses whose annual turnover exceeds K30 million[13] ($9,160) per tax year (1 July to 30 June). Businesses with a smaller turnover may apply voluntarily for VAT registration.

Major zero rated items include:

- Basic foods and agricultural products;
- Exports;
- Medical suppliers and drugs;
- Hotel accommodation in the Livingstone district;
- Local and other taxes.

In general, VAT returns are required monthly. Some sectors, such as the insurance industry, file their returns quarterly. Small firms may also file quarterly. Refunds are generally made within six weeks of application. However, areas singled out by the business community for attention include cumbersome forms and a high incidence of audits following the submission of claims.

Zambia has a number of longstanding incentive schemes introduced prior to the ZDA Act. For example, key incentives for the **agriculture sector** include the following:

- Dividends earned in farming are tax exempt for the first 5 years of operation;
- 100 percent tax allowance for outlay on land development, conservation and other costs, and for capital expenditure on farm improvements;
- Substantial rate of depreciation allowing farm machinery to be rapidly written off against tax;
- Agricultural production is zero rated for VAT;
- Duty on most agricultural inputs has been removed completely or reduced considerably.

Manufacturing of non-traditional exports had previously qualified for a reduced profits tax rate of 15 percent. With the repeal of the Investment Act, this has now been eliminated.

For the **mining** industry the fiscal regime is lighter than in many other countries in terms of royalties and taxes, and a number of financial incentives are also provided. Negotiations with Anglo-American on the privatization of Zambia Consolidated Copper Mines (ZCCM) led to lower taxes on ZCCM's successor companies. These companies currently enjoy the following reduced tax levels:

- Mineral royalty is reduced to 0.6 percent;
- Copper and cobalt price participation fees are tax deductible;
- Excise on electricity is not charged (usual rate is 5 percent);

[13] Zambia Revenue Authority website.

- Company tax rate is reduced to 25 percent (from 35 percent), and losses can be carried forward for a period of 20 years;
- Withholding tax on interest, dividends, royalties and management fees paid to shareholders and affiliates is exempted;
- Duty free importation of capital equipment and utility vehicles is allowed.

These concessions were granted to accelerate the privatization of the government-owned mining companies when there was an apparent lack of interest from potential buyers. The fiscal regime granted to the successor company had until recently become the norm for all new investment in the mining industry.

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

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

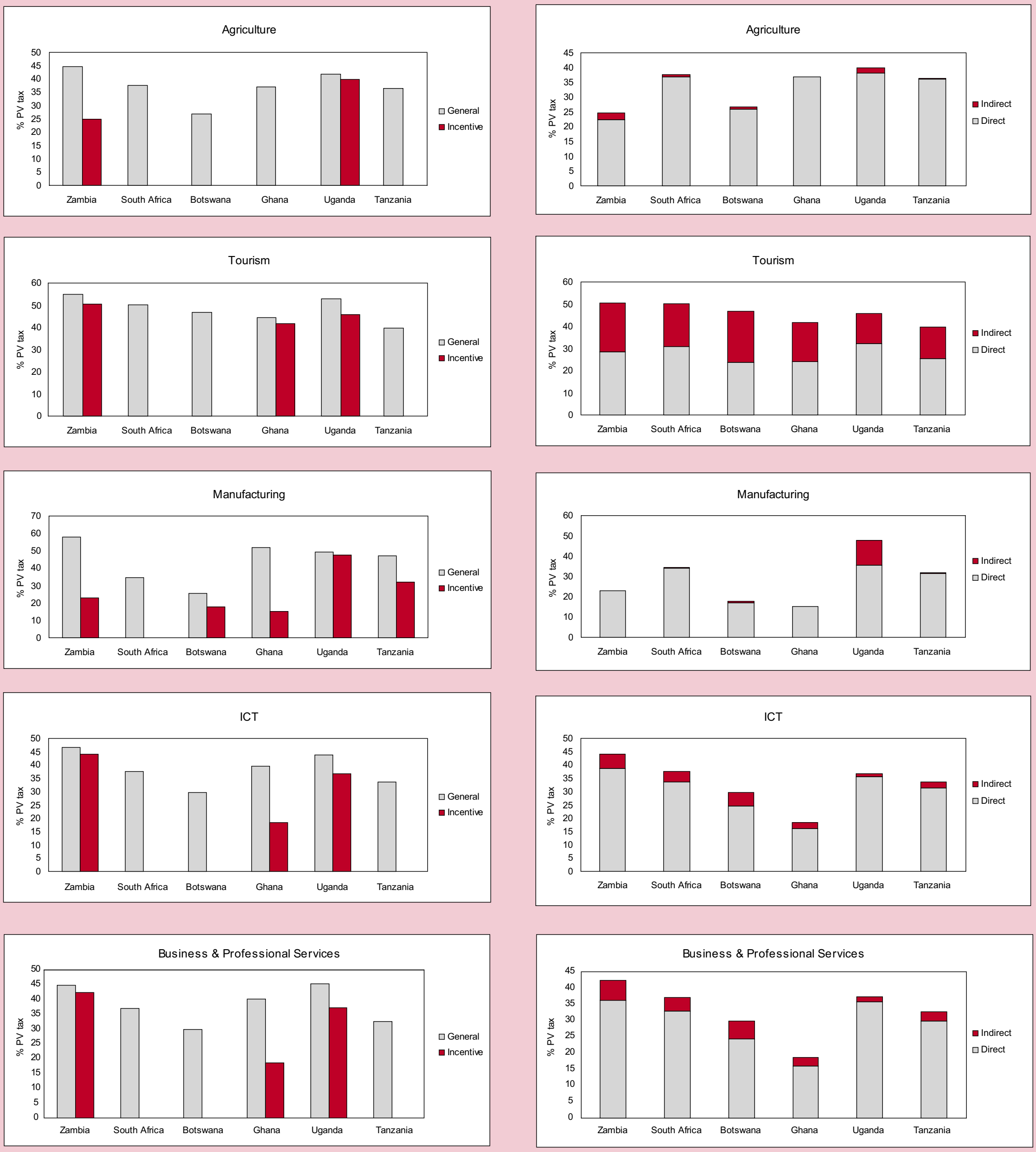
In 2001 additional concessions were extended to the tourist industry, in particular zero-rating their activities for VAT purposes, initially for a two-year period and then extended for a further two years.

Box II.2 presents a comparison of Zambia's taxation of investment with the tax regime in other regional and leading African destinations for FDI.[14] The comparison covers five sectors and does not include the mining sector. The following conclusions may be drawn with respect to the competitiveness of Zambia's taxation regime:

- The general system of taxation (excluding special incentives) places Zambia among the countries with the heaviest tax burden among comparator countries for all sectors.
- Generous incentives for the agriculture and manufacturing sectors reduce the tax burden under the incentives scheme to the lower levels among comparator countries. The manufacturing incentive applies only to non-traditional exports and was eliminated by the repeal of the Investment Act when the 2006 ZDA Act was introduced.
- Sectors that do not benefit from generous special incentive schemes remain heavily taxed when compared to countries in the region.

[14] See Annex 1 for the methodology of international tax comparisons.

Box II.2. Comparative taxation of selected sectors



Left hand column shows general and incentive present value tax rates. Right-hand column shows breakdown of best available tax rates, therefore using incentive rate where available.

3. Multi-Facility Economic Zones

The ZDA Act establishes the concept of multi-facility economic zones. Unlike export processing zones, which were never established in Zambia, the proposed Multi-Facility Economic Zones (MFEZs) will not enjoy customs extra-territoriality, but function like industrial parks with good quality facilities, infrastructure and incentives. MFEZs are intended both for domestic and export-oriented activities, in production and trade.

Section 18 of the ZDA Act allows the Minister, with the approval of Cabinet, to declare an area, premises or building to be a multi-facility zone, and indicate the facilities to be provided and maintained within a MFEZ. The Act also allows for the private sector to develop and operate MFEZs. The Act is broad enough to enable an enterprise that is not situated within an MFEZ complex to be declared as an MPEZ. For example, a textile operation in close proximity to cotton farms, could be considered virtual zones and be subject to the same privileges as MFEZs.

Investors must be in a priority sector (as defined by the Minister of Commerce, Trade and Industry under the ZDA Act) to operate within MFEZs. Zone developers will be granted a ten-year tax exemption on profits and dividends, and relief from import duty on equipment. Investors within an MFEZ will receive a tapered relief from profits tax over ten years, a five-year exemption from dividends tax and exemption from import duties on raw materials, intermediate and capital goods. The profits and dividend taxes exemption period will begin from the first year that profits are earned. Additional incentives, that have been passed by Cabinet for inclusion in the next budget, include a number of double-deductions on corporate income tax. These cover expenditure on export promotion; human resource development; research and development; recreational facilities for staff; and the fight against HIV/AIDS, tuberculosis and malaria. A 100 percent tax allowance will apply on infrastructure improvement.

As mentioned in the previous section, the ZDA Act states that only investments above $500,000 can qualify for incentives. However, it does not say whether this rule will also apply to the incentives in MFEZs. If it does apply to MFEZs, it risks excluding a number of potential investors. This should be clarified.

Before MFEZs can be designated, a number of operational and procedural matters, including clear definition of the rights and obligations of operators, need to be clarified by statutory instrument. The government is currently examining the feasibility of export trade MFEZs in the following border towns, namely Kasumbalesa and Chembe (with the Democratic Republic of Congo), Muinilunga (with Angola), Polungu (with the Great Lakes), Chirundu (with Zimbabwe) and Kazungula (with Namibia, Botswana and Zimbabwe).

4. Assessment of the fiscal framework

Zambia needs to take an integrated view of its fiscal structure. As Box II.2 shows, the overall tax burden is high compared to its regional competitors and is only reduced in certain sectors, most significantly in agriculture and manufacturing, by the incentives on offer. The new ZDA Act removes the incentive for non-traditional exporters and appears to put agriculture incentives beyond the reach of SMEs. At the same time, the new MFEZ regime grants exceptionally generous incentives to larger investors that are located in MFEZs or can be deemed, as single enterprises, to be MFEZs.

The MFEZs incentive will create an especially favorable regime (for corporate taxation and for import duties) for those who qualify and leave other investors to deal with relatively high levels of taxation. It appears that those disadvantaged will be the smaller investors. It should be noted that MFEZ investors will also benefit from duty relief on raw materials, intermediate inputs and on capital equipment even if they are not solely exporters. This could be another source of differentiated treatment compared with other enterprises competing in the domestic market.[15] International experience indicates that these kinds of regimes lead to discriminatory treatment.[16]

The Government might consider reducing the overall tax level and rationalizing its incentive scheme as a way of stimulating local and foreign investment, which will bring with it greater fiscal revenue. Such a move would also signal the government's commitment to broad-based private sector development. In particular there should be no discrimination against smaller investors.

With regards to VAT, the ZRA needs to address the concerns of the business community on cumbersome forms and the high incidence of audits following the submission of claims.

Finally, Zambia has signed Double Taxation Treaties (DTTs) with a number of countries that are important to it as far as trade and investment is concerned. The countries that Zambia has signed Double Taxation Agreements with are Botswana, Canada, Denmark, Finland, France, Germany, India, Ireland, Italy, Japan, Kenya, Netherlands, Norway, Romania, South Africa, Sweden, Switzerland, United Republic of Tanzania, Uganda, United Kingdom and the United States. The expansion of Zambia's DTT network to more Asian countries from which Zambia is trying to attract FDI, particularly China, is essential. DTTs facilitate cross border activity by clarifying the extent to which a TNC's operations will be taxable in the host country.

