MINI-THESIS SUBMITTED IN PARTIAL FULFILLMENT OF THE REQUIREMENTS FOR THE LLM: INTERNATIONAL TRADE AND INVESTMENT LAW IN AFRICA


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Key words

**Copper mining** will mean the business of mining copper and subsequent sale thereof.

**Economic growth**

**Investment climate** will mean the conditions prevailing in a host country which make it attractive as an investment destination.

**Foreign Direct Investment**

**Privatisation** will mean the divesture of state owned enterprises into private hands.

**Revenue** will mean the income that is realized from the taxes charged on copper mining activities.

**Sustainable Development**

**Utilization** will mean the distribution and subsequent re-investment by the state of income realized from copper mining taxes.

**Windfall mining tax** A tax levied by government against certain industries when economic conditions allow those industries to experience above-average profits. Windfall taxes are primarily levied on the companies in the targeted industry that have benefited the most from the economic windfall.

**ZCCM** will mean Zambia Consolidated Copper Mines, Zambia's largest commercial enterprise, generating most of the country's foreign exchange earnings.
Chapter 1

1. BACKGROUND

The copper industry has dominated the mining scene in Zambia for more than seven decades since the first commercial mine was opened in 1928. Despite the existence of other minerals, copper is likely to continue to play a major role as Zambia’s major export for many years to come. At its peak in the late 1960s and early 1970s, copper mining accounted for more than 80% of the country’s foreign exchange earnings, over 50% of government revenue and at least 20% of total formal sector employment. However, its performance declined from the mid-1970s and by the end of the 1980s copper mining was no longer the driving force which had been the engine of the country’s industrial and social development. Developments on the international stage, such as the collapse of commodity prices in the mid-1970s and the unprecedented increases in oil added to its poor performance.

In 1969, the copper industry was nationalised to maximize the returns to the Zambian people. The rationale being that under state control, copper revenues would be used to benefit the nation. During the period 1969–1975 the country saw an unprecedented investment in the construction of new schools, hospitals and roads, using surpluses from copper revenues. However, the copper industry faced a number of challenges after 1975 as a result of under-capitalisation, over-manning, poor technology and low copper prices on the international market.

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1 Simutanyi Neo 2008 Copper mining in Zambia; The developmental legacy of privatisation, occasional paper 165, Institute for Security Studies
4 Simutanyi Neo 2008 Copper mining in Zambia; The developmental legacy of privatisation, occasional paper 165, Institute for Social Security
5 Ibid
While the contribution of the copper mining sector to Zambia’s gross domestic product (GDP) declined, the importance of the industry to export revenue remained significant. The crisis occasioned by the poor performance of the copper industry was felt in Zambia’s inability to finance social welfare programmes, such as education and health. People’s living standards deteriorated, inflation rates were high and the buying power reduced.  

This crisis coincided with the International Monetary Fund and World Bank recommended policies aimed at improving the economy as a condition to access funding. These loans were as stated, not without conditionalities which included among other things, trade liberalization and removal of subsidies, general wage freeze, and devaluation of the currency.

As the state mining conglomerate Zambia Consolidated Copper Mines Limited (ZCCM) was loss making, the Zambian government granted it large subsidies. However, as it remained the major foreign exchange earner in the economy, the one-party state, under President Kenneth Kaunda, directed ZCCM to provide social services in mining areas that the government was no longer able to provide on a large scale. The ZCCM continued to provide social services to mining communities even when the economy was in crisis and the company was performing poorly.

In the early 1990’s Zambia privatised its mines and signed Development Agreements with the new buyers, who are mostly foreign companies. The low revenues from copper sales are partly as a result of Development Agreements which prescribe tax concessions for mining

6 Ibid
7 Ibid
9 Simutanyi Neo 2008 Copper Mining in Zambia; The Developmental Legacy of Privatisation, Occasional paper 165, Institute for Security Studies
10 Ibid
companies, for periods ranging from 10 to 15 years, and a reduction in mineral royalty taxes from the statutory 3% to 0.6%,\textsuperscript{11} which is undoubtedly one of the lowest in the world.

There are serious concerns regarding not only the need for the nation to receive a fair share from the exploitation of its natural resources, but also because of the poor corporate social responsibility of the new mine owners and the appalling health, safety and environmental standards on the mines.\textsuperscript{12}

Undoubtedly, the increased mining activities have brought increased profits to mining companies given the high copper prices on the world market and the favourable investment climate in Zambia.\textsuperscript{13}

However, while the privatised mines have recorded large profits, the Zambian government acknowledges that revenue from copper as a proportion of government income has been very low.\textsuperscript{14}

However, much as the governments need to mobilise more revenues is understandable, there is a risk that proposed changes might lower the country's competitiveness in attracting more investors to the sector.\textsuperscript{15}

It was recently announced that government would introduce a mining windfall tax that would earn the treasury at least US $415 million in the year 2008 alone.\textsuperscript{16} Effectively, mineral taxes

\textsuperscript{11} Fraser Alistair and Lungu John 2007. \textit{For whom the windfall? Winners and losers in the privatisation of Zambia's copper mines}. Civil Society Trade Network of Zambia, Printec, Lusaka

\textsuperscript{12} Simutanyi Neo 2008 Copper mining in Zambia; The developmental legacy of privatisation, occasional paper 165, Institute for Security Studies

\textsuperscript{13} Ibid

\textsuperscript{14} “Zambia President axes copper mines tax breaks” available at \url{www.forbes.com}, accessed on: 13.09.08

\textsuperscript{15} Miners concerned about proposed Zambian Windfall Profits Tax, 2008 Mineweb available at \url{www.mineweb.co.za/mineweb/view/mineweb/en/pages67?oid=44583}

\textsuperscript{16} “Zambia President axes copper mines tax breaks” available at \url{www.forbes.com}, accessed on: 13.09.08
would increase from an average of 31.7% to 47%.\textsuperscript{17} The mineral royalty tax levied on copper ore produced has been increased from a negotiated rate of 0.6 percent to the statutory 3 percent, while the tax on corporate profits has jumped from 25% which was negotiated to the 30%.\textsuperscript{18} This change in the fiscal policy will be implemented alongside the windfall tax levy. This revenue from mines if put to proper use can lead to an improved economy.

\textbf{1.2 Problem statement:}

The last four years have seen a surge in mining activities throughout Sub-Saharan Africa, partly in response to policies of economic liberalisation, privatisation and favourable conditions for foreign direct investment.\textsuperscript{19} The renewed interest in mining activities comes as a result of a boom in commodity prices occasioned by increased demand from China and India. Thus, foreign investors have arrived on the scene to either buy former state mining companies, now privatised, or to start new mining operations.\textsuperscript{20}

Zambia has in the last few years created an investor friendly atmosphere which has seen increased investments in the country especially in the mining sector. The copper prices on the world market are on a record high\textsuperscript{21} as compared to when the copper mines were sold. Mining companies have made and continue to make huge profits. Mining being the driving force for the economy, there has undeniably not been a corresponding increase in the growth of the Zambian economy.

\textsuperscript{17} Magande Ngandu 2008 Budget speech delivered to National Assembly on 25\textsuperscript{th} January 2008, available at: www.zambiabudget.zm accessed on 9.08.08  
\textsuperscript{19} Simutanyi Neo 2008 Copper mining in Zambia; The Developmental legacy of privatisation, occasional paper 165, Institute for Security Studies  
\textsuperscript{20} Campbell B (ed) “Regulating Mining in Africa; for whose benefit? “Uppsala: Nordiska Afrika institutet. 2004  
\textsuperscript{21} Fraser Alistair and Lungu John 2006. For whom the windfall? Winners and losers in the privatisation of Zambia’s copper mines. Civil Society Trade Network of Zambia, Printec, Lusaka.
The boom in copper prices has not been translated to national wealth and there seem to be no serious plans to re-invest the surpluses. Government has since re-negotiated the development agreements, providing for increased minerals and royalties taxes, sought new concessions with mining companies, with the objective that with increased revenue from the mines, there will be seen increased spending on education, health, roads and other sectors of the economy. Suffice to say that the Development Agreements did not provide for increased tax, the government has imposed a windfall tax, to fully benefit from the current high copper prices on the world market. A windfall tax by its very nature is meant to cover a situation where circumstances under which an agreement was negotiated change for the better, and is meant to capture or claw back the profits or benefit coming with the change in circumstances.

This paper will look at whether imposition of windfall tax is a renegation by government of its obligations under the signed Development Agreements, whether the mining windfall taxes are a once off thing (or will there be another change should the world market price of copper change?) and whether they can translate into meaningful development leading to economic growth. The paper will further discuss the classical theory on foreign direct investment and what host nations like Zambia need to do to benefit from Foreign Direct Investment. A comparative analysis will be done with Chile on the implementation and gains from mining windfall taxes and whether there are any lessons to be learnt.

1.3 Research objective

The main objective of this paper is to find out whether a balance can be struck between the benefits to be obtained from mining activities within the host country through imposition of a windfall mining tax and the profits to be made by the owners of the mines. Whether indeed imposition of a windfall tax is a solution to improve social welfare.

1.4 Research hypothesis

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22 Simutanyi Neo 2008 Copper mining in Zambia; The developmental legacy of privatisation, occasional paper 165, Institute for Security Studies
23 Available at: www.investopedia.com A tax levied by governments against certain industries when economic conditions allow those industries to experience above-average profits. Windfall taxes are primarily levied on the companies in the targeted industry that have benefited the most from the economic windfall, most often commodity-based businesses. Accessed on 17.08.08
This paper is premised on the fact that currently Zambia is not benefitting from the high prices of copper on the world market due to the tax provisions in the mining Development Agreements signed with its investors which imposes no social responsibility obligations on them while allowing externalization of profits.

1.5 Scope

This study will be limited to the copper mining windfall profits and windfall tax in Zambia and how efficient management can bolster funding for social programs.

1.6 Significance of the Research

The significance of this research is to show that putting in place a favourable investment climate is not enough for a country to fully benefit from FDI, that other factors must also be present.

1.7 Research Methodology

This research will be conducted by reviewing the literature on windfall profits and taxes.

1.8 Proposed Content

Chapter one is a brief overview of Zambia’s copper mining dependence over the years, the recent challenges faced with the privatisation of the mines and the need for the country to benefit from the high copper prices.

Chapter two will examine the history of copper mining in Zambia, the decision by the Zambian government to nationalise privately owned enterprise and how the rapid growth of the copper industry driven by favourable world prices through the late 1960’s and 1970’s transformed Zambia as a model for a country moving rapidly towards economic independence, industrialization and an end to poverty.
Chapter three will look at the privatisation of the mines and analyze whether the creation of a favorable investment climate has led to an increased flow of foreign direct investment. In particular this research will analyse the Classical theory on foreign direct investment and whether the choice on the approach taken will maximize the gains from foreign direct investment.

The fourth chapter will review the performance of privatization in Zambia and analyse the Mining Development Agreements, both the previous and re-negotiated Agreements vis-à-vis the incentives and tax provisions and whether the introduction of the windfall mining tax is a once off event.

Chapter Five as a case-study will be a comparative analysis on the implementation of the Chile copper windfall mining tax and the lessons that can be learnt by other developing countries seeking to benefit from their mineral wealth through Foreign Direct Investment.

The conclusion will give recommendations on how proper implementation of the copper mining windfall combined with the existence of other factors can lead to meaningful development and economic growth for Zambia.
Chapter 2

2 Introduction

This Chapter will look at the history of copper mining in Zambia from the colonial period when the colony was called Northern Rhodesia till after independence, in modern day Zambia. It will look at how in the colonial period, copper mining was used simply to generate income for the colonial masters with no benefit accruing to the host state, and how eventually, with Independence, Policy changes brought in nationalisation of this important industry to not only match with the economic aspirations of the politicians in seeing that ownership was given to the state but also that economic development was achieved.

2.1 History of Copper Mining: 1924 - 1963

Zambia has relied on mining for its development ever since commercial copper mining started in 1928.24 Despite the existence of other minerals, copper is likely to continue to play a major role as Zambia’s major export for many years to come.

During colonial rule, (1924 -1953) and the period of the federation, 1953- 1963, effective power over the economy resided outside Northern Rhodesia in the hands of international companies and their Directors. Copper mines were the major source of revenue for the colony. They paid monies to the local authority first colonial and later federal based on a combination of royalty and export taxes.25 The revenue was vital to the state and tended to act as a point of leverage between the state and any local group wishing to start some counter veiling power against the mines.26 No other economic activity in Northern Rhodesia even began to compare with the scale, capital intensity and profitability of the mines.

26 Ibid.
Zambia’s copper is mostly imported by the industrialized countries such as Japan, Britain, France, and Germany. Its price is dependent on the state of the economies in the industrialized countries. With more construction works going on in these industrialized countries, Northern Rhodesia was seen as a cheap source of copper to supply these industries. For instance, in 1973, higher prices of the metal prevailed throughout this year; the contrast may be with 1976, when the industry went through a difficult time. The price of copper fell steeply owing largely to the world economic recession. It collapsed from a peak 1400 pounds per ton on 1st April 1974 to fluctuate between 500 pounds and just over 600 pounds per ton from December 1974 to April 1976.27

To appreciate copper mining in Zambia, it is important to look at the history from the colonial era. Beginning in the 1890’s European finance capital in the form of the British South Africa Company (BSA) began to penetrate this area in search of base metals for the expanding economies. Authorities had left Northern Rhodesia and had no control over the colony; their presence in the form of two early mining companies was still there, through Roan Selection Trust and Zambian Anglo American Corporation.28 These were two subsidiaries of two multinational corporations, American Metal Climax Inc. and Anglo American Corporation respectively. It was these two companies that determined the major sector of the colonial capital economy, the copper industry, controlling the sales and marketing of Zambian refined copper as well as pricing arrangements.29 The earlier producer price system of the 1950s had collapsed and was replaced by a system of prices based on the London Metals Exchange (LME) quotations for copper, cobalt, lead and zinc. This new system could have given the producer states more control over prices than before. Yet European buyers still purchased Zambian copper directly from foreign companies.30 Arrangements were made by the multi national companies’ head quarters and their local managers, rarely consulting the exporting nation.