5. Employment

Employment conditions are covered by the Employment Act. It is Zambia's fundamental law in this area and provides for basic employment terms such as the minimum contractual age, establishment of employment contracts, settlement of disputes, and appointment of labour officers.[17] It also provides for certain conditions of employment, such as ordinary leave, sick leave, maternity leave, redundancy and welfare of employees.

The rights and obligations of employers and employees are covered mainly by the 1993 Industrial and Labour Relations Act. The Act encourages consultation with employees by management through works councils. The Act also defines the role of trade unions and outlines frameworks for strikes and minimum wages. According to the Act, the Industrial Relations Court is the final arbiter of disputes.

Zambia is a highly unionized country. For most jobs, wages are determined through collective bargaining and once the parties have come to a consensus, the collective agreements are forwarded to the Minister for approval. However, there are some types of work, such as management, where workers are not represented by unions. Minimum conditions for these are set by the Employment Minister through Statutory Instruments every two years.

[15] Unlike conventional export processing zones, the MFEZs can produce up to 100 percent for the domestic market.

[16] Mauritius and Sri Lanka are examples. See Investment Policy Review of Mauritius, UNCTAD 2001, and Investment Policy Review of Sri Lanka, UNCTAD 2004. Mauritius is now embarking on a consolidation exercise.

[17] Zambia's Employment Act is currently under review.

Investors in Zambia face two main problems in the general area of employment. The first is a very frequent industrial action. Part of the cause for this is that many strikes are not carried out in accordance with the law and collective bargaining agreements. Dispute resolution mechanisms are provided in the law but do not seem to be fully used.

The second problem relates to severance pay, which is currently set at three months basic pay for each completed year of continuous service. This is fairly high compared to other countries, as shown in Table II.1 and encourages many investors to opt for short-term contracts that are not conducive to skills-transfer. The setting of severance pay was recently moved from statute to within the scope of collective bargaining between employers and unions. It is therefore possible that the level of severance pay will be reduced. This is a positive move. However, the severance pay of non-unionised workers employed at the minimum wage remains at three months per year and stays within the scope of statute.

Table II.1. Comparative Survey of Statutory Redundancy Payments

Country	Statutory Redundancy Payment
Egypt	Half a month's pay for first 5 years of service; 1 month for each subsequent year.
Ethiopia	30 days wages for first year of service, 40 days wages for subsequent years, with a maximum of 12 months wages.
Indonesia	One month pay per year of service, up to maximum of 5 months.
Kenya	Not less than 15 days of each completed year of service.
Lesotho	2 weeks wages for each year's service, after minimum of 1 year plus one day's wages for each month of service in which the worker has not taken vacation.
Malaysia	10 days wages for first year, 15 days wages for 2-5 years, 20 days for more than 5 years.
Mauritius	Generally 15 days wages for each year's service.
Mexico	Generally 6 months wages for first year of service, 20 days for each additional year.
Namibia	For workers with one or more years of service, 1 week wages for each completed year of service.
Philippines	1 month's wages per year of service in case of reorganisation. Half a month's wages per year of service in case of closure.
South Africa	1 week's wages per year of service.
Spain	20 days per year, maximum 12 months wages.
Swaziland	10 days wages for each year's service above each year.
Tunisia	1 day per month of service, up to 3 months maximum.
United Kingdom	1.5 week's wages per year while worker was above 41. 1 week's wages per year while worker was between 21 and 41. Half a week's wages per year while worker was below 21.

Source: Termination of Employment Digest, ILO Geneva, 2000

Zambia's labour relations are currently under review with a view to improve and refine existing legislation, including the Employment Act and the Industrial and Labour Relations Act. A comprehensive social security programme has been designed but not yet implemented.

6. Non-citizen employment

Employers who wish to employ expatriate staff are required to apply for work permits from the Immigration Department. The Immigration and Deportation Act enables the Immigration Department to issue work permits on the basis of the applicant's qualifications and experience and on the basis of local labour market tests. The ZDA Act provides for the Agency to assist an investor, who invests a minimum of $250,000 and employs a minimum of 200 Zambians, to obtain up to five work permits. Work permits are generally issued for two-year periods. The minimum employment stipulation for this support has recently been added by the introduction of the ZDA Act.

The conditions for obtaining work permits are very restrictive for a country in need of qualified personnel. As it stands, this law does not take into account the needs of different sectors for expatriate staff. For example, industries that are knowledge-intensive but invest less capital, such as ICTs, can require extensive foreign expertise to put certain technological systems in place. The law also does not take sufficient account of the needs of larger investments that have significant management requirements and may require headquarters expertise to operate the company's organisational systems, whether in finance, procurement, supply chain management, marketing, strategic planning or human resources.

The Immigration Department states that it will exercise flexibility in certain cases, where the benefits to Zambia of foreign expertise has been made clear. Up to now, this has been facilitated by the Zambia Investment Centre, attending the Immigration Department's twice-weekly meetings that review permits. Despite this, many bona fide investors have encountered difficulties in applying for work permits and have expended considerable time and energy in the process.

The current arrangements also send out confusing signals. On the one hand, the law provides for facilitated access to five work permits for technical and managerial expertise, although these must meet the local labour market tests. This scheme does not offer an automatic entitlement of five permits. On the other hand, the authorities report that they will ensure that key positions are covered, although their definition of key position is usually restricted to the director level. Investors report having difficulties in obtaining permits especially where the concerned professions include accounting and finance, for which it was perceived that there are Zambians with these skills who could fill such jobs. There is a need for clearer regulation in this area. Predictability is an important concern for investors and best practice involves having clear policies and consistent application of the law.

Zambia might consider an automatic work permit quota scheme of the kind that is becoming increasingly used elsewhere as an investment promotion initiative. Such schemes are used in order to facilitate large or priority investments. They enable an employer to hire a limited number of expatriate personnel without the need to pass a local labour market test. In most cases, the positions are indefinite and not subject to compulsory localisation or to the appointment of citizen understudies.

In other developing countries, the entitlement to such permits is typically based on the size of investment and not on number of local staff employed, as the former is a sufficient indicator of the importance of the investment. Malaysia, for example, offers one key position for investments of RM

500,000 (about $140,000) rising to five positions for investments of RM 5 million. Ghana offers one position for investments between $10,000 and $100,000, two positions between $100,000 and $500,000 and four positions above $500,000.

It is recommended that the Government introduces an automatic work permit scheme to investors in any sector, providing for a number of automatic work permits to be issued in relation to the size of the investment. For example:

- Between $0 and $500,000, one automatic permit be awarded for every $100,000 invested.
- Between $500,000 and $2 million one automatic permit should be awarded for every further $250,000 invested.
- Above $2 million, one automatic permit should be awarded for every further $1 million invested.

In order to assist designated priority industries, improved entitlements could be offered. The Government has recently approved a scheme in which foreign investors in MFEZs would be entitled to five automatic work permits and one permanent residence permit for a minimum investment of $500,000. This scheme should be made available to all priority manufacturing industries and extended so as to allow a greater number of permits for larger investments.

In due course, attention should also be given to a special scheme for priority services industries. An industry-by-industry approach has to be taken to accommodate services. Some service industries, such as IT-enabled services, typically entail modest investment but require highly skilled expertise. On the other hand, hotels and utilities are more capital intensive.

These arrangements would bring important predictability to investors, and they should not prejudice investors from applying for further permits, subject to the existing provisions of the Immigration and Deportation Act, including the need to pass a local labour market test.

In all cases, whether or not the position is filled as part of an automatic work permit scheme, the individuals to be recruited will still need to be appropriately qualified and to pass the usual security and health checks.

7. Land

Zambia's land system is divided into two categories. These are customary (otherwise known as tribal) land and titled land, which exists as leasehold of 14 or 99 years. No land can be owned in freehold.

All titled land is governed by the Land Act of 1995 and is vested in the President. It can be inherited but can only be sold, with presidential consent, through the Commissioner of Lands. Presidential consent is also required to renew or extend the lease. Where state consent is needed, it is usually granted in a few days as a matter of routine. If no consent is received after 45 days, the consent is deemed to be granted. Whilst no delays seem to be occurring, the requirement for presidential consent for transactions involving titled land is an intervention in the land market that does not appear to serve any public purpose and imposes unnecessary risks for investors. A removal of the provision should be considered. Government oversight should be confined to land use matters and to due process in the conversion of customary land to titled land.

Titled land is allocated for specific use. Thus, land designated for residential purpose cannot be used for, say, industrial building or agriculture without the express authorization of the Commissioner of Lands, acting on behalf of the Head of State.

Customary land and settlement on customary land is governed by customary law and is not covered by the Land Act.

Customary land can be converted to titled land. It first requires the tribal chief to give his consent to declassify the customary land. This procedure is handled by the local council, which is now also responsible for demarcating customary land suitable for title. It then requires the consent of the President to be sold as titled land. This latter procedure can take up to six months.

On the first issue of leasehold for titled land the initial lease is for 14 years. The owner must apply after 14 years to extend the leasehold to 99 years.

A non-Zambian may apply for titled land on the following conditions:

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

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

Foreign investors have reported constraints with respect to land administration:

- Slowness on the part of the councils to open up land for allocation (which has been explained principally by inadequate surveyors and surveying equipment);
- Cumbersome procedure to convert customary land to titled land. Given that most land in Zambia is customary, this is important.
- Poor building standards due to weaknesses at the plan approval stages and inadequate supervision during construction;
- Poor record-keeping;
- Over-centralisation of processing procedures; and
- Insufficient co-ordination between councils and the Ministry of Lands, which ultimately considers and approves applications for property title.

In order to ease the situation, the ZDA and Surveyor General's department are implementing a land bank programme to identify land appropriate for investment. Where the land concerned is customary, the Government plans to negotiate with tribal chiefs to convert the status in anticipation of investment. In urban areas, where the land is titled, the programme intends to purchase the land and either lease or sell it to interested investors.

8. Competition policy

Competition policy in Zambia is governed by the Competition and Fair Trading Act. This act is enforced by the Zambia Competition Commission. According to the Act, the Commission's role is to prevent abuse of dominant position, predatory behaviour, discriminatory pricing, restrictions on distribution and collusion. The Commission is an independent body and its decisions can be appealed against in the High Court.

The Commission has a significant impact on FDI as it must authorize all mergers and acquisitions before they are completed. The Commission applies a merger threshold of 50 percent, which compares well internationally. This means that the Commission must investigate the investment if the newly created entity would have more than 50 percent of the market or if the new entity, together with two other existing firms in Zambia, would together have more than 50 percent of the Zambian market and therefore risk oligopolistic behaviour. In investigating, the Commission bases its assessment on whether the merger or acquisition would restrict or distort competition 'to an appreciable extent' or have a negative effect on the economy.

Although most foreign investors view obtaining investment licenses from the ZDA as the critical entrance issue, for investors merging with or acquiring Zambian companies the clearance of the Competition Commission is also an important regulatory process to take into account.

Investors' experience of the Commission has been positive. Companies surveyed by UNCTAD agreed that the Commission's past authorizations of mergers have shown a good balance between competition objectives and concern for policies aimed at promoting foreign investment in Zambia. Furthermore, investors appreciated the Commission for dealing swiftly with requests for approval.

The Commission also plays a valuable role for investors by ensuring that players entering the market do not meet structural entry barriers such as highly concentrated industries and exclusive dealing contracts, with major distributors that could limit market access.

The officials of the Commission are clearly aware of the fact that in enforcing merger provisions of the Act, they have to play a fine line. On the one hand, they must ensure that mergers in Zambia do not lead to adverse effects on its trade or the economy, and on the other, that FDI is not curtailed by unnecessary administrative hurdles.

9. Rule of law and commercial justice

A well functioning commercial justice system is an essential part of the infrastructure necessary for the private sector to develop. Modern business laws, coupled with an efficient judicial system, are a prerequisite for investor confidence in the rule of law of any country.

Investors who were interviewed noted that the commercial justice sector was failing to adequately serve their needs, often due to continual adjournments by the Zambian courts. In addition, many of the current commercial or business related laws are outdated and some modern business practices are not covered by current laws. The unsatisfactory state of Zambia's commercial justice sector, in both the adjudicative and legislative areas, could have adverse implications for the country's investment climate at the following levels:

- Business contracts may be constrained, with undue reliance being placed on personal relationships as a contract enforcement mechanism. This results in businesses being risk-averse and doing business with limited, well-established networks;
- Shortcomings in the commercial justice environment could become a significant constraint to FDI to the extent that foreign investors tend to be excluded from the local established networks.

A reform of Zambia's commercial justice system should reflect the needs of a modern market economy, including the economic importance of swift and impartial settlement of commercial disputes whether involving national or foreign investors. Reforms appear necessary at three levels:

1. Courts responsible for commercial issues need to develop a stronger customer service approach. They should initiate a case backlog clearance programme, an efficient case administration system and a forum for dialogue between the court administrators and the private sector.

2. Courts should ensure that weak cases are quickly disposed of and encourage plaintiffs to use alternative methods of dispute resolution. National arbitration was discussed in Section B.4.

3. The Government should review civil procedure rules in order to prevent abusive use of the system. A key change should be to abolish redundant steps in the proceedings.

10. Intellectual property protection

The Patents Act, Trade Marks Act, the Registered Designs Act and the Copyright and Performance Rights Act provide the legal framework for intellectual property protection in Zambia. These laws are in line with international practice in this domain:

- The Patent Act provides strong patent protection for a period of 16 years, with the possibility of renewal. The decision of the Registrar in awarding or refusing a patent can be contested in court, as can patent infringements by third parties.
- The Copyright and Performance Rights Act and the Registered Designs Act provide copyright protection of 50 years (copyright) and 5 years (registered design).
- The Trade Marks Act provides exclusive protection, initially for seven years, renewable in 14 year blocks thereafter. Again, decisions of the Registrar can be contested in the High Court

Internationally, Zambia has signed the 1883 Paris Convention on protecting industrial property and the 1886 Bern Convention protecting literary and artistic works. The country also signed the 2000 Patent Law Treaty, although it has not yet entered into force.

Zambia is a member of WTO and, as an LDC, has up to 2006 to conform to TRIPs for patents. Pharmaceutical patents have until 2016 to conform. The Patents and Companies Registration Office is responsible for administering the Acts. The country is also member of the African Regional Industrial Property Organisation, which was established to promote harmonisation of intellectual property laws in the region.

11. Licensing and the administration of regulations

Procedures for company registration in Zambia are fairly straightforward and do not seem to pose an impediment to investors. A certificate of incorporation is issued by the Patents and Companies

Registration Office (PACRO) within a few days of submission of the necessary documents. Registration is computerized and records are shared with the Zambia Revenue Authority, enabling a single identification number. The US Millennium Challenge Account will provide the funding to establish a limited network of provincial offices, removing the need for investors outside Lusaka to make the journey to the capital

According to 2006 World Bank statistics, Zambia performs well in terms of ease of starting a business (Table II.2). The number of procedures required is half the regional average and less than the OECD average. While the cost of establishing a business remains high compared to neighbours such as Botswana and South Africa, it is also below the regional average.

Table II.2. Starting a business

Indicator	Zambia	Botswana	Ghana	Lesotho	Namibia	South Africa	Sub-Saharan Africa	OECD
Procedures (number)	6	11	12	9	10	9	11	6.5
Time (days)	35	108	81	92	95	38	63.8	19.5
Cost (% of income per capita)	18.1	10.9	78.6	56.1	18.8	8.6	215.3	6.8

Source: www.doingbusiness.org (World Bank).

Nevertheless, investors complain that for certain sectors, such as tourism, a large number of licenses do need to be obtained. These involve a number of different authorities for the same business proposal (see Box II.3). The number of licenses, the time required to obtain them, the discretion given to the authorities in their decision-making process, the requirement for annual renewal, the associated and often uncoordinated inspections, and the cost of fees add up to being a significant impediment to many foreign investors.[18]

The administration of regulations governing foreign investors is greatly affected by the perception towards FDI by individuals and government bureaucrats. In this connection, UNCTAD was informed that some government departments seem more welcoming of FDI than others. This creates the impression that there is lack of a coherent FDI policy followed by all government agencies.

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

Box II.3. Tourism sector: requirements for entry of FDI

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

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

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

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

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

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

Source: UNCTAD Survey.

Procedures can be further streamlined and simplified. The computerization of registration provides a good base to build on. It is recommended that the Government:

1. Enable business registration to be processed via the web or, at a minimum, make the necessary forms web-accessible.

2. In order to maintain consistency across government towards processing licenses for investors, ensure that ZDA has the support, at the highest levels, of all government agencies that implement FDI policy. This could be done through a series of workshops and seminars addressing perceptions of FDI.

12. Overall assessment of general measures

While Zambia has undertaken a number of reforms in the last fifteen years, much business-related legislation still bears traces of the country's state-controlled past.

The procedures for business establishment have become more restrictive and cumbersome in the new ZDA Act. Now, all new investments are subject to compulsory screening and approval by the ZDA, on top of other licences and regulatory approvals that must be obtained.

Zambia's fiscal regime is characterized by relatively high corporate income tax rate, which then needs to be compensated for by piecemeal incentives. The new incentive regime introduced by the ZDA Act appears (the Act is not clear) to preclude access to these incentives to small and medium investors, and the new MFEZ regime has launched a new round of incentives, introducing further discrimination against smaller investors. The fiscal framework should be reviewed in order to reduce the currently high standard rate of taxation, while at the same time removing many of the incentives that have so far enabled tax payers to avoid paying the standard rate. Such reforms need to take into account both the impact on investor returns and Zambia's needs for public revenue (and, in turn, its ability to fund important improvements in infrastructure and education that are important for investment competitiveness).[19]

East Asia is emerging as an important source of FDI for Africa. In order to facilitate investment from the region, Zambia should negotiate double taxation treaties with the relevant countries.

Labour disputes have had a harmful effect on Zambian industry. Dispute resolution mechanisms and industrial action laws must be more strongly applied.

The requirement of presidential consent for land transfers should be removed as it is a government intervention in the land market that serves no public purpose and increases investment risk. Government oversight should be confined to land use matters and to due process in the conversion of customary land to titled land.

If compulsory licensing is removed, then foreign investors who do not apply for an investment license will no longer benefit from national treatment on land matters. Regulations will therefore need to be amended in order to enable foreign investors without a license to acquire land.

[19] When UNCTAD advised the Government of Mauritius in 2002 on a similar fiscal reform programme it was required to keep the net fiscal loss of its recommended reforms (including import duty reductions) to 2% of GDP. Egypt introduced a "flat" 20% corporate tax rate in 2005. Whilst there were some early losses of tax revenue, it is now seeing an uplift because the reform is coinciding with strong economic expansion.

The work permit system can be vastly improved by introducing an automatic quota system to enable investors to recruit abroad for a small number of key positions. More generally, clear guidelines on the awarding of work permits should be introduced and published.

Zambia's commercial justice system is inadequate from the point of view of investors. The courts should adopt a more customer-focused approach in order to clear cases quickly. Weak cases should be disposed of or sent to arbitration, and civil procedure rules amended to prevent abuse.

III. STRATEGIC PERSPECTIVES ON FDI AND DIVERSIFICATION

A. Background

Since the 1990s, FDI has come to play an increasing role in Zambia's economy, contributing to increased capital inflows and investment, rehabilitating the copper industry and boosting the production and exports of non-traditional products and services. However, Zambia has under-performed in using FDI in support of development and poverty reduction. Even though it has in many respects greater potential to attract FDI than other LDCs in the region, it is, relative to population and size of economy, being outpaced by its neighbours. Moreover, spillovers from FDI to local enterprises, including technology transfer, have been rather limited, and has not contributed to strengthening competitive production and diversifying Zambia's production and export base.

Economic diversification to reduce the dependence of the economy for foreign exchange earnings and income on a single commodity, copper, has been a long-term objective of subsequent Zambian governments, reiterated recently in the context of FDI. The withdrawal of Anglo-American from Zambia in 2002 refocused attention on the issue. Shortly after Anglo's announcement, a task force was established by the Government to address this issue anew. The task force urged the Government to "accelerate efforts to diversify the Zambian economy as a matter of urgency by implementing, in calendar year 2002-3, the necessary policy changes and public investments" and also recommended the preparation of a National Economic Diversification Programme. Such a programme was subsequently prepared and inspired the Private Sector Development Programme (discussed in Chapter II). Activities identified as priorities included agriculture, agro-processing and tourism.

There has been some diversification of Zambia's economy, which, in particular, reduced its dependence on copper. The share of copper in exports fell from 90% in 1969 to 52% in 2004. But this has happened owing to both the expansion of non-copper activities (notably agriculture, manufacturing and services such as trading and tourism) and the initial drastic decline of the copper industry (Chapter I). Yet, with the significant increase in copper prices since 2004 and with the support of FDI, copper exports are growing again.

New promoted activities will sustain diversification only if they are internationally competitive. This calls for the inclusion of infrastructure services in the programme of diversification. Even though these services are not tradable and do not generate foreign exchange revenues directly, they are inputs into the production of other goods and services. They are thus a key determinant of the competitiveness of the entire economy. In Zambia, as will be seen below, they are uncompetitive, and often of poor quality or unavailable, thus hampering the competitiveness of priority activities and copper mining (for example, the high operating costs of the copper mines can be partly ascribed to the high price and poor availability of electricity).

The diversification programme should not neglect the need to assist the copper mining industry to be more competitive. Copper remains important for the Zambian economy, but its costs are significantly higher than international standards (this exacerbated the sector's previous decline). While higher copper prices will be around for some time it is by no means certain that a higher long term trend of copper prices has been established

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

B. Investment potential

1. General

At the country level Zambia has a number of advantages that are attractive to foreign investors, when compared to other countries in the region. The country is peaceful and the political and security situation is stable. It has many natural endowments, the exploitation of which requires substantial capital investments. Although its local market is small, Zambia has free or preferential access to regional markets as a member of COMESA and SADC, and to developed country markets under GSP, the ACP-EU Agreement, the Cotonou Agreement, the EBA initiative (to the EU) and AGOA (to the United States). Thus, Zambia is well-placed to attract export-oriented FDI, capitalizing on the country's comparative advantages and market access. In addition, its mining sector has the potential to generate foreign exchange earnings that are required for the acquisition of capital goods and advanced technology. The economy is relatively open to trade and most of the policies that restricted private economic activities in the past have been removed. The country was ranked 2nd by the Openness to Trade index and 1st for its Average Tariff Rate in the African Competitiveness Report 2000. Its workforce is large and labour costs are low by international standards. In 2004, 68 percent of Zambian adults had completed primary education.