27 Muna Ndulo 1987 Mining Rights in Zambia Kenneth Kaunda Foundation, Lusaka
28 Slinn Peter 1972, The Legacy of BSA Company: The historical Background” Economic Independence and Zambian Copper; A Case History of Foreign Investment ed Bostock Mark and Harvey Charles NY, Praeger Publishing Co.
30 Ibid
Due to the profit intentions of these foreign companies and their limited interests in Northern Rhodesia as a whole, a large percentage of the surplus which otherwise could have been invested locally was drained away.\textsuperscript{31} The loss was permanent. As there was no intention to develop a well balanced economy with locally based downstream production for example, Northern Rhodesia became a classical “disarticulated economy”.\textsuperscript{32} It produced copper which it could not consume and consumed imported luxury, capital and intermediate goods which it did not produce.\textsuperscript{33}

Among the terms of decolonization which new Independent states had to accept were entrenched clauses protecting the mineral rights of the mining company’s. In Zambia, the BSA which owned the mineral rights in perpetuity was forced to give up its claims to mineral rights for a small compensation.\textsuperscript{34} The settlement brought under government control, a valuable source of revenue, namely mineral royalties.

The copper industry had a lot of influence in the economy of Zambia; need less to say that most of the industrial wealth resided in foreign hands. Consequently, the budget of Zambia’s government was affected because the major export copper is a cyclical product having periods of recession alternating with high prices. The resultant fiscal instability was compounded by the fact that most productive sector was in the hands of the two multinational corporations, in which Zambia’s economic conditions were only one element in their worldwide corporate strategies.\textsuperscript{35}

\textbf{2.2 Independent Zambia: 1964 - 1992}

Continuing foreign economic domination was a politically volatile issue for the Zambian leadership. While they had the political independence, they had no control over the economy, especially the mining sector that was driving the economy. The obvious step was to nationalize ownership of the sectors of the economy dominated by externally based individual or companies.

\textsuperscript{31} Ibid
\textsuperscript{32} Ibid
\textsuperscript{33} Ibid
\textsuperscript{34} Ibid
Individual enterprises could continue to be managed by expatriates. In addition limitations were placed on dividend remittances for all foreign companies on local borrowing and on expatriate controlled retail trade.37

In 1969, through a request by then President, Kenneth Kaunda, 51% of the largest privately owned industry was nationalized by the Zambian government. Kaunda requested the foreign mining companies to turn over 51% of their assets in Zambia to government.38 This action by the government was part of a series of reforms called the “Zambian Economic Revolution” which began with the take over of smaller expatriate owned industries in 1968.39 The outcome of the 1969 step by government was a set of agreements which created a partnership between the two multinational corporations and the leadership of Zambia in the operation of the copper industry. New corporations, Roan Consolidated Mines and Nchanga Consolidated Copper Mines were created out of the older companies as joint ventures, with Government as the majority partner. The President also announced that mining company’s perpetual mineral rights were rescinded. That prospecting, exploration and mining licences would be necessary in the future, that a new mineral tax was being introduced based on profitability that Mining Development Corporation would be set up to over see the operations of the mines.40

Negotiations followed with government obtaining majority share of the equity without loss of foreign expertise. Mining companies were compensated fully over a period of time through redemption of bonds at 6.5% interest rate.41 In 1973, the government paid in full, the purchase of the 51 percent shares in mining companies.42

After independence in 1964, Zambia embarked on its first negotiations to change the tax regime affecting the mining companies.43 This was necessitated by the fact that during the colonial era and the early years of the independence period, mineral royalties accrued to the British South

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36 Muna Ndulo 1987 Mining Rights in Zambia, Kenneth Kaunda Foundation, Lusaka,
37 Ibid
38 Ibid
39 Ibid
40 Ibid
41 Ibid
42 Mupimpila Christopher et al 2007 Global Product Chains, Northern Consumers, Southern Producers and Sustainability; Copper from Zambia A paper prepared for the United Nations Environmental Programme.
African Company. This was because the British South African Company held the mineral rights. With the new changes, mineral rights were vested in the state. The copper industry was nationalised to maximize the returns to the Zambian people. It was then envisaged that under state control, copper revenues would be used to benefit the nation especially with raining revenue for infrastructure development. During the period 1969–1975 the country saw an unprecedented investment in the construction of new schools, hospitals and roads, using surpluses from copper revenues.

In 1973, the president made a new announcement to alter the previous relationship with foreign mining companies. There would be redemption of outstanding bonds, cancellation of contracts and the “reversion of the two mining partnership companies to self management. MINDECO would no longer oversee operations of the mines, this would be placed under the Ministry of Mines and Minerals with financial responsibility, normal taxation and exchange provisions would apply against the profits of the minority shareholders. The apparent intention it would appear was to obtain legal right to change tax laws and foreign exchange and to give to the indigenous Zambians the top positions in the industry. President Kaunda gave jobs to his supporters as a form of reward for supporting his party.

After nationalisation, the government changed the tax regime affecting the copper mines since now the government had become the majority shareholder. The Mines and Minerals Act 1970 made mandatory participation a condition for the establishment of any mining enterprise by a foreign investor. This was not a novel provision in the context of the history of mining activities in Zambia.

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44 Ibid
45 Kaunda Kenneth 1969 Towards complete Independence ,Government Printer, Lusaka
46 Neo Simutanyi 2008 Cooper Mining in Zambia’ The Developmental Legacy of Privatisation Occasional paper 165 Institute for Security Studies
48 Ibid
49 Press conference by President Kaunda, August 31 1973 in Lusaka, Zambia
50 Ibid
In the early period of mining, BSA Company required every registered mining location to be held by the registered holders on joint account with it in the proportion of two thirds to the registered holder and one third to the BSA Company.\(^{52}\) The main reason for the introduction of the policy of government participation, therefore was to ensure that mining rights holders operated within the framework of the overall economic and social goals of the country and also ensure that the mining industry was not completely foreign owned and controlled\(^ {53}\). Government in its Second National Development Plan emphasized the need to have a favourable investment climate in order to encourage the private sector to increase its level of interest in exploiting the mineral potential of the country.\(^ {54}\) It emphasized that legislation must always reflect this objective.

There was the realization of the need for foreign capital in the development of the country’s mineral resources. Among the benefits to be enjoyed from such partnerships were capital and know-how, which were mostly from abroad. As such, there was no complete nationalisation.\(^ {55}\)

Before 1969, there were three main taxes on mining rights holders in Zambia; the royalty tax of 13.5\% based on the London Metal Exchange copper price; the export tax of 40\% if and when the copper price exceeded US$300 per long ton at the London Metal Exchange and income/corporation tax of 45\%.\(^ {56}\) This was a form of windfall tax meant to capture profits in periods when copper prices were high. This was also a tax on production. While the first two taxes were revenue based, the corporation tax was profit based. Corporation or income tax was charged on profits, after the deduction of royalty and export tax.

Royalty describes the rent/tax payable to the owner of the minerals purely on the basis that he/she is the owner of the mine.\(^ {57}\) The concept of royalty is that it is a share of the product or profit reserved by the owner for permitting another to use his property. In Zambia, until 1964,

\(^{52}\) Muna Ndulo 1987 *Mining rights in Zambia* Kenneth Kaunda Foundation, Lusaka.

\(^{53}\) Ibid

\(^{54}\) Second National Development Plan, 1972


\(^{57}\) Ibid
the royalty was fixed by and was payable to the BSA Company. (The royalty was incorporated in the prospecting licence). It became payable to the Zambia Government by virtue of the Mining Ordinance (Amendment) Act, No. 5 of 1965. Royalty was at 13.5% on the price of copper with a reduction per ton, in periods when copper prices were low.\(^{58}\) This was a tax on production and as such, it increased production costs. The mining companies considered the royalty to be retrogressive in that it discouraged investment in mineral production.\(^{59}\)

After independence, tax was continued by the Zambian government for some time largely because it proved to be very profitable in terms of actual government revenue. It was also a political decision in that the government was not very sympathetic to mining rights holders on this issue as they had done little about it under the BSA Company.\(^{60}\)

The figures estimated by the royalty formula bore little relation to modern costs of production but was estimated in during the colonial period when costs were low. Royalty ignored the costs and the government always received the same royalty share of each long ton on mineral produced regardless of great fluctuations in the cost of production to the miner in different mines. The costs of extraction from the various mines of course varied tremendously in most aspects of production arising from differences in ores and several technical factors.\(^{61}\)

During the period 1964-1969 the rate of development of mines was very slow. The mining companies gave the tax system as the only reason for the lack of adequate mineral development. Another reason was that mining companies suspected that nationalisation would come sooner or later and were not anxious to re-invest back into capital which could be expropriated in the near future at a competition level which was undefined or less than economical.\(^{62}\)

The new tax structure became effective in 1970. The mineral royalty and the export tax were replaced with the mineral tax of 51% and a corporation tax of 45%. Thus the rate of tax on

\(^{58}\) Ibid
\(^{59}\) Mupimpila C et al Global 2007 Product Chains, Northern Consumers, Southern Producers and Sustainability; Copper from Zambia Paper to the United Nations Environment Programme
\(^{60}\) Muna Ndulo 1987 Mining Rights in Zambia Kenneth Kaunda Foundation, Lusaka
\(^{61}\) Ibid
\(^{62}\) Ibid
profits was 73.05 percent.\textsuperscript{63} During this period, mining rights holders were given financial relief through removal of burdensome taxes. It was the expectation of government that development would come through private initiative. Despite the tax reforms, mining companies continued to externalize profits and were unwilling to re-invest profits meaningfully. During the period 1975 - 1978, little or no dividends were declared.\textsuperscript{64} The mining rights holders cited the rate of taxation as the factor inhibiting development in that it reduced their liquidity;

\textit{“The change over to a taxation system based entirely on profits is a development which I very much welcome, though the new low grade combined rate of mineral and income tax is 73.5\% is very high indeed; too high I would judge to give adequate encouragement to the development of new low grade mining projects.”}\textsuperscript{65}

Although these measures raised the much needed revenue for the government, the mining companies argued that such high taxes on production and profit discouraged investments and growth of the industry.\textsuperscript{66} With high revenues obtained from the mines, the government had no incentive to enter into any agreements until problems in the industry started surfacing. The falling copper prices and the rise in input costs resulted in foreign exchange shortage for the country. The Second National Development Plan was based on the expectation of a decent profit from the sale of 900,000 tonnes of refined copper per year.\textsuperscript{67} By the mid 1970s it was obvious that both the production and price calculations were far off target. The spending programmes for the country, however, were tied to the estimated availability of foreign exchange from mineral sales. The increasing downturn in the Western industrial system plus the rising costs of imports (particularly oil) and the declining terms of trade for Zambian copper meant that the Zambian economy slowly slipped into an ever worsening recession.\textsuperscript{68} The ability of the Zambian officials to stem this decline was limited by the fact that major forces which control the copper market

\begin{itemize}
\item \textsuperscript{63} Bostock Mark and Harvey Charles 1972 Economic Independence and Zambian Copper. A Case Study of Foreign Investment. New York: Praeger Publishers
\item \textsuperscript{64} Ibid
\item \textsuperscript{65} Statement by Chairman, Anglo- American Corporation, 1970
\item \textsuperscript{66} Curry Robert 1984 Problems in Acquiring Mineral Revenues for Financial Economic Development: A case study of Zambia during 1970-78. \textit{American Journal of Economic and Sociology}, Vol.43 No.1
\item \textsuperscript{67} Burdette Marcia,1984The Class, Power and Foreign policy in Zambia, \textit{Journal of Southern Africa Studies}, Vol. 10 No.2
\item \textsuperscript{68} Ibid
\end{itemize}
were beyond Zambian reach. Zambia’s ability to negotiate the price for the copper was weakened by a chronic oversupply of copper on the market. Despite the formation of a producer cartel of copper exporters (CIPEC), the price continued to drop and stockpiles continued to rise. The overall efforts by CIPEC to lessen the decline were generally ineffective. Moreover, substitution materials such as aluminium and plastics competed actively for copper’s use in the construction and electronic industries. A plan to develop a buffer stock soak up the excess primary copper overhanging the market also came to naught.\(^6^9\) The price for copper continued at a low annual level, despite some brief upturns such as the one in 1979.

It was at that stage that the government started negotiations with the copper mining companies. In the budget speech of 1976, the Finance Minister stated that:

“In order to encourage higher foreign investment in the country, I have decided that investors will be allowed to remit either 15% paid up capital of their companies or 50% of their profit whichever is less.”\(^7^0\)

In 1976, it was anticipated that the mining sector had contributed almost half of the GDP, 92% of the export earnings and 53% of government revenues to the government.\(^7^1\) Costs of production of ore had increased on top of high prices for imports, economic diversification programs were slowed down or halted, the agriculture sector had declined badly and recurrent expenditures absorbed a growing percentage of the Budget. These problems were particularly critical because the engine for the Zambian economy- the copper industry- was in a period of severe recession because of low copper prices\(^7^2\)

At its peak in the late 1960s and early 1970s, copper mining accounted for more than 80% of the country’s foreign exchange earnings, over 50% of government revenue and at least 20% of total

\(^6^9\) The UNTAD proposal for the establishment of stockpiles for agricultural products and raw materials including copper had potential to diminish the severely negative effect of price cycles for these commodities. UNCTAD, June 1975,TC/B/C,1/184 and M Radetzki, The Potential for Monopolistic Commodity pricing by Developing Countries”, \(^7^0\) Ibid

\(^7^1\) Republic of Zambia, estimates of Revenues and Expenditures 1976, Lusaka Government Printer.