However, Zambia's comparative advantage and access to markets may not be enough to attract export-oriented FDI, especially in manufacturing and services such as tourism, where the competition among countries is particularly intense. FDI can help. It represents not only capital, but access to technology, technical and managerial skills, and the knowledge of, and access to, marketing channels. But for such FDI to be attracted on a much larger scale than so far, Zambia has to create a supportive operational environment for firms, reduce the high costs of doing business in Zambia and improve infrastructure and the availability of producer services.

2. Potential by sectors and activities

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

a. Resource-based activities

Copper: In spite of a long history of copper mining, Zambia still has abundant copper resources in both newly discovered deposits (such as Lumwana and Kansanshi deposits in north-western province) and in the existing mines, where production has recently expanded under foreign ownership. Medium-term prospects for growth of world markets for copper are favourable.[20] Copper mining has become more attractive to foreign investors with the doubling in copper prices between 2002 and 2005. This has greatly improved the chance to develop the Konkola Deep deposit, the largest in Zambia, with estimated reserves of 400 million tonnes and an annual production capacity of 200,000 tonnes.[21]

Zambia's regulatory framework for copper mining, introduced in the mid-1990s, is attractive to potential investors: the treatment of mining FDI in terms of licensing, incentives and taxation compares well to those of other countries where mining is an important economic activity. The change in the ownership of two large mining companies – Ramcoz and KCM – has greatly improved prospects for copper production. With the increased copper prices and the higher investment in mining worldwide, the need to provide additional incentives to the mining sector (which have resulted in low tax revenues from copper mining) has become questionable. The deal with Vedanta, with KCM operating profitably at current prices, was therefore concluded without any special tax concessions, increasing prospects for greater tax revenues.

Zambia's main weakness stems from its relatively high production costs. The production costs of major producers range from $0.30 to $0.45 per pound. In contrast, the weighted average cost of Zambian copper mines is $ 0.58 per pound, although down recently from over $0.80 per pound. High copper prices have eased pressure on margins, but they may not last for ever. In the long-term the high costs of production compared to its competitors will be a major threat to the growth and investment potential of the Zambian copper mining industry. The reasons for the low efficiency of the Zambian mining sector are numerous. Some are internal to the mines and include inadequate investment, overstaffing and poor management; however this situation started improving with the large recent inflows of FDI. Some are external and include high transport costs, unpredictable costs of locally supplied inputs, and the high price and poor availability of energy. Since these are also obstacles to exploiting investment potential in non-copper activities, they will be discussed later in the chapter.

Gemstones: Zambia has an abundance of precious and semi-precious gemstones. These include emeralds (the second largest deposit in the world), tourmalines, aquamarine and amethyst (Africa's largest deposit), garnet and malachite. The focus on copper has left gemstones' potential largely unexploited. It is only thanks to small-scale mining investment - of which a significant proportion by foreign investors - that Zambia has begun to gain world recognition as a supplier of gemstones. Some investors engaged in gemstone mining, who were interviewed for this report, have suggested that with the right policy environment, appropriate infrastructure and institutional support, the sector has an export potential greater than the current value of copper and cobalt exports. International demand for gemstones is strong, not only in Europe and North America, but also in South-East Asia.

[20] The volume of world exports of copper ores and concentrates rose by 75% between 1995 and 2000, from 2.6 to 4.5 million tons. The International Copper Study Group expects world refining capacities to increase by 11 per cent between 2002 and 2006.

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

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

- **Lack of finance for investment and working capital**. There are currently about 450 registered investors with 10-year gemstone licenses.[22] With the exception of seven large and medium-sized foreign companies, the rest are small-scale local and foreign investors. Access to capital from local financial institutions for investment, and particularly working capital, is critical to them. However, partly because of the extremely high and volatile interest rates and also because of the reluctance of local banks to provide credit to small investors, the majority of license holders are either not operating at all or are operating at much lower capacity. The small-scale foreign investors frequently initiate their projects with finances obtained overseas, but as the project advances they use local credit facilities to raise funds for working capital. At the current bank lending rates, miners claim that this option is not viable. If so, in awarding licences the Ministry of Mines and Mineral Development should accept that this is a constraint and not award licences to operators that cannot provide or procure adequate funding.

- **Poor road access to mining areas**. Zambia's transport network has been developed with a view to cater to the needs of copper mining, which is concentrated in the Copperbelt region. But gemstones deposits are spread all over the country, in rural areas, away from the transportation network. One of the leading companies in gemstone production, for example, Old Mukushi, is located 100 kilometers from the nearest tarred road, while another leading firm, Mapatiza, is 70 km away. The distance is even greater for firms operating in the north-eastern part of the country. Some of the mines close during the rainy season, because they become inaccessible or because the equipment and energy sources needed to keep the mines dry are lacking.

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

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

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

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

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

Agriculture: Arable land in Zambia is estimated at 74 million hectares, and about 14 per cent of this is currently used for agriculture.

There is also a plentiful water supply from rivers and lakes, which provide the country with considerable potential for irrigation and hydroelectricity supply[23] Foreign investors' interest in agriculture is increasing. FDI has been instrumental in increasing exports of horticulture and floriculture products in recent years. In response, the Government has developed plans to put aside 1 million hectares of land divided into nine blocks across the country for cultivation and investment, and develop them. Agronomic surveys have been carried out and where necessary, the status of the land is being converted from tribal to titled. Three of the land blocks are currently being developed and will be used to pilot the scheme.

Besides sugar and cotton production, which are major cash crops, Zambia can also easily support the growing of fresh and out-of-season horticulture products. The rich variety of crops gives Zambia greater scope to move into higher value added agro-processing. There are growth prospects for major staple food and processed food products in the regional and developing country markets. While Zambia has preferential access to COMESA and SADC, tariffs for food and processed food products are high in Asia, Arab and North African markets. Zambia is paying MFN duties in these markets as it is not a member of the Global System of Trade Preferences among Developing Countries (GSTP) under which many of the major developing countries have exchanged tariff preferences between themselves.

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

b. Manufacturing

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

Textiles: Zambia has a comparative advantage – the availability of cotton – which has not yet been turned into a competitive advantage in the production of textile products in spite of the privileged access to a large United States market under the Africa Growth and Opportunities Act (AGOA) for which Zambia and other eligible African countries have unlimited duty-free and quota-free access to the US market. So called AGOA I (originally due to expire in 2004, but currently extended to September 2007) has no local content requirement for fabrics (which means that they can be imported from cheapest sources), AGOA II will require that the yarn or fabric be either produced locally to encourage backward integration or be sourced from the United States or from other AGOA-eligible countries. But to date, Zambia has made only indirect use of the market access opportunities under AGOA. Cotton and poly-cotton yarn still account for over 90% of Zambia's exports of textile-related products. The industry had suffered from the lack of investment and poor management in the 1980s and early 1990s. This was partly reversed in the post-liberalization period when new investors, including foreign ones, acquired operations. In 2004, exports of cotton and other textiles increased to $143 million from $7.6 million in 1990. Most of these exports, consisting mainly of poly-cotton yarn as inputs for production of garments, have gone to other AGOA-eligible countries, namely, Lesotho and Mauritius, and to South Africa under the SADC Trade Protocol. Garments production in Zambia is hampered by high costs.[24] For example, Zambian producers are not able to compete in textiles exports to Europe, because of the high cost of transport compared to those of producers in Central and Eastern Europe and even in Central Asia.[25] The regional market offers a potential for exports of textile products, although even within this market the cost of transport can be a deterrent.

Copper products and mining services: Zambia's copper products extend to unwrought metals, copper wires and cables. There is wide scope for further vertical diversification towards downstream activities, such as the production of copper-based products and mineral-based chemicals. World demand for copper products is strong and prospects are good.

FDI in the mining supply industry is insignificant, although there is potential for upstream activities, such as the production of explosives and other inputs used for mining. Africa Explosives Limited (AEL), a foreign-owned company in manufacturing explosives for mines which acquired the State-owned Kafironda in 1997 under the privatization programme is indicative of this potential (Box III.1).

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

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

Box III.1. Developing mining supply industries

Zambia's State-owned explosives company, Kafironda, was taken over by African Explosives Limited (AEL) a leading explosives producer of South Africa. The company invested in new equipment and introduced new products and services, improving the key aspects of blasting techniques in Zambia's mining, and exporting the products to the DRC and Zimbabwe. The world market for explosives has been moving to bulk systems for both surface and underground mining. AEL has introduced these systems to a number of mines in Zambia, significantly improving blasting efficiency and providing cost savings to the customers. It relies on Zambia becoming a platform for introducing this method to the Central African market. In addition, AEL, through its Zambian subsidiary, has started producing and supplying mini-bulk explosives, which are specifically designed and tailored to the quarries and small-scale mining operations that are commonly found in Zambia. It has also set up a technical support team to train and assist its Central African customers.

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

Agro-processing: To date agro-processing is limited mainly to sugar refining, cotton ginning and spinning of yarn cotton, and some amount of dried paprika for exports. There is considerable scope for increasing sugar production and expanding the range and improving the quality of sugar products such as bagasse for generating electricity and its by-product, filter cake which is used in the production of fertilizer and rum. Presently, Illovo of South Africa with some minority foreign partners is the main sugar producer, selling 65 percent of the refined sugar domestically and exporting the balance to the region.[26]

c. Services

Tourism still represents a major potential growth industry for Zambia, in spite of its recent rapid growth, with tourism revenues rising from $35 million in 1990 to $578 million in 2003. Zambia's image as a tourist destination is far from fully tapped. Zambia's attractiveness lies in its diversity, which includes: an accessible wildlife; a varied and impressive scenery; unspoilt wilderness areas; abundant water resources; a rich cultural and natural heritage sites; sunny and hot climate. Zambia has 19 National Parks and 34 Game Management Areas (GMAs) covering 33 percent of the country, but only 5 percent has been developed for tourism. The country also has over 35 percent of the water resource in Southern Africa and the world famous Victoria Falls is located within its borders.

As a democratic country with a history of political stability and peace, Zambia is in a position to meet the growing demand for specialized tourism such as adventure tourism. It has the potential to develop special interests activities such as white-water rafting, hiking and fishing. These are upscale tourism activities, often generating high returns per tourist. Recent growth of tourism has been largely due to a rapid increase in private investment. FDI has created new tourism facilities in the Livingstone District, attracting an international clientele. Since the mid-1990s practically all publicly-owned tourism lodges and four major hotels in the country have been privatized.

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

Major tourist attractions, however, are in rural areas, which lack adequate access roads, electricity, telecommunication facilities and airline connections to main tourism markets. If these constraints are eased or removed, the growth potential for Zambia's tourism industry is estimated at doubling its recent direct and indirect contributions to domestic value-added and employment.

Infrastructure services: As mentioned earlier, telecommunications, water, electricity and transport services are strategically important for any diversification strategy. They impact on the supply capacity of Zambia's economy directly and indirectly and thus are important determinants of future investment and growth. Except for the Zambia Railways which has been concessioned and the liberalization of the cellular phone industry, other infrastructure services are still provided under monopoly conditions by state enterprises, most of which, according to investors and local business representatives, are poorly managed, are weak financially and provide uncompetitive services hampering competitiveness of many activities representing investment potential, as discussed earlier. If they are put up for privatization, they would represent a significant FDI potential. The reform and reinvigoration of these key services will be a great challenge to the government to pave the way for the country to realize its overall FDI potential. Section D.2 examines infrastructure services in greater detail.

C. Market access

Export market access is Zambia's key locational advantage for attracting FDI into manufacturing. Such FDI can exploit Zambia's rich resources, including agricultural raw materials, for processing. A window of opportunity for Zambia to attract export-oriented FDI is provided by Zambia's abundant access to important markets under various preferential trade schemes. While trade and investment opportunities are considerable and Zambia has a wide range of resources, to date, these resources remain under-utilized and the opportunities unexploited.

Two caveats need to be made immediately. One is that to exploit these opportunities, Zambia needs to improve its transport links with these external markets (see below). The second is that Zambia shares privileged or preferential access to these markets with other countries, and its producers will have to compete with suppliers from these countries. FDI can help enhance certain elements of export competitiveness. But more is also needed for improvements in infrastructure, as well as stable macroeconomic conditions with low inflation and interest rates, and a competitive exchange rate.

1. Preferential opportunities in trade and investment relations with the EU

Duty free and quota free access into the European Union under the Everything But Arms Initiative (EBA) for LDCs, which was introduced in 2001, grants better access conditions than under two earlier trade arrangements, the ACP-EU Agreement and the Cotonou Agreement.[27] For more than 1,000 agricultural and food industry products, preferences are no longer limited to a partial reduction of duties, as was the case with ACP imports. There is therefore a large, hitherto untapped potential for expanding exports to the EU. As of mid-2009 there will be no tariff quotas limiting duty free access of any agricultural or food industry products. Among others, sugar, canned fruits, fruit juices, jams and marmalades will be included. This opens a new perspective for export-oriented investments.

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

Such market preferences contributed to the rapid growth of two non-traditional exports, fresh vegetables and cut flowers, from Zambia by foreign firms. Zambian horticultural exports take place out-of-season, during the European winter period. There is substantial potential for export growth of both fresh fruits and vegetables and processed fruits and vegetables in the traditional UK and other EU markets.

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

Since May 2004, the enlargement of the EU market has enhanced access to new rapidly growing markets for semi-manufactures, manufactures and foodstuffs, under the Common External Tariff and its preferential arrangements. Additional market opportunities will arise for copper products as several new EU member countries are important copper processors and importers of copper products.

2. Preferential opportunities in trade and investment relations with other major developed countries

Zambia benefits from duty-free access for a large number of agricultural and industrial products to the US market under the United States GSP scheme and the US Africa Growth and Opportunities Act (AGOA). These schemes have been extended to include agricultural products such as tomatoes, cucumbers, dried onions and orange, grapefruit and other citrus fruit juices; and manufactures such as clothing, footwear, travel goods and a number of other industrial products. AGOA has created a substantial impact particularly on textiles and garments exports for several LDCs, namely, Lesotho, Madagascar and Malawi. However, so far Zambia has not used it to its advantage, as noted above. Using Zambia as a base for textile and garments production to enter the United States market will be enhanced when the third country fabric rule will no longer apply, after September 2007 because Zambia could easily meet the fabric sourcing requirement. This will present an opportunity to Zambia's textiles and garment industry. As Zambia has the raw material, it could attract investment aimed at textiles and garments production, including backward integration into fabric weaving and knitting. Currently, Mauritius, South Africa and several Far East producers are investing in garment production in some AGOA-eligible countries of Africa to gain access to the United States markets, but so far Zambia has not been able to attract any share of these investments.

AGOA also allows for the expansion of agriculture and food industry exports to the United States. American food safety requirements are particularly strict, however, and many import prohibitions are applied for health and sanitary reasons to African countries as a whole. American investment could help in making inroads into the United States market as investors can bring in the standards to meet the market requirements.

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

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

D. Policy challenges

What then can Zambia do, apart from further improving the investment framework (Chapter II), to better utilize its FDI potential in terms of boosting FDI inflows (annual inflows of over $400 million seem to be within Zambia's reach, at least for some time)? And perhaps more importantly, what can Zambia do to significantly enhance the benefits from FDI through, for example, stronger spillovers to, and linkages with, local enterprises, and greater FDI contributions to the diversification and competitiveness of the Zambian economy?

Actions and policy challenges to improve investment conditions across the board are considered below.

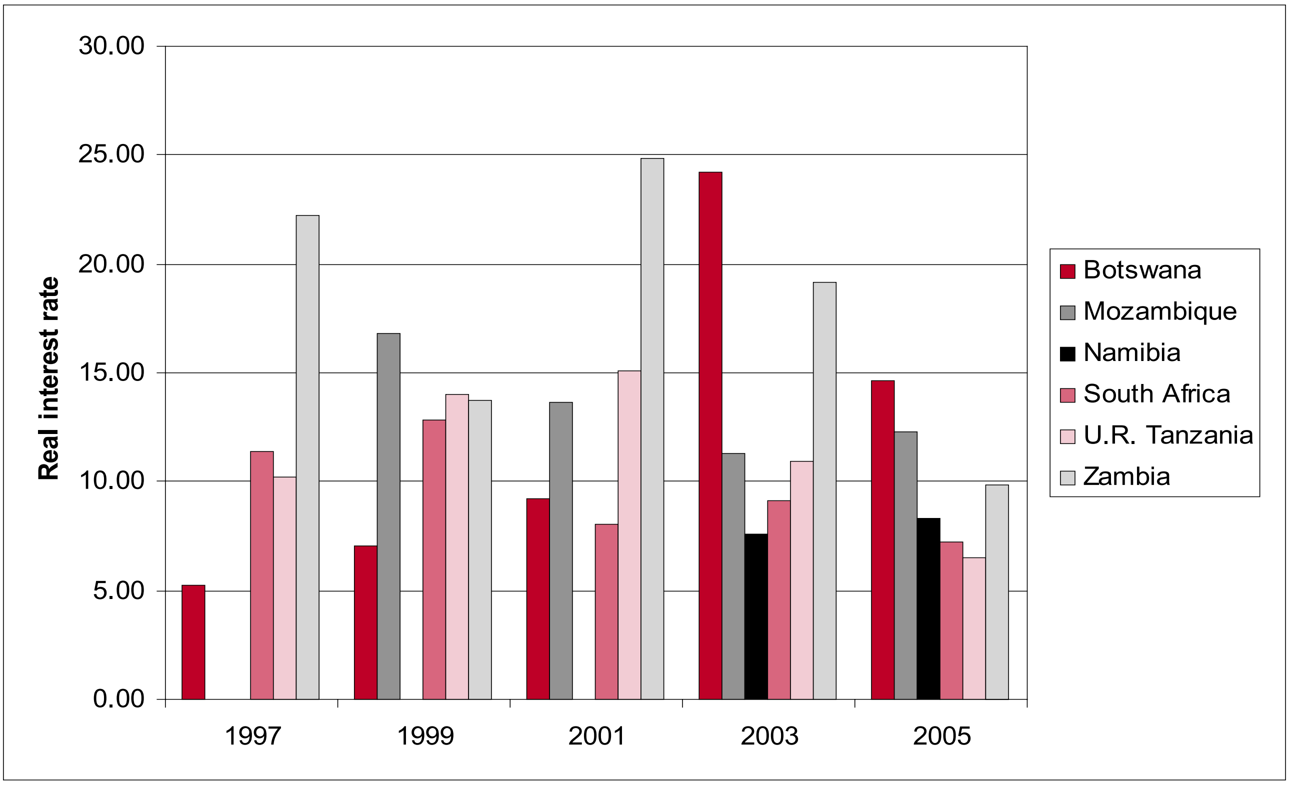
1. Macroeconomic climate

FDI policy in Zambia has not treated macroeconomic policies as an integral part of investment promotion efforts. For many years, key determinants of FDI inflows were understood mainly in terms of fiscal incentives, entry procedures and the provision of one-stop-shop services. The persistent instability of macroeconomic variables has been viewed simply as an unfortunate problem that hinders mainly domestic investment but not necessarily FDI, especially export-oriented FDI. This view was reinforced by relatively high FDI inflows during the 1990s, seemingly not affected by macroeconomic instability. But inflows were largely associated with privatization and concentrated on copper, where the impact of macroeconomic instability is less serious. Copper is sold in world markets, with earnings denominated in foreign currency. Moreover, large mining companies have access to international finance and their profitability is less exposed to fluctuations in local interest and inflation rates or volatility in the exchange rate. Large international hotels catering to international tourists can be in a similar situation. But linkages of local enterprises to mining companies and hotels are strongly and adversely affected by all these factors. Furthermore, not all FDI in Zambia operates in such an enclave environment.

Financing. For local entrepreneurs, a major obstacle to investment plans has long been the high real cost of domestic borrowing. This has also affected small- and medium-sized foreign investors, operating in non-traditional export industries, relying on local financial institutions for financing investment and working capital. This constraint for local firms could also have affected the creation of linkages between them and foreign firms. Recent improvements in the cost and availability of domestic lending should be acknowledged. The real cost of borrowing in Zambia has fallen quite sharply in recent years and, while still high, is now lower than in some regional peers. (Figure III.1). Factors in this improvement are likely to include HIPC completion in 2005, a reduction in government debt and a lowering of the statutory reserve ratio by the Central Bank. At the same time, commercial bank lending to productive sectors also increased from 6.2 percent of GDP in 2002 to 7.9 percent in 2004.

High inflation rate. Persistent high inflation makes business planning difficult and undermines investor confidence in a government's ability to manage the economy. Zambia's inflation was very high in the 1990's (in one year it was over 200 percent). This persistent problem for business has not yet been convincingly tackled. Inflation was still high in 2005, at around 17 percent (compared with Botswana at 7 percent, Namibia at 4 percent and South Africa at 1 percent). Incomplete data for 2006 suggest that inflation is now down to a single digit level and this is very encouraging progress.

Figure III.1. Comparative real interest rates 1997-2005



Source: IMF, International Financial Statistics

Exchange rate weakness. The post-liberalization period saw a large fall in the exchange rate, from 34 Kwacha per US$ in 1990 to 5,000 Kwacha per US$ in early 2003. This chronic weakness complicated business operations particularly for those enterprises producing for the local market and requiring imported inputs. For foreign investors, it also raised risks of receiving adequate returns and servicing debt when cash flow generated locally was converted to foreign currency. Since 2003, the exchange rate has been more stable. Indeed it has shown some strength since 2005 underpinned by favourable copper prices, renewed FDI in the mining sector, improved agricultural export performance and a positive donor response following Zambia's attainment of the HIPC Completion Point.

Consolidating today's greater macroeconomic stability should hold a central place in Zambia's investment promotion strategy. Endless refinements in specific policies and incentives to attract investment without convincingly overcoming the problem of macroeconomic instability will not lead to the desired outcome of broadening FDI and deepening its impact. Entrenching recently improved fiscal management will be a decisive factor in achieving this.