\(^7^2\) Burdette Marcia 1977 Nationalisation in Zambia; A critique of bargaining theory, *Canadian Journal of African Studies, Vol. XI. No 3*
formal sector employment.\textsuperscript{73} However, its performance declined from the mid-1970s and by the end of the 1980s copper mining was no longer the driving force which had been the engine of the country’s industrial and social development.

The cumulative effect of a continued dependence on an export sector which was vulnerable to cyclical prices and on a development strategy of import substitution became painfully clear in the 1970s. The managers of the state and the state controlled industries began to turn to debt financing to keep the industries and the state solvent. Zambia began to be entrapped in a new dependency – financial institutions of the West.\textsuperscript{74}

The financial position of government in the late 1970s stood in stark contrast to that in the 1960s. When Zambia attained its independence in 1964, the country inherited a rather favourable situation. There was a relatively low external debt and good promise of foreign exchange to pay off any and all debts and to keep the national balance of payments in surplus.\textsuperscript{75} In 1971-1972, temporarily depressed prices for copper meant less foreign exchange for the country. The gap between revenues and expenditures in international accounting was filled by running down reserves. Consequently, these reserves were not available to pay off new debts accrued by the state in the later 1970s. Little new foreign direct investment came in the country and despite the first nationalisation (1969), the economy was being drained of income.\textsuperscript{76}

The foreign minority partners were averaging from K11million to K13 million per year for their service fees.\textsuperscript{77} After 1975, this outflow was stanched when the mines became “self managed”. Yet, in order to purchase that self management privilege, the GRZ had paid US$226.3 million.\textsuperscript{78}

\textsuperscript{73} Simutanyi N 2008 \textit{Copper mining in Zambia; The developmental legacy of privatisation}, occasional paper 165, Institute for Security Studies
\textsuperscript{74} Ibid
\textsuperscript{75} Ralph M. Jeker 1978, Assessment of the Risks of borrowing from a Developing Country’s Point of View: Zambia,”Aussemwirtschaft 33, (1-2)
\textsuperscript{76} Burdette Marcia 1984 The Class, Power and Foreign policy in Zambia, \textit{Journal of Southern Africa Studies}, Vol. 10 No.2
to the minority partners. This money was raised by the government borrowing $150 million on the Eurodollar market, which at the time carried an interest rate of 13 percent.\textsuperscript{79} The difference between the loans and the re-nationalisation costs were bridged by the government officials and banks using the remaining national reserves.\textsuperscript{80} These economic difficulties were exacerbated by geopolitical events which put heavy pressure upon the Zambia political economy.

Instability within the region leading to continued attacks on the Benguela Railroad ensured that it remained closed. Strife over Namibia and Angola meant that portions of Western Zambia were often vulnerable to attack and even occupations by South African troops. The war in and around Rhodesia (now Zimbabwe) disrupted rail and road routes as well as dislocated some vital trade links, for South Africa was still a major supplier of goods to the Zambian economy.\textsuperscript{81} Since most South African goods travelled to Zambia via Zimbabwe, this put the Smith regime astraddle Zambia’s primary trade routes. Even after the Independence of Mozambique in 1975, which lessened the strain along Zambia’s eastern border, the problems were not over. The decision of the FRELIMO Government in Mozambique to shut down the rail road from the Rhodesian border to Beira in 1976 affected Zambia as well, effectively shutting down another transport link. This situation became severe such that when the price of copper went through a cyclical up turn and there was plenty of copper available in Zambia’s stockpiles, the mine managers still could not guarantee that the copper would make it to its Western European and Asian markets.\textsuperscript{82} NCCM and RCM lost these potential sales at a time when they needed the cash flow.

From 1969 to 1974, the combined incomes from the mining sector contributed 32 to 48 percent of GDP and were responsible for over 90 percent of the total foreign exchange earnings of the economy.\textsuperscript{83} Between 1975 and 1979, however, mineral taxes, income taxes on the companies and dividends to the state were non-existent or miniscule. In 1977, the contribution of the copper industry to GDP dropped to 11 percent.\textsuperscript{84}

\textsuperscript{79} Ibid
\textsuperscript{80} Burdette Marcia 1984 The Class, Power and Foreign policy in Zambia, \textit{Journal of Southern Africa Studies}, Vol. 10 No.2
\textsuperscript{81} Ibid
\textsuperscript{82} Ibid
\textsuperscript{84} Ibid
As the costs of producing Zambian minerals continued to rise, their attractiveness to consumers declined despite devaluation of the Kwacha in 1976 and again in 1978. When the additional costs of sales (insurance, freight, sales, and commissions) were added to the production costs the Zambian mines found themselves producing and selling copper near the break even point and sometimes even at a loss. By the end of the decade in 1979, Zambia was listed as a high cost producer of copper.  

The pressure to export did not however, abate because the companies needed the revenues and the state needed the foreign exchange generated by the sales of minerals abroad. Strangely, the mines which supply about 90 percent of the foreign exchange earnings for Zambia also consumed about 60 percent of the value of imports. The mines therefore, were producing lower profits than before and their foreign exchange earnings were far less than had been hoped for. With foreign exchange receipts down, national reserves were run down to pay external debts and new loans had to be negotiated for the state and for the mines. The transportation problem which had rocked the state worsened. The delays which contributed to the export and import schedules meant constant shortages and higher costs of sales and inflated prices for imported goods. The overall trade picture was gloomy in 1977-1978.  

In reaction to the economic dislocations, the Government announced a set of austerity budgets, cutting back deeply in such programmes as food subsidies and putting tight controls over import licences. Without the additional revenues from mineral sales to offset the expenditures, the Government officials turned to deficit financing and to the multilateral lending and aid institutions of the market economies of the West, particularly the private commercial banks, the International Monetary Fund (IMF) and IBRD. Loans and grants from commercial banks and bilateral governmental aid sources tend to intertwine and interact with IMF and IBRD financing.

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85 646,797 tonnes in 1979, CISB, Zambia Mining Year Book, 1977-79
The overall effect should be understood to be a combination of these financing sources with the host state’s own economic policies.

Hence, the government which prior to the mid-1970s had not had extensive dealings with these foreign financial centres, now had to assemble a set of policies to cope with its new situation appropriate to the status of a large-scale debtor nation.

Prior to 1975, Zambia had not resorted to the multilateral funding institutions extensively. As mentioned above, the country had surpluses on current account most of the years since Independence. In most of the years, it had had a positive balance of trade with the rest of the world. Traditionally, export credits and guarantees to the mines, some private commercial loans and occasional bilateral loans as well as banks internal reserves had proven sufficient to serve the country’s needs. After 1975, the safety nets had weakened. Balance of payments slipped into a chronic deficit. From 1973 to 1979 the balance of payments was only in surplus twice, and the overall payment arrears were sizeable. In years when the copper prices were high, the payment arrears were almost paid off but the overall external debt of the state continued to rise. Facing a possibility of a steeper deficit, Government and Central Bank officials negotiated a compensatory financing facility with the IMF in 1976. There was no requirement for the government to draw on this facility; rather the funds were earmarked to offset the balance of payments and payment arrears to foreign debtors. Conditionalities were attached for the extension of this facility to the Zambian government such as devaluing the Kwacha (local currency), reduce on local/domestic spending and invoke a series of money saving policies. For the mining industry, measures included a reduction in the labour force from an estimated 66,000 in 1976 to 51,000 in 1986. This was done by way of retrenchment, voluntary retirement and dismissals.

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88 Ibid
89 Ibid
90 Ibid
91 Ibid
92 Simutanyi Neo 2008 Copper Mining in Zambia; The Developmental Legacy of Privatisation occasional paper 165, Institute for Security Studies
93 Ibid
It is not clear whether it was the pressure from the IMF/World Bank or conservative fiscal and monetary policy from technocrats and civil servants that led to these decisions being made. Despite putting in place such measures, the economy continued to stumble further, with increased debt and servicing, $173 million in 1973.94

Given the scale of Zambian mining and GDP, such a debt was not particularly onerous, with a deep recession in the copper market and GDP decline, foreign exchange receipts to the state continue to decline and the ability of government to repay the debts become even more uncertain. Debt servicing started consuming a large percentage of export income, thus taking it away from such areas as capital expenditures.95

In 1978, Zambia returned to the IMF for another loan. The IMF instead promised SDR $390 million. In return Zambia promised to devalue the Kwacha again, by 10%, reduce the money supply by 8.07% and cut back even further on government spending.96 Despite these interventions, total debt continued to rise; debt services reached $190 million in 1978. Zambia further held discussions with the World Bank on balance of payments and development loans. Within the same year, government negotiated another Eurodollar loan, this time for $57 million.97 It was difficult for Zambia to negotiate favourable terms for such loans.

The growing indebtedness of the state was mirrored in the mineral industry. Typically, big industrial ventures carry a heavy burden of debt to finance various capital expenditure programmes. As long as equity is high and the company is making money, re-financing is not a serious problem. But with equity not expanding in the Zambian mines and copper not being sold at good profits, the “gearing” of the companies appeared less favourable to foreign financial

94 Jeker Ralph 1978 Assessment of the Risks of borrowing from a Developing Country’s Point of View: Zambia,” Aussemwirtschaft 33, (1-2)
96 Ibid
97 Ibid
As an indicator of financial stress, the government became a major lender to its own state owned industries, NCCM and RCM.99

By March 1978, RCM and NCCM owed the Central Bank of Zambia over $200 million.100 Later, the state indirectly lent money to the mines in a complex trade of debt for equity. Despite loans from the Government, the long period of low copper and cobalt prices and low profits for the companies meant that earnings were too small to finance the companies from within.101

A solution to try and lessen the financial pressure on the companies was to try to reduce costs. To lessen the mines expenses and to plan for more efficient capital outlays, the management of NCCM and RCM invoked a series of cost cutting policies and merged various operations of the mines.102 As part of the $400 million stand-by loan to Zambia in 1978, the IMF had requested that the mining companies restrict their borrowing to rather strict limits and try to cut costs.103 It is important to note that while the IMF cannot force restrictions, since ultimately, the state has the authority over the mines; it did apply pressure to influence the mines to cease their borrowings and to take some deep cuts in operating and technical areas.

The most affected were the capital expenditure programmes of the mines. More visible was the announcement in 1981, to merge the two companies, NCCM and RCM, to create a new company, Zambia Consolidated Copper Mines Limited (ZCCM) which was one of the largest copper mining companies in the world.104 As a short term measure, a few savings were made. However, the financial squeeze affected Zambia’s foreign policy.105

ZCCM was created as a merger of the two state mining enterprises which had themselves been created when the Zambian copper industry was nationalized in 1969.106 Thus, ZCCM was a combination of state and private interests. The main share holders in the company were the

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98 Ibid
99 Ibid
100 The Economist, September 1978
102 Ibid
103 Ibid
104 Ibid
105 Ibid
106 Ibid
Zambian government, with 60.3 percent of the shares, and the South African conglomerate Anglo-American Corporation (AAC) which controlled 27.3 percent.\textsuperscript{107} AAC also held preemptive rights to purchase any shares sold by the government once the government share in ZCCM fell below 50 percent, and through its representation on the ZCCM Board of Directors, had an effective right of veto over the sales of any major assets.\textsuperscript{108}

The formation of the ZCCM had been a response to the prolonged depression in the international price of copper which had began in mid 1970’s\textsuperscript{109} It was envisaged that the centralized control of the industry would allow for more effective use of resources and during the 1980’s a number of restructuring initiatives were undertaken with the assistance of the World Bank and outside Consultants.\textsuperscript{110}

Towards the end of the 1980s ZCCM took up several responsibilities that the state was no longer able to fulfill effectively, such as the provision of health and educational services, tourism, transport and farming.\textsuperscript{111} The ZCCM not only performed these added responsibilities but also paid the salaries of some political appointees, purchased motor vehicles for government and was responsible for providing ‘free’ air transport to senior members of the Kaunda regime.\textsuperscript{112} The diversion from the core business of mining and the politicisation of the ZCCM board led some observers to conclude that this may have been responsible for the poor performance of the mines in the 1980s and early 1990s.\textsuperscript{113}

At the beginning of 1990’s ZCCM was the fifth largest copper producer in the Western world, accounting for up to 4 percent copper of the production of refined copper.\textsuperscript{114} However, the company faced problems related to both the immediate financial viability and its long term

\textsuperscript{108} Ibid
\textsuperscript{109} Ibid
\textsuperscript{110} Ibid
\textsuperscript{111} Ibid
\textsuperscript{112} Ibid
\textsuperscript{113} Ibid
\textsuperscript{114} UNCTAD 1994 A Review of the Major Developments in the World Copper Market and Industry from 1980 to 1992 and Future Prospects, Geneva,
development. The level of reinvestment was also low and copper production had reduced drastically by a quarter between 1982 and 1990. Over this same period, ZCCM’s debt had risen from a third of its total asset value to over half, and its ability to service this had become contingent on rescheduling agreements and the support of the Zambian government. To maintain effective operations, ZCCM needed to undertake new investment. However, it was unlikely that the funds required could be generated from within the company.

The collapse of the Zambian economy in the 1980s was intimately related to the poor performance of the copper mining industry. Some unprofitable mines and shafts were shut down in Ndola, Mufulira, Luanshya and Chililabombwe. This went hand in hand with a retrenchment of mine labour and the scaling down of ZCCM’s social responsibilities to the communities.

Refinancing of ZCCM and establishing it as an independent private sector mining company emerged as an option on the government’s agenda.

Under strong encouragement from the IMF and other external lenders, Zambian technocrats and civil servants designed a set of policies: to create a more attractive investment climate in Zambia for foreign capital; to build a larger and more productive agriculture sector on commercial rather than peasant farmer or cooperative lines; to expand the manufacturing sector; and to resuscitate the mines. This was meant to open the economy further to foreign capital. This in turn required some adjustments of the prior economic nationalism that had been contained in the Economic Reforms. Despite the situation there was still a need to tighten foreign exchange

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116 Ibid
117 Ibid
118 Reuters, 1 October,1991
119 Simutanyi Neo 2008 Copper Mining in Zambia; The Developmental Legacy of Privatisation occasional paper 165, Institute for Security Studies
120 Ibid
122 Simutanyi Neo 2008 Copper Mining in Zambia; The Developmental Legacy of Privatisation occasional paper 165, Institute for Security Studies
measures to seal loopholes in the outflow of foreign exchange.\textsuperscript{123} This was contrary to the expectation of foreign owners who would have preferred to repatriate a high percentage of the profits they made overseas. To rely on international aid or grants to help supply capital to the Zambian economy was unrealistic given the worldwide decline in the percentage of this aid from most of the advanced industrial states, the traditional sources of such capital.\textsuperscript{124}

By 1984, Zambia’s long and medium term foreign debt amounted to $4,500 million, about one fifth to private companies and banks, the remainder to foreign governments and multilateral institutions.\textsuperscript{125} Zambia was one of the countries in the world with very high external debt.\textsuperscript{126} Much of this was incurred to try and offset the reduction in the copper export earnings. Despite repeated rescheduling, debt service (interest and principle payments on earlier borrowing) for government and government guaranteed debt alone absorbed about half of export earnings, aggravating balance of payments difficulties. Merchandise imports had dropped to about one third of their 1970 volume, falling by almost half between 1980 and 1985 alone.\textsuperscript{127}

Increasingly, the Government relied on credit from the IMF to repay old debts and to maintain imports.\textsuperscript{128} By 1984, it owed IMF $600 million, and as a precondition for obtaining new loans, Zambia agreed to modify long-standing debt policies. In particular government guidance of the economy was diluted by abolishing fixed credits for almost all goods, giving parastatal corporations more autonomy, relaxing foreign exchange controls, and cutting government spending. According to the IMF, these measures would foster efficiency in production, reduce consumption to release funds for investment, and ameliorate balance of payment difficulties. These prescriptions seemed to be the only viable solution. This has been critiqued on theoretical

\begin{itemize}
\item \textsuperscript{123} Republic of Zambia, Ministry of Development and Planning, Annual Review: Performance of the Zambian Economy 1975 (Lusaka, December 1975)
\item \textsuperscript{124} Burdette Marcia 1984 The Mines, Class Power and Foreign Policy in Zambia, \textit{Journal of African Studies}, Vol. 10, No.2
\item \textsuperscript{125} Makgetla Neva 1986 Theoretical and Practical Implications of IMF conditionality in Zambia, \textit{The Journal of Modern African studies}, 24,3
\item \textsuperscript{126} Copper Mining in Zambia available at www.newint.org/easier-english/mining/copper.html
\item \textsuperscript{127} Mwananshiku Luke Minister for Finance, Statement at the official opening of the workshop on the debt problems facing Zambia, University of Zambia Lusaka 26\textsuperscript{th} November 1985.
\item \textsuperscript{128} Makgetla Neva 1986 Theoretical and Practical Implications of IMF conditionality in Zambia, \textit{The Journal of Modern African studies}, 24,3
\end{itemize}
grounds and in the light of the Zambian realities. This however, is beyond the scope of this paper and this paper shall therefore, not delve into that discussion.

After 1980, government wage and salary policies tended to reinforce income inequality. Average real wages plummeted between 1974 and 1983, falling about 40 percent. As IMF conditions brought price rises and wage restraint, real wages fell, on average between, 10 and 15 percent a year. However, government granted the largest increments, in both percentage and absolute terms, to the top salary earners. ZCCM conditions were in comparison to other parastatals more superior, despite the low sales. To pay the high salaries, government had to abolish subsidies on essential commodities, affecting the entire lower–income group.

Government spending could be seen on things like financing the housing or offices for the small high income group, imported construction materials, largely for expensive buildings. In 1982 an estimated $35 million left the country as a result of shopping trips in neighbouring countries by well off individuals. The purchase of 71 Mercedes Benz vehicles from South Africa for a S.A.D.C.C summit cost almost $2 million.

According to the IMF, the use of resources to maintain the living standards of the high income group, and to repatriate profits, was required to encourage investment. The Zambian parastatals did not bring about the balanced development of the economy. They failed to establish more self reliant production, while funds continued to flow overseas and to well of individuals, as well

129 Ibid
131 Ibid
134 Government of Zambia, Report of the Administration Commission of Inquiry into the salaries, salary structures and conditions of service of the Zambian public and teaching service, the local government service, the Judicial service, the Zambian police and prisons service (Lusaka 1980) Vol. I
135 Ibid
136 Makgetla Neva, 1986 “Investment in the Third world; the Zambian experience” I.D.R.C
137 Ibid
138 Ibid
139 Ibid
as into inappropriate investments.\textsuperscript{140} The deficiencies in the production structure, however, followed largely from the reliance on market forces in selecting investments, rather than from the public ownership itself.\textsuperscript{141}

The government’s political legitimacy was thus severely undermined by an economic crisis that saw the copper industry no longer able to provide employment to the majority of the Zambian labour force or act as the engine of growth for the entire economy.\textsuperscript{142} By 1989, there were repeated urban food riots and industrial unrest leading to unpopularity of the ruling party United National Independent Party (UNIP) and its President, Kenneth Kaunda.\textsuperscript{143}

In 1990, the Movement for Multiparty Democracy (MMD) was formed, headed by Zambia Congress of Trade Union (ZCTU) leader Frederick Chiluba. They won the elections in 1991.\textsuperscript{144} For their manifesto the MMD promised to liberalise the economy and privatise state owned enterprises. The ascendancy to power of the MMD ensured a return to neo-liberal approaches to economic management. Therefore, the realities on the ground, the pressure from the donor countries and the international finance institutions and the change in political thinking made the State to rethink the country’s development strategy.

Because the country’s economy has historically hinged on copper mining, the privatisation of the mines was critical to the country’s development agenda.\textsuperscript{145} It was thought then that privatisation of the copper mines would attract foreign investment into the sector.\textsuperscript{146}

\textbf{2.3 Conclusion}

In Conclusion, it is admitted that there were reasonable growth rates in the 1960’s and early 1970’s primarily due to high copper production and prices and increases in maize and

\begin{itemize}
  \item \textsuperscript{140} Ibid
  \item \textsuperscript{141} Ibid
  \item \textsuperscript{142} Simutanyi Neo 2008 Copper Mining in Zambia; The Developmental Legacy of Privatisation occasional paper 165, Institute for Security Studies
  \item \textsuperscript{143} Ibid
  \item \textsuperscript{144} Bratton, M, & Nicolas Van De Walle 1997 Democratic experiments in Africa: Regime Transitions in Comparative Perspective, Cambridge: Cambridge University Press
  \item \textsuperscript{145} Lungu John 2008 The Politics of Reforming Zambia’s Tax Regime A paper presented at the Mine Watch Conference, Politics Economy ,Society Ecology and Investment in Zambia, Oxford University
  \item \textsuperscript{146} Ibid
\end{itemize}
manufacturing output, as well as increases in numbers of social facilities and physical infrastructure.\textsuperscript{147} However, the nationalisation programme in general and import substitution in particular, proved very costly.\textsuperscript{148} Zambia failed to diversify the economy from copper mining and import substitution strategy proved unsustainable.\textsuperscript{149} The decline in the world copper prices since 1974 contributed to economic decline causing reduced government expenditure on development; balance of payment problems; and inability to service external debt.\textsuperscript{150} Lack of savings by the government during periods of high copper prices to cushion the impact of any fall in copper prices worsened the situation.\textsuperscript{151} Extensive state intervention gave rise to bureaucratisation, corruption and uncertainty, discouraging productive private investment and foreign trade initiatives.

\textsuperscript{147} Bertha Hwedie 2003 Development Policy and Economic Change in Zambia: A Re-assessment, \textit{DPMN Bulletin} Vol. X No. 2
\textsuperscript{148} Ibid
\textsuperscript{149} Ibid
\textsuperscript{150} Ibid
\textsuperscript{151} Ibid
Chapter 3

3. Introduction

This chapter will look at the decision by the government to adopt IMF and World Bank recommendations to privatise previously nationalised industries. This paper will particularly focus on the privatisation of the mines, whether this was the solution to the economic woes Zambia was facing. It will also look at the policies Zambia put in place to create a favourable investment climate and whether this has increased the flow of Foreign Direct Investment to the country. Thus will in effect, analyse the classical theory resting on Foreign Direct Investment.

3.1 Privatisation

3.2 Background

The increased government control over the mining industry in Zambia had concomitant changes in the country’s system of government. During the era of President Kaunda, the majority of parastatals were managed by the state under umbrella management institutions. Under pressure from the donors, Zambia had begun to sell state owned companies during the last stages of the second republic.\(^ {152}\) The new government under the multiparty system of democracy had stressed its unwavering commitment to macroeconomic policy reforms, liberalisation and privatisation of state owned companies, including ZCCM.\(^ {153}\)

In the 1980’s the World Bank and IMF Started to use the leverage that came with Zambia’s massive debts to them and its inability to fund government revenues from mining income to push the country to adopt economic liberalisation policies.\(^ {154}\)

Following the recommendations of the IMF and World Bank, the government undertook economic policy reforms to rejuvenate the economy from 1983.\(^ {155}\) In 1987, facing protests against its austerity measures in its adjustment programme, the Government rejected the

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152 Mupimpila Christopher and Nicolien Van der Grijp 2007 Global Product Chains, Northern Consumers, Southern Producers and Sustainability: Copper from Zambia Report prepared for United Nations Environmental Programme
153 Ibid
154 Fraser Alistair and Lungu John2007 For Whom The Windfalls? Winners and Losers in the Privatisation of Zambia’s Copper Mines
155 Ibid
conditions of its loan and instituted a “New Economic Recovery Programme” that limited debt service payments to 10% of net export earnings.\textsuperscript{156} Zambia’s refusal to pay at the IMF’s preferred rate resulted in almost all of Zambia’s donors deciding collectively not to lend the country any assistance.\textsuperscript{157} Within eighteen months, Zambia rescinded this decision; the price of future support would be compliance with donor priorities.\textsuperscript{158}

However, the Structural Adjustment Programmes worsened, rather than improved the economy.\textsuperscript{159} Agricultural and manufacturing outputs and exports failed to increase significantly.\textsuperscript{160} This was attributed to the inadequate incentives for farmers due to uncompetitive exports of manufacturers, high inflation, unemployment and rising external debt.\textsuperscript{161}

A Technical Committee within the Ministry of Commerce, Trade and Industry set up in 1990 had carried out some preliminary work on the privatisation of state owned enterprises. However by the time of the political transition in 1991, no privatisation transactions had taken place. The process of privatisation only gathered momentum in 1995.\textsuperscript{162} From its inception, apart from some key Ministers, the privatisation process had only lukewarm support even within the cabinet.\textsuperscript{163} As a result, neither the mines nor the utility companies were included in the governments’ original privatisation portfolio.\textsuperscript{164} A careful plan in which the small companies were privatised first was opted for. Despite the lack of support and slow beginning of the privatisation process, and most notably, the failure to take action towards the mining sector, by 1996, the privatisation programme in Zambia was cited as one of the government’s key successes.\textsuperscript{165} By 1997, 224 companies of a total of 275 tranch for privatisation were sold and

\textsuperscript{156} Ibid
\textsuperscript{157} Ibid
\textsuperscript{158} Ibid
\textsuperscript{160} Ibid
\textsuperscript{161} Ibid
\textsuperscript{162} Fraser Alistair and Lungu John 2007 For Whom The Windfalls? Winners and Losers in the Privatisation of Zambia’s Copper Mines Civil Society Trade Network of Zambia, Printec, Lusaka.
\textsuperscript{163} Ibid
\textsuperscript{165} Ibid
the government had committed itself to tender the mining conglomerate by February 1997.\textsuperscript{166} The World Bank attributed the success of privatisation programme to the fact that the process through the Zambia Privatisation Agency was predominantly private sector driven, with little interference from government.\textsuperscript{167} Others condemned it for the de-industrialisation, deepening debt and increasing poverty that came with it. Foreign Companies bought the largest and most viable firms with very little profit staying in Zambia.\textsuperscript{168} World Bank eventually accepted that despite massive lending and massive adjustment programme “The supply response from the extensive privatisation of small and medium enterprises was limited….outcomes could have been significantly better… in terms of faster and stronger resumption of economic growth and reversal in per capita income and poverty trends…. If the relevance and efficacy of Bank strategy had been higher. Outcomes of many Bank operations and of the overall Bank program were unsatisfactory.”\textsuperscript{169}

3.3 Privatisation of ZCCM

Since Zambia is heavily dependant on copper, the privatisation of the mining conglomerate was the main issue in terms of potential economic turn around. It was only in 1996, that the government accepted advice to begin the process of the privatisation of Zambia Consolidated Copper Mines (ZCCM) in unbundled units by open tender, with the aim of reaching agreements before 1997.\textsuperscript{170} The move on the privatisation of the mines was decisive in securing funding from the multilateral donors and thereafter, the bilateral donors.

The Zambian government had examined a number of options for transferring ZCCM to the private sector. The aim of such examination was to meet three core objectives. The first was to access the new investment required to secure the future of the Zambian mining industry as a

\textsuperscript{166} Fraser Alistair and Lungu John 2007 For Whom The Windfalls? Winners and Losers in the Privatisation of Zambia’s Copper Mines Civil Society Trade Network of Zambia, Printec, Lusaka.
\textsuperscript{167} World Bank Findings, October 1996, Times of Zambia, October 15, 1996
\textsuperscript{168} Fraser Alistair and Lungu John 2007 For Whom The Windfalls? Winners and Losers in the Privatisation of Zambia’s Copper Mines Civil Society Trade Network of Zambia, Printec, Lusaka.
major world producer of refined copper. In order to achieve this, the bulk of new funds would have to be sought from outside Zambia, and there were concerns over the resulting level of foreign control. The second objective was to find a strategy which either retained some degree of local control over the industry or otherwise qualified the influence of the new owners. The final objective of the government was to secure the best selling price that could be obtained for the assets. This would primarily reflect the importance of the company and the desire not to be seen as selling the nation’s asset too cheaply.