2. Infrastructure services

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

a. Transport

Zambia's landlocked location makes transport inherently expensive. However, this disadvantage is compounded by Zambia's poor transport system. Transport costs account for 60 percent to 70 percent of the cost of production of goods and commodities in Zambia.[28]

Zambia's railway network is well-positioned for transporting exports to the surrounding region and, in transit, to the ports of Benguela (Angola), Dar-es-Salaam (United Republic of Tanzania), Beira and Maputo (Mozambique), and the main ports of South Africa. Until the recent restructuring of the Zambian Railways, the railway system was rapidly deteriorating due to poor maintenance and lack of investment. Breakdowns and other operational problems were frequent, with negative consequences on the carriage of freight.

However, important improvements are foreseen, with the provision of a 20-year operating license for Zambia Railways to a South African consortium in 2003. This successful concession follows the contribution of ODA from the Swedish International Development Cooperation Agency (SIDA) (see Box III.2). The consortium is expected to pay $253 million to the Government during the life of the concession. At the same time, this operator has announced plans to rehabilitate 500km of track as well as rolling stock and other assets. The total investment is likely to be around $80 million and will improve the transit of goods and natural resource products from the copperbelt region to the Congolese border for transit to Angola, to the Zimbabwe border for transit to Mozambique and South Africa and to Kapiri Mposhi, near Lusaka, where goods can be transferred to the Tanzania Zambia Railway.

The Government has also signed an agreement with a private company, Northwest Railways, to connect the copperbelt town of Chingola directly to the Angolan rail network, providing a through route to the Angolan port of Lobito.

The road transport system does not provide a cost-effective alternative to railways. Less than 10 percent of the total roads in Zambia are tarred and accessible in all weather conditions. The road freight cost from any of the regional seaports to Lusaka is higher than the cost to the capital city of other countries in the Southern African region. The poor road system and delays on account of truck and fuel shortages considerably reduce Zambia's attractiveness as a location for FDI aimed at supplying markets in the region (such as in agricultural production or in food processing, of which more than half of all exports are to the Democratic Republic of the Congo), in spite of Zambia's privileged access to

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

these markets.[29] Diesel and tyres, which are more expensive in Zambia than elsewhere (in the case of diesel because of high taxes), contribute over 50% to the costs of transportation.[30] Gemstone mining is particularly affected by the lack of a proper road network as most of the precious and semi-precious minerals are found in remote areas of the country.

Box III.2. The role of ODA in private sector participation: the case of Zambia Railways

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

SIDA's involvement in ZRL started in 1997, when it provided $3.7 million to help fund the restructuring programme of the company. In addition, SIDA provided management expertise: five experts for two and a half years each, serving in senior posts in the management team of ZRL, including a managing director.

In 1998, the tasks of the team were extended to preparing ZRL for eventual concessioning. The core mandate of the team during its five years of work included several tasks: reducing overstaffing, introducing new procedures, reorganizing the company focusing on large customers and the core railway business, and selling non-core assets such as land and buildings.

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

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

Air transport is vital for several non-traditional exports, notably horticulture, floriculture and tourism. However, horticulture and floriculture producers interviewed, indicated that insufficient cargo connections to Europe have hampered their investment expansion plans and put them at a disadvantage compared to competitors like Kenya. The high cost of aviation fuel (see Table III.1) has been an important factor in increasing cargo prices and leading to several carriers, such as Das Air, British Airways World Cargo and Mk Airlines withdrawing their services from Zambia. Cargo capacity for fresh produce consequently declined from 200 tonnes per week in 2004 to 100 tonnes per week in 2005. The result is that most exports are now sent by special flights, chartered by the Zambia Export Growers' Association. But because each shipment is often not large enough to use the full capacity, these flights must be shared with other countries and their arrivals and departures are therefore irregular and unpredictable. Capacity also exists in passenger planes' cargo holds, but this is scarce.

[29] The withdrawal of the State sector from haulage business in the post-liberalization period has left a huge gap, which has not yet been filled in by the private sector. As a result, some 60% of cross-border exports had to be carried by foreign trucks (coming mainly from Zimbabwe and South Africa), which added to the cost of transport.

[30] World Bank (2003a), ibid. p.13

To save airfreight costs, some vegetable exporters are sending produce by truck to Johannesburg and from there by air to Europe. This is not the optimal way for fresh produce to reach distant markets and makes it difficult to match the highest product quality standards. Failure to meet standards of freshness will be an underlying threat to a company's relations with its clients.

Table III.1. Comparison of aviation fuel prices at selected airports ($ per gallon)

Location	Price as at February 2005	As at August 2005
Lusaka	2.32	2.76
Nairobi	1.50	1.88
Johannesburg	1.48	1.85
Accra	1.73	-
Entebbe	1.73	2.21
London Gatwick	1.44	1.83
Luxemburg	1.42	-
Harare	-	2.80
Ostend	-	1.06
Amsterdam	-	1.82

Source: Zambia Export Growers' Association

b. Telecommunications

Telecommunication expansion will both help exploit investment opportunities, including the development of agriculture and mining in relatively isolated areas, and provide investment opportunities with the main operators. Fixed lines are currently provided by the state operator ZAMTEL. In addition to Cell Z, which is owned by ZAMTEL, there are two private mobile phone operators, Kuwait-owned Celtel and South African-owned MTN. All nine provinces in Zambia receive telephone coverage and one of the cellular providers, Celtel, has extended its network to all 72 districts in Zambia. MTN is planning to follow suit. Cell Z is also expanding its rural network. Internet service provision is liberalized, and any ISP may operate its own international data gateway.

However, the cost of an international call is high in comparison to other African countries (Table III.2). This is because all international calls must pass through ZAMTEL's international voice gateway. In theory, any operator may apply for a licence to run its own international gateway. In practice, the licence fee of $12 million, compared to an average in several neighbouring countries of between $50,000 and $100,000, acts as an effective barrier to entry for new operators.

A recent report commissioned by the Government[31] recommended a fee of $100,000 for the first year and $50,000 a year thereafter to be applied in the first instance to incumbent mobile operators. The Government should therefore take concrete steps, without delay, to reduce the licence fee and liberalize internet telephony (VoIP). This will provide competition, increase capacity and reduce prices. Liberalization should also include licensing of new technology such as Wi-Max to enable broadband internet penetration in competition with and beyond ZAMTEL's fixed line network.

[31] Advisory services for fair competition and liberalization of the international gateway, by Analysys, Squire Sanders and Patmat Legal Practitioners, 2006.

Table III.2. Telecommunications indicators for selected African countries, 2004

	Zambia	Ghana	Lesotho	Namibia	South Africa
Fixed and mobile phone subscribers (per 1000 people)	33.7	92.7	109.1	206.1	473.1 (2003)
Telephone cost of call to US ($ per three minute call)	6.45	0.39	3.28	..	0.79

Source: World Bank, World Development Indicators, 2005.

c. Energy

The availability, cost and reliability of energy are critical for many investors, in particular those engaged in energy-intensive production. Except for oil imports of about 15,000 barrels a day, the country is self-sufficient in energy. It is richly endowed with hydroelectricity sources and coal as compared to other countries in the region (Table III.3) and it is a net exporter of hydroelectricity. Domestic energy sources are not fully utilized. Hydropower potential is estimated at 6,000MW although installed capacity is only 1,715 MW, less than one third of the potential.[32] Proven coal reserves are 30 million tonnes with probable reserves of several hundred million tonnes. However, there is only one coal mine in operation, Maamba Colliery. Its output declined from 192,000 in 1998 to 92,000 tonnes in 2003, owing to a chronic shortage of working capital.

Table III.3. Production from primary energy sources in selected African countries

Country	Oil (thousands barrels of per day)	Coal (million short tons)	Hydro (billion KwH)
Botswana	0.00	1.06	0.00
Ghana	7.00	0.00	8.36
Lesotho	0.00	0.00	0.00
Mozambique	0.00	0.02	6.98
Namibia	0.00	0.00	0.00
South Africa	26.21	250.28	2.06
United Republic of Tanzania	0.00	0.01	2.36
Uganda	0.00	0.00	1.91
Zambia	0.00	0.21	7.71

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

[32] World Bank (2002a).

The country's electricity is supplied by the state-owned Zambia Electricity Supply Company (ZESCO). Sixty percent of its output is provided to copper mining companies, which pay a higher price than other customers. In addition, most of these companies buy their electricity from the private power distributor, Copperbelt Energy Company, which bought the power division of ZCCM when it was privatized in 1997.

Only some 23 percent of Zambians have access to electricity. This hinders the emergence of agriculture-based enterprises by retarding the development of activities such as irrigation and food processing. Ongoing technical problems at two hydroelectric power stations operated by ZESCO caused a 16 percent decline in power generation between 2001 and 2003, halving electricity exports. Electricity tariffs are among the highest in the region, undermining export competitiveness of copper (Box III.3) and non-traditional exports as well as contributing to inflationary pressure.

Box III.3. Importance of electricity for efficient mining

The costs and reliability of electricity is critical to the competitiveness of a modern mining industry, which requires electricity supplies 24 hours a day. Electricity represents an important proportion of the costs of production. For example, every month KCM spends about $20 million on operations. Half of that covers the costs of electricity, which is used, among other things, to pump out about 300,000 cubic meters of water per day. For every ton of ore mined, 50 cubic meters of water are pumped out. In the past, the method of distribution and the practice of cross-subsidization applied by ZESCO were the main causes of high production costs for most, if not all, of Zambia's mining divisions. The tariff charged by ZESCO to the mines was not determined by market-based supply and demand, but was fixed as a matter of government policy at a level that enabled ZESCO to supply electricity to households at lower rates. Although this policy was modified as part of the privatization of the mines, current tariff rates are still skewed.

The Government can address this quickly by liberalizing the pricing and method of distribution of power to the business sector and by privatizing ZESCO. By opening generation and distribution of power to the private sector, the Government will be better able to exploit the country's hydroelectric and coal resources and reduce costs. In addition, the removal of price distortions will increase the viability of supplying to non-mining sectors.

d. Recommendations on infrastructure services

1. Revise taxes on basic fuel. Diesel and aviation fuel are significantly more expensive in Zambia than in many other countries in the region due largely to the relatively high taxes. The taxation policy should be reviewed with a view to making taxes comparable to competitor countries. For the economy as a whole, the multiplier effect of higher diesel and aviation fuel prices has had a strongly negative effect on export-oriented industries.

2. In order to improve the conditions for private investment and strengthen agricultural export potential, the Government should give priority to removing the present bottleneck in air cargo transport. Reducing airport landing fees should be seriously considered.

3. Urgent attention should be given to the construction and improvement of the rural road network.

4. Review the pricing and method of distribution of power to the business sector. Zambia has the capacity to generate enough electricity to supply domestic as well as export markets. The extraction of domestic energy sources needs to be improved and expanded with a view to reducing electricity costs, increasing energy generation and ensuring better distribution. The Government should consider the extent to which liberalization of the sector and the privatization of ZESCO could help.

5. Improve rural access to electricity through applying least cost solutions in regions where additional investment in mining and agriculture could be beneficial for economic development. The pricing of electricity for mining and other businesses could be reviewed with a view to eliminating distortions that hamper new investment.