Three principal options were examined by the government, each with different consequences for the resulting structures of ownership and control. The first option was for a single or group of foreign transnational mining corporations to acquire a controlling interest in ZCCM. The second option was to restructure ZCCM by dividing it into a number of different companies which could be offered for sale on an individual basis. This appeared on the government’s agenda in 1994, following the submission of a World Bank funded study. The third option, which also emerged in 1994, was to transfer ZCCM intact into the private sector as an independent mining company under the control of existing management. Each option had advocates and critics, and was subject to a number of constraints which this paper shall not delve into.

The new Zambian Government began informal discussions with Anglo American Corporation on the future of ZCCM in 1992. In doing so, it recognised not only that AAC was the largest private shareholder in the company, but that on the basis of the existing rights, its cooperation was essential for the success of any privatisation proposal. This coincided with the changes in the corporate strategy of AAC. First the transition to majority rule in South Africa was re-opening opportunities for the company to expand its interests through out Africa, and especially in states

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172 Ibid
173 Ibid
174 Simutanyi Neo 2008 Cooper Mining in Zambia’ The Developmental Legacy of Privatisation Occasional paper 165 Institute for Security Studies
175 Ibid
176 Ibid
177 Ibid
178 Chadwick J 1993 African Anglo American, Mining Magazine
179 Ibid
like Zambia which had strongly supported the struggle against apartheid. Secondly AAC was intent on expanding its interests in base metals such as copper, and was searching for potential investment opportunities. However, some members of AAC’s senior management doubted that these could best be achieved by reviving their interests in the Zambian copper industry, and discussion between AAC and the Zambian government indicated considerable differences in their respective views on the potential value of ZCCM. Within Zambia, there were concerns over the implications for the nation’s economy should control of its prime asset be monopolized by a foreign mining company. It was strongly believed that if AAC gained control of ZCCM, the future development of the Zambian copper industry would become subsidiary to AAC’s own corporate interests. ACC had a reputation for taking a long term view in acquiring assets and of biding its time until it chose to develop them. It was feared that this approach could delay the replacement of Zambia’s existing sources of ore. It was also suggested that it was highly unlikely that AAC would commit the scale of resources required to rehabilitate existing operations and to develop new mines.

The option of restructuring the Zambian copper industry as an integral element of privatisation was proposed in a World Bank funded study. The report advised that ZCCM be unbundled, rather than privatised intact, stating that the strongest argument for not privatizing ZCCM as a whole is that whoever (presumably foreign) should own an undivided ZCCM will have a very strong influence on the government of Zambia and national economy. To overcome this, it was proposed that each of the mining divisions should become a separate operating company. A majority interest would be sold to private investors, while ZCCM would retain minority interest and supply technical and support services to them. It provided an opportunity to tap the resources of a number of foreign mining companies, while avoiding the domination of the copper industry

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181 Ibid
183 Bull Theo 1994 ZCCM : Corporate Confusion Multiplied Profit
184 Ibid
185 Ibid
186 Ibid
187 Strategic Options for the Privatisation of ZCCM, the Kienbaum Report
188 Reuters News Services, 1994
by a single one. ACC was opposed to this proposal process which it characterized as being long, difficult and expensive.\textsuperscript{189} It believed that the Kienbaum proposals underestimated the degree of interdependence between units within ZCCM, and that unbundling would create new costs by duplicating facilities. As individual units, higher cost mines would be more susceptible to periods of low copper prices, and the over all effect of disintegration of the company would be to decrease the combined value of the assets. Many of these concerns were shared by others. They doubted that ZCCM could be easily divided due to its existing financial and technical integration.\textsuperscript{190} They perceived little advantage in supporting a highly controversial proposal of questionable viability. Government decided to undertake a number of further studies to address the issues that had remained unanswered.\textsuperscript{191}

Refinancing ZCCM and establishing it as an independent private sector mining company was an option considered by the Zambian government.\textsuperscript{192} In part, it reflected the influence of the successful privatisation of the Ghanaian state Enterprise Ashanti Goldfields.\textsuperscript{193} In May 1994, ZCCM announced a two year “Interim Short Term Plan” aimed at concentrating capital expenditure on the most profitable units, disposing of unprofitable and underutilized units.\textsuperscript{194} The aim of the sales of these peripheral assets was not the division of the company, as envisaged by the unbundling option, but rather the maintenance of the core activities of the company as a single unit. Proposed to be sold off were Zinc and Lead mines respectively. This was confirmed in a ten year plan, formulated by the management of ZCCM, based on the company remaining a single entity, financed through retained earnings and debt, and without any additional equity investment.\textsuperscript{195}

\textsuperscript{189} Ibid
\textsuperscript{191} Reuters News Service, 1994
\textsuperscript{192} Craig John 2001Putting Privatisation into Practice: The Case of Zambia Consolidated Copper Mines Limited Journal of Modern African Studies Vol. 39, No 3
\textsuperscript{193} Ibid
\textsuperscript{194} ZCCM Annual Report 1994
\textsuperscript{195} Credit Lyonnaise Laing 1994 ZCCM Survive or Perish ,London: Credit Lyonnaise Securities, Mining Research International
Along side these proposals, then President and the Finance Minister outlined proposals for the government to substantially reduce its shareholding in ZCCM.\(^{196}\) Initially, up to 10 percent of the company’s shares would be sold to the Zambian public, with a similar percentage subsequently offered to the foreign investors. This factor had to comprehend with the pre-emptive rights of AAC.\(^{197}\) Although the government’s holding of around 60 percent of the equity of ZCCM would allow for the placement of an initial 10 percent of equity, further changes in ownership would require agreement with AAC. Indeed, even if this was possible, the question of whether ZCCM could have found investors willing to support an international sale of equity is open to question. Prior to its floatation, Ashanti Goldfields had been exclusively rehabilitated and its management had gained the confidence of international investors. By comparison, at ZCCM the rehabilitation work was still to be done and it was doubted that the existing management had the ability to achieve it.\(^{198}\)

ZCCM was in the end, privatised through the unbundling option and envisaged a two stage approach to privatisation. In the first stage, the majority shares in the operating companies would be sold to new investors, with ZCCM maintaining a minority interest in each new company.\(^{199}\) With ZCCM transformed into an investment company with minority shares in a range of independently managed mining companies, stage two would commence. In this the government would sell all or most of its shareholding in ZCCM to domestic and international investors. The Zambian government emphasized that the strategy offered the opportunity to transfer the industry into the private sector, mobilise new investment, diversify ownership and create new opportunities for Zambian participation.\(^{200}\) However, its re-emergence over other option was a result not only of its own merits, but also of a number of developments which re-defined the opportunities available to the Zambian government.\(^{201}\)

\(^{196}\) Reuters News Service, Lusaka, 1994  
\(^{197}\) Craig John 2001 Putting Privatisation into Practice: The Case of Zambia Consolidated Copper Mines Limited Journal of Modern African Studies Vol. 39, No 3  
\(^{198}\) ZCCM Annual Report 1994  
\(^{200}\) Ibid  
\(^{201}\) Ibid
Despite the measures being undertaken by ZCCM, its ongoing viability in its existing form became increasingly doubtful.\textsuperscript{202} The company’s level of copper production had been on a downward trend since the beginning of the decade, and after 1993 its profitability had evaporated.\textsuperscript{203} The “Short Term Interim Plan” was failing to meet its targets and this continued deterioration led, in late 1995, to the government requesting technical assistance from the World Bank to formulate a new action plan.\textsuperscript{204}

The outcome of these studies was a further restructuring of ZCCM management and the appointment of a number of expatriates to key positions within the company.\textsuperscript{205} In addition, ZCCM’s own attempts to dispose of peripheral assets proved to be unsuccessful. Many industry observers held ZCCM responsible for this arguing that overly restrictive qualifying criteria had excluded participation of many potential investors.\textsuperscript{206} Together these developments further undermined the credibility of ZCCM’s existing management, and increased doubts as to whether the company could enter the private sector as an independent entity.\textsuperscript{207}

The separation of one of the big projects, Konkola Mine Deep Project, from the rest of ZCCM had a number of consequences for the privatisation of the company. First, it removed from ZCCM the prime assets that could attract a transnational mining company to seek control of the company as a whole.\textsuperscript{208} With this project detached from the future of ZCCM, AAC indicated to the government that they were not interested in acquiring a controlling interest in ZCCM, and would be willing to waive their pre-emptive rights in the context of privatisation.\textsuperscript{209} Secondly the separation diminished the future prospects of the company as an integrated unit. This project had offered ZCCM a replacement for its steadily depleting sources of ore and without them, the future position of the company as a major integrated copper producer was compromised. Alongside this, the further declines in the production and profitability performance of ZCCM were also

\begin{itemize}
  \item \textsuperscript{202} Ibid
  \item \textsuperscript{203} Ibid
  \item \textsuperscript{204} Republic of Zambia 1995
  \item \textsuperscript{205} Craig John 2001 Putting Privatisation into Practice: The Case of Zambia Consolidated Copper Mines Limited Journal of Modern African Studies Vol. 39, No 3
  \item \textsuperscript{206} NEDCOR Securities 1995 Zambia Consolidated Copper mines: Fiddling while Chile booms London: NEDCOR Bank Limited, Mining Research
  \item \textsuperscript{207} Ibid
  \item \textsuperscript{208} Craig John 2001 Putting Privatisation into Practice: The Case of Zambia Consolidated Copper Mines Limited Journal of Modern African Studies Vol. 39, No 3
  \item \textsuperscript{209} Sunday Telegraph 1995
\end{itemize}
decreasing the attractions of the company to the potential investors, and raised the issue of whether any company or consortium would have either the desire or the capacity to undertake the rehabilitation of the entire company. 210 In this light, some further separation of the assets that constituted ZCCM appeared unavoidable.

It was in this context that the unbundling of ZCCM into a number of separate operating companies emerged as the most viable option for transferring the company to the private sector. While AAC continued to state that unbundling was not the preferred option, having acquired rights over the biggest project, it indicated that it was willing to cooperate with the government's choice of privatisation strategy. 211

When Zambia finally invited bids for the mines, only one bid was received from a Consortium comprising foreign companies. 212 The initial bid was unacceptable to the Zambian government but nonetheless accepted subject to contract. 213 In the following months, the terms offered were revised downwards and this resulted in the collapse of the deal. The agreement covered the purchase price, the capital expenditure that the consortium would be required to invest, the level of debt to be assumed and the residual equity to be held by ZCCM. 214 The consortium cited the financial crisis in East Asia which materially reduced expectations of future copper prices and the physical deterioration of the assets which they sought to acquire as the major reasons for the revised terms. 215 Negotiations failed and the consortium disbanded.

Pressure was brought upon the government to complete the first stage of the privatisation process by donors who made the release of US$ 530 million balance of payment support pledged in 1998 conditional upon its completion. 216 Concern was also raised within the Zambian Community over the costs of the continued delay in privatisation to the economy as a whole, most importantly, the viability of ZCCM as a going concern appeared to be increasingly

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211 Ibid
212 Ibid
213 Ibid
216 Times of Zambia, Lusaka 1999
doubtful.217 The government and AAC, in 1998 drew up a survival plan aimed at maintaining the company as a going concern on a temporary basis while its remaining assets were privatised.218 The plan underlined the critical financial state of ZCCM, warning that the company was facing liquidation, the overall impact of which would have far reaching consequences for the Zambian economy.219 AAC indicated its willingness to acquire a greater part of ZCCM than was previously anticipated. The terms of the sale agreed included a cash payment, committed investment for existing operations and a retained interest for ZCCM of 20 percent of the equity, while in a parallel transaction, the Zambian government agreed to purchase AAC’s remaining shares in ZCCM.220 With pressure from donors and no other bidders having come forth, the Zambian government realized that the likely alternative to accepting these terms was the even less palatable liquidation of ZCCM.221 It took a further twelve months for the deal to be concluded. AAC’s failure to find a partner led to a revised agreement in 1999, which covered most of the assets included in the previous agreement. The government implemented a range of concessions to benefit the mining industry, including reduced rates of corporation tax and exemptions from import duties, which made the terms on which the assets were acquired even more favourable to the new owners.222 AAC chose to exercise its pre-emptive rights, and the expectation to develop the massive Konkola Deep Mining Project was part of the terms (KDMP). However, Anglo only waited until 2002 for the copper price to rebound before deciding that it was not going to, and that there was not as much money to be made in the short term from KDMP as they had hoped. AAC, along with other minority investors in Konkola Copper Mine- the Commonwealth Development Corporation (CDC) and the World Bank International Financing Corporation (IFC) completely pulled out of Zambia, handing the mine back to state ownership.223

218 Ibid
219 Ibid
220 Ibid
221 Ibid
222 Ibid
223 Fraser Alistair and Lungu John 2007 For Whom The Windfalls? Winners and Losers in the Privatisation of Zambia’s Copper Mines Civil Society Trade Network of Zambia, Printec, Lusaka.pg 12
Production was threatened, while the government panicked greatly. In 2004, Government was finally relieved to sell 51 percent of interest to a British-Indian Company, Vedanta at a reduced price. Within a year, copper prices rebounded and Vedanta immediately recouped their investment. As the world copper prices fluctuate under the global trading rules, investors make short term decisions to maximize profits. Shares and share holding companies change hands rapidly.\textsuperscript{224}

Liberal economic policies, foreign assistance and democratization did not spur economic growth, sustainable development and poverty reduction.\textsuperscript{225} In spite of privatisation of the copper mining industry, production and world prices declined and have worsened since the 1990’s. These and other problems of increased mining costs forced AAC to withdraw its investment in 2002, less than two years after purchasing a majority stake in the Konkola Copper Mine.\textsuperscript{226} This was a big blow to the copper dependant Zambian economy.

The manufacturing industry collapsed due to mismanaged privatisation, and partly due to competition from Zimbabwe and South Africa manufactured goods.\textsuperscript{227} Further more, liberalisation was accompanied by corruption, which also contributed to poor economic performance.\textsuperscript{228} Rampant graft had permeated all the institutions of the government. There had been gross misuse of national resources including foreign assistance, mishandling of privatisation and electoral fraud.\textsuperscript{229} Privatisation of public companies was deliberately mismanaged to allow leaders in the ruling party and the government, and their international allies to purchase them cheaply, and at times, without depositing the money in the government treasury or distributing it to intended beneficiaries.\textsuperscript{230} In particular, the privatisation of the Zambian copper mines was seriously flawed.\textsuperscript{231}

\textsuperscript{224} Craig John 2001 Putting Privatisation into Practice: The Case of Zambia Consolidated Copper Mines Limited Journal of Modern African Studies Vol. 39, No 3
\textsuperscript{225} Hwedie Bertha 2003 Development Policy and Economic Change in Zambia: A re-assessment DPMN Bulletin Vol. X No. 2
\textsuperscript{226} Ibid
\textsuperscript{227} Tangri R 1999 The politics of patronage in Africa Oxford: James Currey Ltd.
\textsuperscript{228} Ibid
\textsuperscript{229} Ibid
\textsuperscript{230} Ibid
\textsuperscript{231} Hwedie Bertha 2003 Development Policy and Economic Change in Zambia: A re-assessment DPMN Bulletin Vol. X No. 2
3.4 Creating a Favourable Investment Climate

Privatisation of state enterprises is key to the government’s efforts to raise efficiency, promote private sector development and bolster economic growth.\textsuperscript{232} This was certainly the plan of the Zambian government when it decided to adopt the recommended policies of the World Bank and IMF in line with the policy of liberalisation.

As part of the programme, the government enacted a sound legal framework which saw the creation of the Zambia Privatisation Agency, a statutory body mandated to carry out the privatisation of all state owned enterprises. The objectives of privatisation with regard to the mines were:\textsuperscript{233}

- Transfer control and responsibility to private sector mining companies as quickly as possible
- Mobilise substantial amounts of committed new capital for the ZCCM
- Ensure that ZCCM realized value for its assets and retained a significant minority interest in its principal operations
- Transfer or settle the ZCCM’s liabilities, including third party debt
- Diversify ownership of mining assets
- Promote Zambian participation in the ownership and management of the mining assets

\textsuperscript{232} Zambia, Structural Adjustment and Labour available at www.essentialaction.org/labour_report/Zambia
\textsuperscript{233} Simutanyi Neo 2008 Cooper Mining in Zambia’ The Developmental Legacy of Privatisation Occasional paper No 165,Institute for Security Studies
An important note from the conduct of the privatisation is that though it was claimed that one of the objectives of privatisation was to promote transparency, this can hardly be said to have happened.\textsuperscript{234} The privatisation of the mines was implemented in an extremely secretive fashion and only in the recent past have the public had access to the Development Agreements that were signed.\textsuperscript{235} This is however, beyond the scope of this paper. Nor have some of the objectives of mine privatisation been fully met.\textsuperscript{236} In particular, there has been little Zambian participation in the ownership of the privatised mines.\textsuperscript{237} Further, as mentioned, the process of privatisation lacked transparency with some disastrous consequences for the government.\textsuperscript{238} Some of the investors stripped the assets of the companies they had bought while others did not even qualify to run the mines which were ultimately surrendered back to the government.\textsuperscript{239}

The World Bank called for the change of the Investment Act as a condition to its 1993 PIRC II Loan. The most significant policy changes were enshrined in the 1995 Investment Act. With regard to the privatisation of the mines, changes were made to the Mines and Minerals Development Act, 1972.

The Investment Act established the Zambia Investment Center to assist companies through the process of buying into the Zambian Economy. It provided the General incentives that applied to all investors as well as special incentives for investors in a particular field such as mining, manufacturing and agriculture. The Act dispenses with the foreign exchange controls, allowing companies to expropriate, without interference, all funds in respect of dividends, principle and interest on foreign loans, management fees and other charges.

Other efforts linked to the Investment Centre have involved for example, investment guarantees under which the Investment Act assures investors that property rights shall be respected and that no investment of any description can be expropriated unless Parliament has passed an Act relating to the compulsory acquisition of that property. Moreover in case of expropriation, full

\textsuperscript{234} Ibid
\textsuperscript{235} Fraser Alistair and Lungu John 2006. For Whom the Windfalls? Winners and Losers in the privatisation of Zambia’s copper mines. Civil Society Trade Network of Zambia, Printec, Lusaka.
\textsuperscript{236} Simutanyi Neo 2008 Cooper Mining in Zambia’ The Developmental Legacy of Privatisation Occasional paper No 165,Institute for Security Studies
\textsuperscript{237} Ibid
\textsuperscript{238} Ibid
\textsuperscript{239} Ibid
compensation shall be made on the market value and must be convertible at the current exchange rate.

Investors are guaranteed that investments will not be adversely affected by any changes in the investment Act for a period of seven years. The country has gone further by being a signatory to the Multi-lateral Investment Guarantee Agency (MIGA) which guarantees foreign investment protection in cases of civil strife, disasters, as well as other disturbances.

The Mines and Minerals Development Act 1972, was repealed and replaced with the Mines and Minerals Act 1995. This statute was in force during the negotiations of the mining Development Agreements.

The Act provided for particular incentives to investors in the mining sector. Under the Act, tax paid for copper exported from Zambia-called a mineral royalty tax is charged at the rate of 3 percent of the net back value of the minerals produced.\textsuperscript{240} As an incentive, the Act permits mining companies to minimize their income returns by allowing deductions for capital investment in mining.\textsuperscript{241} It also provides relief from paying customs duties on imported machinery and equipment required for any of the activities carried on or to be carried on.\textsuperscript{242} The Act permits the government to enter into Development Agreements with companies under which they may renegotiate the rate of mineral royalty to be paid by each company and any such agreed upon rate shall be the rate payable under the Development Agreement.

These policies were not just recommendations from the World Bank or IMF. The Permanent Secretary from the Ministry of Mines in giving the governments position reported “\textit{The private sector wanted concessions so that when they take over these assets they would be able to recapitalize and at the end of the day, make these mines profitable. So in the Mining Act, you will find provisions for these concessions. The companies wanted to drive certain taxes down. And}

\textsuperscript{240} Section 66 (1) (a) of the Mines and Minerals Act Cap 213 of the Laws of Zambia. The net back value is the market value of minerals free on board at the point of export from Zambia or in the case of consumption within Zambia, at the point of delivery.
\textsuperscript{241} Section 96 of the Mines and Minerals Act Cap 213 of the Laws of Zambia
\textsuperscript{242} Ibid Section 97
this is how we came up with very low mineral royalties. Today I think we are the lowest in the whole of Africa at 0.6 percent of gross turnover for mineral royalties. This is how over the period, we have pegged the company tax at 25 percent for the mining sector, compared to manufacturing companies which are at 35 percent. And then on imports of capital equipment, these things are brought in duty free if they are brought in for mining operations and for exploration work in mining. Not only that we have made many items tax deductible when you come to income tax calculations. Capital investment is tax deductible and the interest that you pay on loans is also tax deductible, so that the whole package is very, very attractive.”

Taking the tax provisions in the Development Agreement signed between the Government of Zambia and Mopani Copper Mines, Government of Zambia and Konkola Copper Mines, the two largest copper mines, the following incentives were granted;

- The government removed all foreign exchange controls to allow the mine owners to externalize profits, without a limit on how much could be externalized.244

- With regard to tax it was agreed that the mining companies would pay tax and royalties in accordance with the applicable legislation.245 Further, that where there was a conflict between the Law and the clause on tax in the Agreement,246 the Agreement would apply.

- The government undertook that it would refund mine owners Value Added Tax (VAT) within 30 days from the date of submission of the Companies monthly VAT return in respect of each accounting period.

- Other incentives include the clause on Stability Periods in which the government agreed not to increase corporate income tax applicable to companies from those prevailing. Government would not impose any new taxes or fiscal imposts on the

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243 Fraser Alistair and Lungu John 2006. For Whom the Windfalls? Winners and Losers in the privatisation of Zambia’s copper mines. Civil Society Trade Network of Zambia, Printec, Lusaka. (Interview with former Permanent Secretary, Ministry of Mines)
244 Mining Development Agreement between Mopani Copper Mines and The Government of the Republic of Zambia.
245 Ibid
246 Ibid, Schedule
conduct of normal operations. As an incentive, mine owners would not pay duty on electricity consumed.\textsuperscript{247}

Income tax would be payable at 25 percent. Carry forward losses where permitted for a period of 10 years from which loss was incurred. This means that losses made in one year could be subtracted in subsequent years from taxable profits.

Royalty was negotiated at 0.6 percent and companies exempt from payment in the first 5 years following completion of the Agreement.

Other incentives include zero rating of customs and excise duties on all consumable items imported during the period up to the value of US$16,000,000 for the first 12 months up to US$10,000,000 for three years.

The government undertook not to amend any of these tax regimes after the agreement was completed, for a period of 20 years or more. This would be in the Stability Period in which until the Development Agreement expires, the terms of the Agreements are legally binding and overrule/supersede any existing or future legislation where there is a conflict.\textsuperscript{248}

The Price Participation clause allows government to claw back profits when copper prices at the London Metal Exchange exceeds US$2,700 per tonne. The Government would claim back a percentage of each sale made. While this is a progressive clause, it is watered down by the fact that the payment on the government is deductible by the companies for income tax purposes. Consequently the income tax payable by the companies is reduced, a counter effect on the windfall tax, which had negotiations not been done due to pressure or from a desperate situation, would introduce a new source of revenue for the government.

The mining companies did not dispute the fact that the Development Agreements they signed with the Zambian government were extremely favourable and that the investment climate in the...
country is generous. The mines stood to make huge profits from the sale of copper, with the global prices being high.

The tax concessions in the Development Agreements partly reflect the fact that the principal objective of privatisation, which was creating an attractive or favourable investment climate to bring in new capital in the country was prioritized above ensuring that new investors accepted responsibilities to share in the wealth that would flow from their operations. These concessions can be attributable to the weak bargaining position Zambian negotiators found themselves in.

Did the creation of a favourable investment climate, to the point where there was departure from the law, actually bring in more foreign direct investment in the mining sector? It can be said that privatisation of copper mines brought in more foreign direct investment in the sector. The Permanent Secretary of the Ministry of Mines stated;

“It has been very, very successful. Closed mines have opened up, new mines are coming up, and the existing mines which were limping are all doing very well.”

Undoubtedly, the increased mining activities have brought increased profits to mining companies given the high copper prices on the world market and the favourable investment climate in Zambia. Foreign investors have arrived on the scene to either buy former state mining companies, now privatised, or to start new mining operations.

Before foreign investors bought the mines, most mines had ceased operations, laid off a number of its workforce and only maintained a skeleton staff. Foreign investors put up financial

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249 Fraser Alistair and Lungu John 2006. For Whom the Windfalls? Winners and Losers in the privatisation of Zambia’s copper mines. Civil Society Trade Network of Zambia, Printec, Lusaka
250 Ibid
251 Ibid
252 Simutanyi Neo 2008 Copper Mining in Zambia; The Developmental Legacy of Privatisation, Occasional Paper 165, Institute for Security Studies
investments, as part of the commitments they had undertaken in the Share Sale Agreements, to refurbish the mines. This extended the mines lives and offered hope of jobs to former miners.253

Under ZCCM, facing historically low global copper prices, there was an acute shortage of investment with the possibility that mines would close. It was recognised then, that despite the importance of the industry, it did not make any sense for the government to continue subsidizing loss making entities to the tune of US$ 1 million per day at a time when the government was itself facing serious financial difficulties and a huge external debt in excess of US$ 7 billion.254 Significant investment has now been delivered, re-invigorating the industry and increasing production.255

It was projected that with new mines coming on stream in 2008 (Lumwana and Muliashi) and the completion of the expansion programme at Konkola Deep Mining Project (KDMP), copper production would reach 800,000 tonnes in 2007 and 1,000,000 tonnes in 2009.256 There is no doubt that these new developments will bring increased profits to mining companies given the high copper prices on the world market and the favourable investment environment in Zambia. While the projections to open new mines have actually come to fruition, the projections concerning the rate of production to be achieved for 2009 are very doubtful. Not only have copper prices on the world market fallen again, with the world economic crisis being experienced, some mining operations have been closed due to the increased cost in running them.

The performance of the mining industry, which was in a slump from the mid-1970s, has greatly improved since 2004.257 For example, the contribution of mining to gross domestic product (GDP) increased from 6.2% in 2000 to 11.8% in 2005.258 Zambia’s copper production also increased by 7.1% in 2006 as a result of increased investment in the mining sector.

253 Ibid
254 Ibid
255 Ibid
257 Simutanyi Neo 2008 Copper Mining in Zambia; The Developmental Legacy of Privatisation, Occasional Paper 165 , Institute for Security Studies
258 Ibid
Copper output increased from 459,324 tonnes in 2005 to 492,016 tonnes in 2006,\textsuperscript{260} with a target for 2007 of 600,000 tonnes.\textsuperscript{261} Production had previously declined from a high of 750,000 tonnes in 1976 to a low of 368,000 tonnes in the mid-1990s, the lowest being 257,000 tonnes in 2000.\textsuperscript{262}

Copper production drastically declined between 1994 and 2000 and only picked up after the completion of privatisation.\textsuperscript{263}

\textbf{3.5 Impact of Privatisation on the Economy}

Since 1991 the government of Zambia has been pursuing liberal economic policies. Important to this policy framework has been embarking on a very rigid, rapid and far-reaching structural adjustment programme. This strategy (supported by IMF and World Bank) was a dramatic shift from the previous government controlled approach to economic management.\textsuperscript{264}

At the heart of the new order of economic management has been, inter alia, trade liberalisation, removal of foreign exchange controls, public service reform, introduction of cost sharing (arrangement where both government and citizens share the responsibilities of meeting the costs) with respect to the social sectors -- education and health, the heralded privatisation programme -- government withdrawal in running business. Privatisation has tended to stand out as the major driving force for economic development.