6. In telecommunications, the licence fee for an international voice gateway should be brought down to a realistic level and legislation should be introduced to allow the introduction of competing technologies, legalise VoIP and privatize ZAMTEL.

3. Privatization

Since the early 1990s, the private sector has started to play a greater role in the national economy, following a privatization programme that covered a wide range of public enterprises of varying sizes, mainly in manufacturing and mining. The programme was initiated in order to increase the efficiency of firms considered as motors of the economy and accelerate the development of the private sector. Prior to the privatization programme, the state controlled over 80 percent of the country's productive and service-related activities.

To date, privatization has been concentrated in mining, manufacturing (such as textiles, cement, refining and brewing) and financial services, as well as a concession for Zambia Railways (discussed in the previous section). However, Zambia's plan to privatize energy and fixed-line telecommunication services (including ZESCO and ZAMTEL) has stalled. Instead, the Government has opted for their 'commercialization,' that is keeping them under state control, but introducing private-sector management and practices and, in some cases, offering private firms a minority stake.

The option of further public investment in these critical services is not likely in the near future given the heavy burden on government expenditure. These services require drastic improvements not only through new massive investments, but also, and perhaps more importantly, in technology and modern management systems. The decision not to privatize these utilities, which provide essential inputs to all goods and services produced in Zambia could therefore delay urgently needed improvements in productivity.

At present, there are doubts in Zambia about the benefits of privatization for consumers and whether the speedy privatization programme implemented since the early 1990s has been beneficial for the economy as a whole (see Box III.4). However, an evaluation by the World Bank shows that in general, export-oriented companies emerged successfully from the privatization process, unlike their domesticallyoriented counterparts.[33] This was largely due to the increased capital that foreign investors were able to bring in order to finance improvements in productivity, and has been bolstered more recently in the mining sector by improving terms of trade.

Box III.4. Privatization of Zambia Consolidated Copper Mines

By far the most important and controversial element of Zambia's privatization programme was that of Zambia Consolidated Copper Mines, sold in seven unbundled units, for $246 million between 1997 and 2000. Attention has focused both on the timing and form of the privatization and the reduced royalty rate and other terms enjoyed by the new owners.

The privatization of Zambia's mines had been made an important condition in a number of financing facilities extended by the World Bank and the IMF, from as early as 1993. However, initially concerned by the possible social impact of ZCCM's disposal, the Government had stalled. It was only from 1996 and under increasing pressure, that the Government initiated the process of privatization.

The sale of each unit proceeded in two stages. In the first stage, a majority of the shares were sold to the winning bidders from a competitive tender, with the Government retaining a minority interest. In the second stage, the Government would then be required to sell this minority stake to Zambians and local and foreign financial institutions.

In each case during the first stage of sale, buyers were able to negotiate legal stability contracts called 'Development Agreements,' lasting twenty years. These contracts provided special fiscal terms for the new private operators, including a tax-deductible royalty rate of 0.6 percent (providing a reduction from the royalty rate of 3 percent specified in the 1995 Mines and Minerals Act), reduced corporate tax rates of 25 percent and the ability to carry losses forward for twenty years. Foreseeing possible price rises, the Government included a price participation clause. In the case of the Mufilara Division and the Nkana mines, for example, this meant a charge of two percent of the copper price over and above $0.85 per pound. However, this charge is tax deductible, capped at $4.4 million and limited to five years.

Recriminations have focused on the requirement for the Government to divest itself completely of the mines and the poor timing of the sale, under pressure from the World Bank and IMF to make a quick disposal. Critics argue that had the Government retained a stake, it would have been able to profit more from higher prices. At the same time, had it waited until prices picked up, it would have been able to obtain a higher price for the sale.

Also being questioned are the terms of the development agreements, which with the hindsight of strong copper prices appear generous. The investments made by the operators have brought them high returns. However, relative to the full royalty rate of 3 percent paid by all new operators (albeit a minority of Zambia's copper output), significant revenue to the Government has been foregone. This revenue could have been useful in funding the infrastructure upgrades essential to Zambia's development.

It can be argued that the development agreements were an appropriate solution at the time. The mines were loss-making to an indebted government that lacked the required capital to improve them or invest as joint partners. In addition, there appeared to be no prospects of price increases and the mines were not

[33] World Bank (2003b).

initially financially beneficial to their investors. To illustrate this point, in 2002, Anglo-American, CDC and the International Finance Corporation withdrew from Konkola Copper Mines, which produces 70 percent of the country's output, citing declining copper prices and an inability to turn a profit. Had they waited two more years, they would have enjoyed the benefits of doubled copper prices.

In responding to criticisms, the Government is trying to revisit the development agreements, specifically on royalties. Legally, the agreements are protected, even if other countries such as Algeria, Bolivia, the Russian Federation and Venezuela have used the attraction of high natural resource prices to renegotiate contracts.

Whatever the outcome of these discussions, the main lesson to be drawn from this episode is about negotiating with investors. Legal stability contracts for large investments are widely practised in developing countries. Their purpose is to offer stability to investors by preserving the legal, regulatory, fiscal and policy regime in force at the time, often for a period of up to 20 years. Many contracts also provide protection and non-discrimination clauses.

Where Zambia differs is that through Section 9 of the 1995 Mines and Minerals Act, the Government was not restricted to stabilizing the incentive rates prevailing at the time or offered in the bid conditions of the privatization, as in other countries. It was allowed to stabilize levels of taxes and royalties that had been negotiated individually with the preferred bidder of each package once that bidder had been selected. The latitude that Section 9 allows is unusual and places the Government in a weak bargaining position.

Sources: UNCTAD, Government of Zambia, First Quantum, Cambridge Journal of Modern African Studies, Christian Aid.

Privatization of telecommunication and energy services alone is no guarantee of success. Indeed, if not carefully prepared and executed, it can lead to adverse effects, such as the creation of private monopolies and further public resentment about privatization, as has been the case in many countries. Concerns about transferring the monopoly power to private hands and possible monopolistic practices should be addressed by regulations put in place before privatization and through the creation of strong and independent regulators. Issues relating to the provision of services in remote geographical areas, where these services are not profitable but socially desirable, should be dealt with through legal powers provided to regulators. Possible adverse social effects of privatization should also be addressed.

Recommendations concerning privatization are:

1. The Government should proceed with the privatization of public enterprises in energy and telecommunications. It is unlikely that any other method of dealing with inefficient enterprises will ensure the urgently needed improvements in the provision of infrastructure services, without draining the central government budget.

2. The privatization of major utility companies has to be carefully planned, prepared and executed, addressing concerns related to monopoly power, universal provision of services and adverse social affects, through regulations prepared before privatization and through setting up strong and independent regulatory bodies.

4. Human capital and local private sector capabilities

An adequate availability of local skills and the presence of a dynamic domestic private sector are essential conditions for attracting FDI and benefiting from it. Assimilation of knowledge and advanced skills into the local economy normally takes place through spillover effects and linkages between domestic enterprises (as buyers or suppliers of inputs) and the affiliates of foreign companies. While FDI inflows have brought new technologies and training practices to Zambia's foreign-owned affiliates, and the privatization programme and economic reforms have introduced a more competitive and open economic climate, local investors in privatized firms and other local entrepreneurs have nevertheless been faced with the significant challenge of having to train and re-skill their workers both in order to grow and compete and in order to provide TNC affiliates with the quality of product they require. The challenge has been particularly severe in the services sector (for example, hotels, supermarkets) where in the past lack of competitive market environment created less pressure to seek high quality skills to provide good service. At the same time, workers have had to acquire the skills needed to remain employed in this economic climate.

In response and since the mid-1990s, the Government has restructured the educational and training programmes in the country with a view to creating a national system that meets the skill requirements and needs of the new economic system. To that end, it formulated the Technical Education, Vocational and Entrepreneurship Training (TEVET) policy in 1996. This was a major improvement on past practice and highly relevant to private sector development. The policy sought a broader and integrated approach than its precedents.[34] Four elements are worth highlighting. First, it incorporates entrepreneurship development, which was given scant attention in the past. Second, the new policy encompasses all types of technical education and vocational training like nursing, extension services training, community development and engineering, thereby giving greater attention to a wide range of technical skills. Third, it acknowledges and covers training given at both the formal and informal sectors. Finally, it recognizes the importance of enterprise-level training and the need for interaction between enterprises and public-sector training institutions.

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

1. Most had little expectation of finding all the skills they would need and came into the country prepared to train and develop skills in-house. Many of them indeed do this;

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

[34] See Government of Zambia (1996).

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

4. With the expansion of the private sector, employee turnover has become common and a major concern to enterprises, leading them to increase salaries to keep skilled workers;

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

6. In general, foreign firms in Zambia see training and the broadening of the skills base to be the responsibility of Government.

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

In the context of the above, the following are the recommendations for increasing skills capability and linkages between foreign and local enterprises:

1. Establish a linkages programme to identify and upgrade local enterprises that have the potential to supply to, and learn from, foreign affiliates and subsequently become exporters in their own right. Such programmes have been successful in a number of emerging economies. The Irish National Linkage Programme, Singapore Local Industry Upgrading Program (LIUP) and the Malaysian Penang Skills Development Centre (PSDC) are good examples.

2. Establish a joint public-private sector one-stop centre, where entrepreneurs have access to business development services and inputs (i.e. entrepreneurship training, information, finance, quality control, networking, and business counselling). Programmes such as EMPRETEC and Enterprise Africa, are already in operation in some African countries, and their introduction should be considered in Zambia.

3. The potential contribution of firm-level learning and training for skills development is not yet fully understood in Zambia, despite recent efforts to take it into account in policy formulation. The option of tax incentives for enterprises providing verifiable technical training should be considered.

4. It is noted that fiscal incentives in the form of double-deductions for human resource development were approved by Cabinet in July 2006, allowing investors in MFEZs to claim twice the sum of their training budget as a taxable expense. The intention is for this measure to be included in the next amendment to the Income Tax Bill.

5. Investment promotion

Investment promotion useful to attracting FDI. It is important, in particular, for countries that are less known among global investors, such as Zambia, but that have resources, locational advantages and polices that are attractive.

To this end, the Zambia Investment Centre (ZIC) was established in 1992 with the mandate of administering, monitoring and promoting investment.[35] Its main focus has been the evaluation of applications for investment, issuing investment certificates to foreign and domestic investors, and facilitating investors. It also developed a number of programmes, comprising: image building through regular publications and a website; supporting investment missions to Zambia and replying to investor queries; identifying investment opportunities; coordinating a public-private sector dialogue within the Zambia Business Forum; and organizing investment fora abroad.

In 2006, the Government passed the Zambia Development Act (see Chapter II), which will establish the Zambia Development Agency (ZDA). The ZDA will act as a «one stop shop» facility and will combine the former functions of the Zambia Investment Centre, the Zambia Export Processing Zones Authority, the Zambia Privatization Agency, the Export Promotion Board and the Small Enterprises Development Board. Its main purpose will be private sector development through the promotion of investment, exports and production.