The private sector-driven economic approach went with the emphasis on calling foreign investors. One undeniable fact is that Zambia has not only structurally adjusted its economy as

\textsuperscript{259} Ibid
\textsuperscript{260} Bank of Zambia, Quarterly Reports, various issues, 1975–2007.
\textsuperscript{261} Bank of Zambia, Quarterly Report 2007.
\textsuperscript{262} Bank of Zambia, Quarterly Reports, various issues, 1975–2007.
\textsuperscript{263} Simutanyi Neo 2008 Copper Mining in Zambia; The Developmental Legacy of Privatisation, Occasional Paper 165, Institute for Security Studies
\textsuperscript{264} Muweme Muweme 2004 Factors that attract FDI (Foreign Direct Investment in Zambia) Business and Economy in Zambia.
shown above over the past decade but has also tried to make itself an attractive destination for FDI by improving the standards of treatment given to foreign firms.

However, while the privatised mines have recorded large profits, the Zambian government acknowledges that revenue from copper as a proportion of government income has been very low.\textsuperscript{265} This is indeed not surprising seeing the concessions that the government had given the mine owners in the Development Agreements. Royalty which is prescribed at 3 percent by the Mines and Minerals Act is being charged at 0.6 percent. This is in effect revenue forgone by the Zambian government, a subsidy to the mine owners. The tax concessions which were granted for periods ranging between 10 to 15 years also contribute to the low revenue being received by government. For the period 2002–2006, Zambia received about US$752 million in various taxes from foreign investors holding large-scale mining licences.\textsuperscript{266} It is believed that government earned about US$70 million from total copper sales of US$3 billion.

Debt forgiveness, which saw Zambia’s US$7.2 billion foreign debt reduced to around $500 million in 2005, combined with improved copper prices on the world market, raised a concern that the country should exact a fair share from the mining companies’ profits by reviewing the Development Agreements.\textsuperscript{267} While the copper price was as low as $0.70 per pound at the time of privatisation, it increased to US$7.75 per pound in 2006. As a result, mining companies have recorded astronomical profits since 2004. For example, records of the performance of two of Zambia’s largest copper mining companies, namely Konkola Copper Mines (KCM), which is owned by United Kingdom-based Vedanta, and First Quantum Minerals, reveals that KCM’s profits increased from $52.7 million in 2005 to $206.3 million in 2006, while First Quantum’s profits shot up from $4.6 million in 2003 to $152.8 million in 2005.\textsuperscript{268}

\textsuperscript{265} Ibid
\textsuperscript{266} Simutanyi Neo 2008 Copper Mining in Zambia; The Developmental Legacy of Privatisation, Occasional Paper 165 , Institute for Security Studies
\textsuperscript{267} Muweme Muweme 2004 Factors that attract FDI (Foreign Direct Investment in Zambia ) Business and Economy in Zambia.
\textsuperscript{268} Ibid
It is very clear that there has been little economic development flowing out of the privatisation of the mines. There is no doubt that mining has both a positive and negative impact on the local economy.\textsuperscript{269} New mining activities have the potential to stimulate economic activities through sub-contracting services and supplying goods.\textsuperscript{270} It can be stated for Zambia, from the various literature that spillovers from FDI are not inevitable.\textsuperscript{271} The right conditions need to exist. First, for positive spillovers to occur there has to be a smaller technological gap between domestic and FDI firms.\textsuperscript{272} It therefore follows that FDI will not generate the spillovers unless it is placed within a broader economic policy context. Investment in basic infrastructure, education and training, and encouragement of Zambian firms to invest in technological development becomes crucial.\textsuperscript{273} These policies will do a great deal in increasing Zambian firms’ technological capability, and hence make it easier for the nation to benefit from spillovers.\textsuperscript{274}

Secondly, there needs to be an institutional framework that prevents state capture from domestic firms.\textsuperscript{275} Influence-peddling in Zambia has affected industrial competition and ultimately productivity.\textsuperscript{276} If domestic firms can be prevented from influence-peddling and be subjected to more competition, they may be more willing to go into partnership with foreign firms.\textsuperscript{277}

In essence, Zambia has followed the classical theory on Foreign Direct Investment which reduced to its basic form, marks a shift from earlier doctrinal objections held by many developing countries on the role played by the multinational corporations in their economies,
which saw justification for the expropriation/nationalisation of foreign companies or assets.\(^{278}\)

The expropriation/nationalisation of MNCs by many developing countries particularly during the early days of their independence symbolized a rejection by these countries of being externally dependant upon foreigners.\(^{279}\) This hostility has largely waned with many countries realising and recognizing that positive economic gains can be achieved from the presence of FDI.\(^{280}\) The slow down of growth in the world economy, change in political leadership, and the scarcity of financial capital in the wake of the debt crisis of the early 1980’s has contributed to this change in attitude. Most governments have or are promulgating laws or regulations that are investor friendly. In broad terms classical theorists advance the claim that FDI and MNCs contribute to the economic development of host countries through a number of channels which include transfer of capital, advanced technology equipment and skills, improvement in the balance of payments, the expansion of the tax base and foreign exchange, the creation of employment, infrastructure development and the integration of the host economy into international markets.\(^{281}\) The benefits from FDI are derived through positive spillovers, as illustrated above. MNCs provide information relating to new technologies, new markets, new customers and management techniques from which domestic firms benefit,\(^{282}\) making them more productive, competitive and efficient.\(^{283}\)

Although the classical theory seems to paint an overwhelminglly positive picture about the benefits that can be derived from FDI, empirical evidence on the subject is mixed. Some studies have found a positive spill over effect, some no effect and others a negative spill over effect. For instance whilst Todaro\(^{284}\) finds that FDI helps in accumulating foreign exchange and hence contributes to the country’s balance of payment, Sharan\(^{285}\) observed that between the period 1964-1971, FDI had a negative impact on India’s balance of payment. A study


\(^{279}\) Ibid

\(^{280}\) Ibid

\(^{281}\) Ibid

\(^{282}\) Greenaway D et al 2001 “Do Domestic Firms Learn to Export from Multinationals” Leverhulme Center Research paper No. 11 The University of Nottingham.

\(^{283}\) Girma et al 2003 “Do Exporters Have Anything to Learn from Multinationals?” Leverhulme Center Research Paper No. 22 The University of Nottingham.


\(^{285}\) Ibid
carried out by the Research and Information System (RIS) for the non-aligned and other developing countries based in India has found the evidence of the effect of FDI on domestic investments to be mixed. In some countries it was found that FDI crowded out domestic investment, while in others, FDI flows appeared not to have any effect on domestic investment, while yet in others, FDI was noted to have effect by bringing in domestic investment. The existence of conflicting empirical evidence on the impact of FDI does not imply that there are no benefits to be derived from FDI. What the evidence points to is in fact that the benefits derived from FDI are dependant on the existence or absence of certain factors.

A number of scholars in acknowledging the importance of FDI and its welfare contribution to the host economy share the view that the benefits derived from FDI depend on the existence of a number of factors. These factors range from the economic policies pursued by the host state, the sectors in which investment is made, the political risks present, availability of effective institutions and the presence of developed financial markets, to the stock of skilled human capital availability. These factors constitute what is called the absorptive capacity of the host state. Nevertheless, as much as FDI can be a source of good, it can also be a source of economic harm. FDI may contribute to underdevelopment if the profits are not reinvested in the host country. The view that the growth impact of FDI depends on the characteristics of the country in which FDI takes place is widespread. The benefits derived from FDI depend on whether the host country environment is conducive to the overall investment, economic spillovers and income growth. Unless there are developed local markets and institutions, investment-friendly policies and administrative framework, as well as complementary factors of production, there will be modest gains from FDI.

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287 Ibid
288 Ibid
290 Ibid
291 Nunnenkamp P 2004 To What Extent Can Foreign Direct Investment Help Achieve International Development Goals? World Economy Vol. 27
3.6 Conclusion

In conclusion, it is thus, not surprising that despite the notable increased FDI to the mining sector, which is the driving force of Zambia’s economy, this has not translated into real economic growth for the country as most of these factors are clearly non-existent. Zambia has concentrated more on creating a favourable investment climate while neglecting the other factors that would increase its absorptive capacity. The economy is still centered on mining despite its demonstrated cyclical nature. The economy is not diversified and manufacturing is non-existent. There is no proper allocation of the little resources that are derived from the increased activity in the copper mining. While some reforms have been adopted, recommendations of the World Bank/IMF such as fiscal discipline, tax reform, interest rate liberalisation, a competitive exchange rate, trade liberalisation, a reduction of public expenditure, deregulation, these must be followed through. These reforms require the state, beyond its provision of the necessary market institutions, to play a minimal role in the market. The state and market should provide a check on and facilitate the functioning of the other. Unless FDI is aligned with the development objective of host countries, there will be no added value in having FDI.
Chapter 4

4. Introduction

This Chapter analyses the Mining Development Agreements, both the previous and re-negotiated Agreements vis-à-vis the tax provisions and incentives granted by the government, and whether incentives on their own can attract FDI and benefit the host country. It will look at the calls for the introduction of a mining windfall tax and whether the introduction of the windfall mining tax is a once off event which can lead to economic growth.

Many Developing countries anxious to bring in big business to develop their natural resources have found themselves in a “race to the bottom” in terms of offering financial inducements. Countries compete with each other in offering to slash taxes and royalty rates where appropriate, to win the necessary investment.292

One of the arguments in favour of privatisation was that it would save the government money by relieving them from propping up an enterprise losing up to US$1 million a day.293 It would also generate resources: increased investments by the new owners would generate significant profits that would be channelled back to the government through taxation and dividends.

Although this has happened to some extent, evidence from a variety of reports suggests that the amount of revenue transferred to the Zambian government by the new mining companies is relatively small when compared to the revenues transferred to governments in other resource-rich countries like Botswana or Chile.294

It is widely believed that Zambia was placed under considerable pressure, by calls from the World Bank and IMF to quickly privatise the mines and at some point, Privatisation of ZCCM was a condition repeatedly attached to several loans from both these institutions and was a pre-

293 Simutanyi Neo 2008 Copper Mining in Zambia; The Developmental Legacy of Privatisation occasional paper 165; Institute for Security Studies
294 Dymond Abi 2007 Undermining Development: Copper Mining In Zambia A Report conducted by Action for Southern Africa (ACTSA) Christian Aid UK and SCIAF. Available at www.christianaid.org accessed 16.08.08
condition for Zambia to qualify for debt relief through the highly indebted poor countries (HIPC) initiative.\textsuperscript{295} This severely weakened its bargaining position, leaving it unable to replicate models that had been successfully applied elsewhere – in Botswana, for example, as mentioned above. As a result, various mining companies locked the government into 15-20 year contracts that, allow the exploitation of its key natural resource on unfavourable terms.\textsuperscript{296}

While the incentives cited in the previous Chapter were put in place to attract FDI, these, in reality work against the host country, such as have happened in Zambia. It is therefore, important for the host country to look at the long term benefits to the country and not just at attracting FDI. The major problem being that these companies know better than governments what the rights are worth, and take advantage to negotiate better deals for themselves. The following is an analysis of the various incentives granted by the government and how they affect the economy.

\textbf{4.1 Analysing Development Agreements}

Mineral royalties provide a starting point. Royalties are payments to governments of a fixed percentage of whatever value is being extracted.\textsuperscript{297} Given the high quality of Zambia’s copper deposits, the high rate of extraction, and the country’s dependence on copper, the Zambian government should be able to charge a relatively high rate of mineral royalty. An International Monetary Fund (IMF) survey in 2001 found royalty rates in developing countries vary from 2 to 30 per cent, with most between 5 and 10 per cent.\textsuperscript{298} Zambia’s Mines and Minerals Act specifies a royalty rate of just 3 per cent of the netback value of minerals produced.\textsuperscript{299}

IMF and World Bank pressure on Zambia to privatise its copper-mining industry at the end of the 1990s led to the setting of what is believed to be one of the lowest royalty rates ever

\textsuperscript{295} Simutanyi Neo 2008 Copper Mining in Zambia; The Developmental Legacy of Privatisation occasional paper 165, Institute for Security Studies
\textsuperscript{296} Fraser Alistair and Lungu John 2007 For Whom the Windfall? Winners and Losers in the Privatisation of Zambia’s Copper Mines, Civil Society Trade Network of Zambia, Printec, Lusaka.
\textsuperscript{297} Ndulo Muna 1987 Mining Rights In Zambia Kenneth Kaunda Foundation, Lusaka.
\textsuperscript{298} Baunsgaard Thomas 2005 A Primer on Mineral Taxation, IMF working Paper WP/01/139 pg 26
charged: 0.6 per cent.³⁰⁰

Then Minister of Finance, Ngandu Magande argued that the government was reluctant to increase tax as it was seen that investors would take their investments elsewhere. He argues that investors were to be given more time as they were still paying off the loans they had borrowed from outside and also in the process of setting up the mines.³⁰¹ He seems to believe that taxing companies would lead them to re-invest less of their profits, and thus in the long-term create fewer jobs.³⁰² It can in fact be argued that companies will stay in Zambia, and will borrow to cover investments if they expect to benefit in the future, so long as they expect the price to show some stability - taxing will reduce their profits, but have marginal effects on their investment decisions.³⁰³ Price variations massively outweigh such a consideration (3% royalty rate) in calculating profits. Another way of thinking about it is that ‘production' in mining describes the pace of removal of a non-renewable resource from the nation's stock of natural capital - the longer you wait to tax production, the less there is in the end to tax.³⁰⁴