At the time of writing, the ZDA had not yet been established. A number of factors remain to be resolved. These include the structure of the Agency, the composition of its Board, and the harmonization of personnel policies. Nevertheless, for the ZDA to be an effective investment promotion organ, the following recommendations should be considered:

1. Creating a "Client Charter," which codifies services to investors, in the ZDA and other major government agencies that are involved in providing services to investors. The charter should be a mission statement and should include benchmarks on time taken to issue approvals or provide services. It should be made public and serve as a benchmark by which government departments and the public can measure performance in promoting investment. This will contribute towards a more efficient delivery of one-stop-shop service.

2. Strengthening the investment promotion functions of the ZDA. In the short term, this means providing it with sufficient resources that will enable it to re-organize itself and build capabilities in developing the following activities:

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

(b) Building capabilities to undertake in-depth analysis of direct investment flows into priority areas, researching investment potential and identifying measures that help realize the potential; prepare

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

project profiles; monitoring external competition to enable successful positioning; formulating or revising strategy on investment promotion, including internal evaluation of the costs and benefits of different techniques of investment promotion; and benchmarking of results.

(c) Training to staff on investment promotion strategy and techniques.

3. Further developing image-building activities to include media relations and press tours and participation in a larger number of international conferences and seminars. For investment generating activities, further targeted approaches in overseas promotion, as was undertaken in South Africa, should be employed. There should also be greater participation in investment fora, greater use of direct mail, telemarketing, one-on-one meetings with potential investors, and matching prospective investors with local partners.

4. Paying equal attention to after-care services. Satisfied investors will reinvest more than new investors. They will also act as ambassadors to potential new investors.

5. Undertaking policy advocacy and involving the private sector in developing FDI promotion campaigns.

Only a ZDA with strong investment promotion capabilities can genuinely contribute to attracting investment to the areas identified in this report. However, ZDA's resources are limited. Therefore, to maximize its contribution, the different roles mentioned above should be concentrated on particular sectors and time periods.

A preliminary examination would suggest that the bulk of its work should be in sectors for which investors are not fully aware of the opportunities available. These are agroprocessing and tourism. In this area, ZDA should research, identify and target new investors, build a positive image of the country, facilitate investors and help them clear the regulatory hurdles. However, image-building campaigns should only start once the operating environment improves. Any earlier and it would ring hollow.

For all the sectors identified in this chapter, the ZDA should provide aftercare and support the improvement of the operating environment by identifying infrastructure bottlenecks and advocating across government for consequent improvements in infrastructure, prompt liberalization of the infrastructure environment and streamlining of licensing.

IV. CONCLUSIONS AND RECOMMENDATIONS

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

FDI has also contributed to the long-term policy objective of Zambia, which is to diversify its production and export base from mining to other products and services. As shown in this report, the recent rapid growth in non-traditional exports can be partly attributed to FDI. There is also some evidence to suggest that new technologies and skills have been transferred to Zambia as a result of recent FDI inflows. Their impact on the local economy, however, has not been significant. This is partly because of weak linkages between foreign affiliates and local enterprises and partly because of the absence of targeted policies and incentives to encourage technology and skill diffusion.

To date, the performance of the Zambian private sector has been poor due largely to the high cost of capital and domestic inputs for local production, which make sustaining competitiveness in an open economy practically difficult. That said though, the immediate prospects for both domestic and foreign investment are encouraging as Zambia is still far from exploiting its considerable investment potential, which exists in many industries and activities. It is still rich in copper deposits, in spite of its long exploitation. In other mining activities, the existing potential has hardly been tapped. This is true in particular for the exploitation of gemstones, which, according to industry sources, have the potential to contribute more to exports than copper and cobalt put together. FDI potential extends also to services – notably tourism, financial and infrastructure services – agriculture (including agro-processing) and manufacturing, including copper products. In the latter two sectors it is greatly enhanced by Zambia's privileged market access in the region and to large markets in developed countries, including the EU, United States and Japan.

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

1. Further improvements in the investment policy and regulatory framework

Zambia has done much in the last decades to foster private sector development and FDI. This was typified by the 1993 Investment Act. The new Zambia Development Agency Act introduces compulsory licensing and screening of new investors, possibly restricts the scope for incentives, and makes it more difficult to employ foreign workers and obtain land. This report recommends the following:

- Compulsory screening and approval should be restricted to investors in sectors such as infrastructure and mining, or those applying for incentives. Registration for information purposes should only require information directly relevant to monitoring FDI statistics.

- Zambia should ratify its outstanding BITs and negotiate agreements with countries from which most of its FDI originates, the United Kingdom and South Africa. Double taxation treaties should be negotiated with newly emerging investor countries in East Asia.

- Zambia should take an integrated approach to reforming its fiscal framework. The current practice of high taxes mitigated by widespread piecemeal incentives should be reviewed in favour of a lower general level of corporate taxation , as a way of encouraging local and foreign investment, improving the business environment and developing a stronger fiscal base. There is a need for clarification with regard to eligibility for fiscal incentives under the ZDA Act's $500,000 threshold.

- The requirement of presidential consent for land transfers should be removed as it is a government intervention in the land market that serves no public purpose and increases investment risk. Government oversight should be confined to land use matters and to due process in the conversion of customary land to titled land.

- The unpredictable nature of the work permit system can be improved by the introduction of an automatic quota system, dependent on size and sector of investment, to enable investors to recruit abroad for a small number of key positions. More generally, guidelines on the awarding of work permits should be introduced and published.

- Zambia's commercial justice system is failing to meet the needs of investors. The courts should adopt a more customer-focused approach in order to clear cases quickly. Weak cases should be disposed of or sent to arbitration and civil procedure rules amended to prevent abuse.

2. Consolidation of recent improvements in macroeconomic policy

Although the macroeconomic policy climate of Zambia has improved in recent years, additional efforts are required in the area of macroeconomic policies in order to strengthen business confidence and create a stable policy environment. Relatively high interest rates and, as a result, the prohibitive cost of debt finance, have been a major stumbling block to domestic enterprise development as well as to FDI in non-traditional activities where many investors are small- to medium-scale operators.

Achievement of the HIPC completion point has significantly reduced Zambia's debt service obligations. To the extent that this will increase the Government's fiscal space, it should be used to create better conditions for private investment in priority areas.

3. Increasing the availability and competitiveness of infrastructure services

The cost and availability of essential services necessary for production and exports are among the main constraints to investment in Zambia. Transportation, energy and telecommunication services are not available in many areas of the country with significant investment potential. Where they are available, they are often of poor quality, unreliable and very expensive, typically several times more expensive than in the countries competing with Zambia for FDI. If the competitiveness of all these services does not improve drastically across the board, Zambia will never exploit fully its investment potential and benefit from its wide access to international markets. Progress has been recently achieved in railway transportation, with the successful concessioning of Zambia Railways. The road network is being upgraded and extended, with the help of donors, but not as fast as planned in 1988 by the National Road Board in its investment programme.

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

4. Develop and strengthen the domestic private sector

A weak domestic private sector significantly reduces potential to benefit from FDI through linkages and spillover effects. Building a strong and dynamic domestic enterprise sector is likely to attract additional FDI as it demonstrates an economic climate conducive to investment. In Zambia, the domestic private sector is still at an early stage of development. Despite recent changes in policy-orientation favouring private sector development, local investors still perceive the current policy environment as unfriendly. The public-private sector dialogue and partnership of the Private Sector Development Plan could help in addressing this problem. Lower interest rates are a basic pre-condition to domestic enterprise development. The positive movements observed since 2003 in this respect are encouraging and must be maintained. It should be noted, however, that falling interest rates do not automatically lead to greater availability of credit to local investors, in particular SMEs. Banks may still consider lending to such enterprises as too risky. Therefore additional measures are needed to facilitate lending to SMEs such as mobilizing the support of bilateral and multilateral agencies, introducing venture capital financing and creating a special financial institution assuming the role of an investment partner in new local investment projects.

The Government has restructured its educational and training programmes with a view to creating a national system that meets the requirements of a market economy. These efforts should be strengthened as many skills are still lacking. Investors, especially foreign ones, have to resort to importing skills, in particular management and specialized technical skills. There is therefore a risk that an excessively restrictive practice of granting work permits could serve as an obstacle to foreign investment and productivity gains. A better option would be to introduce incentives encouraging in-house training and skills development. The benefits of FDI for development could also be increased by the introduction of a linkage promotion programme to identify and upgrade local enterprises that have the potential to supply to foreign affiliates. Incentives to foreign affiliates to use local suppliers should also be part of such a programme.

5. Policy coherence and investment promotion

The Government should explain clearly its vision and objectives concerning the role and the potential long-term benefits of FDI. The role of individual government departments and agencies in attracting investment should be clearly spelled out so as to bring about a unified approach to the implementation of FDI policy. So far, actions by individual institutions have often been uncoordinated and sometimes counterproductive thereby reducing the effectiveness of government efforts to attract FDI and benefit from it.

The eventual establishment of the Zambia Development Agency would enhance coherence in investment promotion. It is therefore vital that the Ministry of Commerce, Trade and Industry (MCTI) finalises the establishment of the ZDA. In doing so, it should also develop a client charter, introduce an investor tracking system, increase staff training, further develop its image building functions, strengthen its aftercare services and undertake policy advocacy. Targeting potential investors is also important and will be greatly facilitated by the upcoming Investment Guide to Zambia.

ANNEX. METHODOLOGY OF INTERNATIONAL TAX COMPARISONS

The Comparative Taxation Survey compares taxation on investment in several sectors in Zambia with taxation in selected other countries – neighbours and countries elsewhere that have succeeded in attracting FDI to the sectors concerned. The comparisons enable Zambia to assess the competitiveness of its taxation.

Taxation affects the cost of investment and its profitability and thus the return on investment. This impact is not just a question of looking at the headline rate of tax on profits. The tax burden on the investor depends on a number of factors and their interaction including expenses allowed, rates of capital allowances (tax depreciation), the availability of tax credits, investment allowances and tax holidays, the loss-carry-forward provisions and the taxation of dividends among other things. Moreover, customs and excise duties affect the cost of investment and operating margins. Together these make up the overall fiscal regime that affects the cost of and return on investment.

Comparative tax modeling is a method of taking into account the most important of these variables in the fiscal regime in a manner facilitates comparison between countries. The tax variables included in the analysis are:

- Corporation income tax
  - Rate of tax including tax holidays, if any
  - Loss-carry-forward provisions
  - Capital allowances, investment allowances and investment credits
  - Tax on dividends
- Customs import duties and excise duties on business inputs

Financial models of project investment and financing, revenues and expenses are utilized for a hypothetical business in each sector. These are based on typical costs and revenues experienced in such businesses in a developing economy. The business models cover a selected business within each sector.

The fiscal regime in Zambia and the chosen comparator countries for each sector is applied to the standard business model for each sector over 10 years beginning with the initial investment. The financial models calculate net cash flow to the investor assuming that the company pays out all residual profits after tax (100 per cent dividend pay out) and that the investor gains the residual value of the company which is sold after 10 years for an amount equal to its balance sheet value.

The impact of the fiscal regime is presented as the present value of tax (PV tax). PV tax is the total of taxes and duties collected by government over the 10 years as a percentage of the project cash flow pre-tax and post-finance where both cash flows are discounted to a present value at a rate of 10 per cent per annum. PV tax thus measures how much of investor's potential project return is taken by the government in taxes and duties. The higher the PV tax the more than the fiscal regime burdens investors and reduces the incentive to invest.

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