Moreover, OECD guidelines, standards for company behaviour signed up to by OECD member governments, expressly state that ‘enterprises should refrain from seeking or accepting exemptions not contemplated in the statutory or regulatory framework related to taxation, financial incentives or other issues.'³⁰⁵

Another example of such incentives is the rate of corporate income tax. While KCM’s corporate income tax rate is set at 25 per cent, there are several exemptions and allowances – for instance, an extended carry-over loss period – which can lead to the headline rate not being paid in

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³⁰² Ibid
³⁰³ Ibid
³⁰⁴ Ibid
practice. While it is standard practice to allow losses to be carried over and offset against future profits, the net effect of this and other tax exemptions, according to the World Bank’s International Finance Corporation,\textsuperscript{306} is that mining companies in Zambia can legally enjoy a marginal effective tax rate\textsuperscript{307} of 0 per cent. It is therefore, more practical to obtain revenues by imposing royalty on market value of the company’s production. Profit taxes on the other hand, are more difficult to collect because profit figures can be easily manipulated. In Zambia it has been difficult to obtain data from the mining companies either on profits made or production.\textsuperscript{308}

Operating across many tax jurisdictions, there is a tendency to reduce revenues or inflate expenditure deductions in order to minimize the tax liability in a particular country.\textsuperscript{309} It is also normal that in addition to income tax, companies may pay with holding tax on dividends, often only when these are distributed to non-residents. However, some countries compensate for a higher tax rate on mineral extraction by exempting the distribution of dividends from withholding tax.\textsuperscript{310}

Price participation as an investment incentive constitutes a separate contract in its own right. If the price of copper at the London Metal Exchange (LME) exceeds a specific benchmark (US$2,700-2,800 per tonne), then the government, via ZCCM-IH, an investment holdings company through which the government owns shares in the mines, starts to claim back a certain percentage (in KCM’s case, 25 per cent) of the difference between the benchmark price and the current price.\textsuperscript{311} Zambia rarely receives the full percentage as 'there are conditionalities attached, and a cap on the amount that ZCCM can receive from KCM in any one year (roughly US$16-19

\textsuperscript{306} Fraser Alistair and Lungu John  2007 For Whom the Windfall? Winners and Losers in the Privatisation of Zambia’s Copper Mines, Civil Society Trade Network of Zambia Printec,Lusaka
\textsuperscript{307} The World Bank calculate an aggregate figure, called ‘the Marginal Effective Tax Rate to describe how much each industrial sector is taxed and concluded that because of the relatively low taxes and significant incentives the mining sector enjoys an METR of around 0% In particular, the expensing of many equipment purchases and moderately accelerated depreciation deductions for the rest, the METR on machinery reflects the largest subsidy received in any sector for any asset.
\textsuperscript{308} Baumsgaard Thomas 2005 A Primer on Mineral Taxation IMF Working Paper WP/01/139
\textsuperscript{309} Ibid
\textsuperscript{310} Nyika Paper part II
\textsuperscript{311} Dymond Abi 2007 Undermining Development: Copper Mining In Zambia A Report conducted by Action for Southern Africa (ACTSA) Christian Aid UK and SCIAF. Available at www.christiaaid.org accessed 16.01.08
million). Reports from the defunct Zambia Privatisation Agency also note that there is a cap of US$125 million on how much ZCCM can receive ‘over the life of the operations.’ 312

Price Participation in itself is a good principle except in the Zambian scenario, the amount government receives is pathetic. The high percentage of profits retained by KCM impacts negatively on the amount the Zambian government is currently receiving in dividends. Press reports suggest that ZCCM received nothing in dividends from KCM between 2003 and 2005, and to date has only received US$2.3 million for 2006 and 2007. 313

However, the Zambian government urgently needs funds to finance its five-year National Development Plan, (for the period 2006 – 2011) whose funds are realized from exports and taxes. Increased dividends – and increased revenue transfers from the copper mining sector more generally – could be one way of filling this gap without the government having to resort to increased borrowing or reliance on aid.

Estimates in a KCM presentation to investors suggest that employee contributions through ‘pay as you earn’ (PAYE) account for nearly half of KCM’s tax contributions to the government. 314 Meanwhile, KCM’s reported net profits in financial year 2006/07 were US$301 million. 315

While the state holds, 20.6 percent in Vedanta's Konkola Copper Mine, a 10 percent stake in First Quantum's Kansanshi open pit mine and similar stakes in Mopani and others, these are relatively small crumbs from the bounteous bread basket that has been copper income during the commodity boom. 316 Clearly, in one sense, Zambia might not have much of a mining industry today were it not for the investment from the foreign mining houses.

There are other models to observe which show that countries can offer incentives and create a favourable investment climate while at the same time, gaining from the foreign Direct

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313 Dymond Abi 2007 Undermining Development: Copper Mining In Zambia A Report conducted by Action for Southern Africa (ACTSA) Christian Aid UK and SCIAF. Available at www.christiaaid.org accessed 16.01.08
315 Zambia Copper Investments Annual Report 2007
316 Lipmann Anthony 2008 Can resource-rich Zambia keep more wealth?, Reuters, Commentary (www.zambian-ecnomic.com also at www. lipmann.co.uk/articles/Zambia) accessed on 17 08
Investment that comes into the country -- KGHM in Poland is still more than 50 percent government-owned and Codelco in Chile, the state-owned copper miner, is still the main source of that country's wealth through the taxes that it pays for copper mining.\(^{317}\)

Zero rating of customs and excise duties on all consumable items imported during the period up to the value of US$16,000,000 for the first 12 months up to US$10,000,000 for three years is another such incentive which can have a negative effect. This treatment is extended to companies that supply equipment to mining companies. In principle, mining companies should be treated similarly to other economic activities with regard to duties. In practice mining companies are treated differently as special incentives are offered to investors in the mining sector. Without special treatment of imports, these would be an attractive way for the government to secure an up-front revenue stream.\(^{318}\) Given the very substantial import needs during project development, this revenue is typically even more front loaded than royalty payments.

Other such mining incentives include refunding mine owners Value Added Tax (VAT) within 30 days from the date of submission of the Companies monthly returns. As stated earlier, mining companies negotiated to pay a lower corporate tax. Government undertook to refund VAT that companies pay on goods that it buys locally, since the company from which these goods were initially bought will have paid the VAT aspect of the price charged to the Government, and the government then pays that back to the purchaser. VAT contributions are reflected as a minus or negative figure, in effect, a subsidy from Government to the mines.\(^{319}\) Mining companies in developing countries more often than not, export, if not all, most of their output. Combined with the very large investment needs, this can complicate the treatment for VAT purposes.\(^{320}\) Where the mining operations are in a constant refund position, it is important to note the magnitude of the VAT refunds, which can be substantial especially in the investment period.\(^{321}\) It is this refund

\(^{317}\) Ibid
\(^{318}\) Baunsgaard Thomas 2005 A Primer on Mineral Taxation IMF Working Paper WP/01/139
\(^{319}\) Fraser Alistair and Lungu John 2007 For Whom the Windfall? Winners and Losers in the Privatisation of Zambia’s Copper Mines, Civil Society Trade Network of Zambia Printec Lusaka
\(^{320}\) Baunsgaard Thomas 2005 A Primer on Mineral Taxation IMF Working Paper WP/01/139
\(^{321}\) Ibid
problem that leads countries to choose to exempt from VAT all imported capital goods and inputs for mineral extraction.

Government undertook not to amend any of these tax regimes after the Development Agreements was completed, for a period of 20 years or more. This would be in the Stability Period in which until the Development Agreement expires the terms of the Agreements are legally binding. While this to the government can seem attractive and in the short run, an inexpensive way of minimising investor risk, in the long run, it may have costs by limiting the governments flexibility to set tax policy. This can result in large revenue loss and increased administrative costs. While it is appreciated that the inclusion of such clauses is to guard against unforeseen changes to the financial premises of the project, especially as regards the fiscal framework, it should be also be appreciated that risk will affect both the investor and the government. While the traditional view has been that the investor is risk averse whereas the government is risk neutral, this is unlikely to be the case in many developing countries. There are clearly limits as to how much risk it would be prudent for a small mineral rich country to carry. A tax will have an impact on investor risk in terms of the perception of fiscal stability and how it affects commercial risk. While the investor’s perception of fiscal stability depends on a country’s political and economic track record, a specific concern is that the fiscal terms may change during the life of the project. This concern may be partially accommodated through appropriate policy designs. If a project turns out to be very profitable, it is more likely that the government will seek renegotiations to increase the government take; the investor may likewise put pressure on the government to renegotiate in cases where a project turns out to be less profitable than expected.

Further, no agreement can take away the sovereign right of any country to legislate in the public interest and these taxes fall within that right. The change in the tax regime by the Zambian

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322 Ibid
323 Ibid
324 Ibid
325 Ibid
government should as such not be seen as a renegation of their undertakings under the Development Agreements.

Since 2005 when copper prices on the market increased, the Zambian government has hesitated in talking the bold move of amending the tax regime. However, despite the fact that the government set up a negotiating team to start the process of negotiating the Development Agreements with the mining companies, this never came to be.\footnote{327 Lungu John 2008 The Politics of Reforming Zambia’s Tax Regime , a paper presented at the mine watch Zambia Conference, Politics, Economy, Sociology, Ecology and Investment in Zambia, Oxford University, London} It has been alleged that Zambia has lost $2 billion dollars (K8 trillion) as a result of delayed taxation on the mines.\footnote{Zambia has lost $2bn from delayed taxation on mines Times of Zambia, 2008 available at www.zambianeconomist.com accessed on 13:08:2008} The government had been too slow in increasing taxation on the mines which resulted in the country losing out. The right time to have introduced the new tax regime was in 2005 when the copper prices went up.

Because of the changed economic conditions, civil society and the opposition political parties in Zambia mounted pressure on the government to re-negotiate the Development Agreements.\footnote{Dymond Abi 2007 Undermining Development: Copper Mining in Zambia a Report conducted by Action for Southern Africa (ACTSA) Christian Aid UK and SCIAF. Available at www.christiaaid.org accessed 16.01.08} The pressure did not only come from institutions within the country. There was pressure from other international non-governmental organisations such as the Scottish Catholic International Aid Fund (SCIAF), Christian Aid and Action for Southern Africa (ACTSA).

In a surprising twist of events, the World Bank and IMF supported the call to renegotiate the Development Agreements. Visiting IMF alternate Executive Director Miranda Xafa leading a team of directors on a study of the economic performance in Zambia was quoted as saying the new tax changes were in order, adding that before the government introduced changes in the mine taxes, Zambia was the lowest taxing country.\footnote{IMF Backs Zambia’s New Tax Regime on Mining Profits , African Press Agency available at http://www.netnewspublisher.com/imf-zambia-new-tax-mining/ accessed on 4/3/09} While the World Bank has expressed its support for the move, calling the new fiscal regime more equitable, critiques counter that the Bank was responsible for insisting on rock bottom tax rates in 1998 that have deprived the
government of much needed revenue as copper prices soared. The government instead, armed with massive support from the non-governmental organisations and civil society in general decided that it would be a waste of time to engage in re-negotiating and instead made a unilateral decision to change the fiscal regime affecting the mining companies in the 2008 budget.

In setting the scene for the shape and design of the new fiscal regime, the government focused on a key objective in nearly all existing development agreements that had been entered into with the mining companies: to “secure maximum benefits for the Zambian people and an appropriate return on investment for the mining companies”

4.2 Proposed fiscal changes

The following changes to the tax laws were made:

a) Increasing the corporate income tax from the current 25 percent to 30 percent (payable after deducting costs and royalties).

b) Increasing the mineral royalty tax from the current 0.6 percent to 3 percent. This is the statutory prescribed rate of taxation.

c) Introducing a withholding tax on interest, royalties, management fees and payments to affiliates or sub-contractors in the mining sector at 15 percent

d) Introducing a variable profit tax of up to 15 percent on taxable income which is above 8 percent of gross income. This means that in addition to the 30 percent corporate tax, companies will also pay an extra 15 per cent. This is likely to happen as a result of the boom

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in commodity prices. This tax transfers a share of the windfall profit of copper to the Zambian government.

e) Introducing a windfall tax to be triggered at different price levels for different base metals. A windfall tax will be charged on the sales value of copper for every 50 cents increase in the price of copper per pound on international copper exchanges. The windfall tax will be 25 percent when the copper price is between $2.50 to $3.00 per pound or $2500 to 3000 per tonne; 50 percent when the price is between $3.00 and $3.50 and 75 percent when the price exceeds $3.50. This could push the sales tax on copper up to over 5 percent.  

f) Capital allowances which are currently at 100 percent will now be 25 percent. Capital expenditures for new projects shall be ring fenced and only become deductible when the projects start production.

g) The reference price on which these taxes will be based will be the price tenable at the London Metal exchange, Metal Bulletin or any other metal exchange market recognised by the Commissioner General of taxes.

Despite the government’s decision to change the tax regime, the mining companies are resisting paying the taxes, especially the windfall tax. Most mining companies have argued that government needed to consider the impact of the new tax regime on investors. Mine owners had hoped to recuperate the investment they are putting in before the majority of Zambians would start seeing meaningful benefits from the projects. The main concern about the changes to the law is that the existing Development Agreements would no longer be binding on the Republic. A clause in the amended Acts provides "Notwithstanding any provision to the contrary contained in any law or in any development agreement between the government and a

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335 Report by SCIAF, ACTSA Zambia’s New Mining Tax Regime
337 Ibid
The issue of the binding nature of the Development Agreements pauses a problem. Government appears to have reached a compromise to effect changes to the law without being seen to have overtly cancelled these agreements. Stating that the agreements will not be binding on the Republic means that the agreements may not necessarily be cancelled but will, in theory at least, allow the government to introduce changes to the law solely to overcome the Stability provisions contained in the Agreements. This is a breach of the terms of the Agreement and could reflect upon the country’s capacity to uphold their end of the deal. As such, a possible and equitable remedy for the mining companies is compensation for breach of the Agreement.

The changes to the tax regime received mixed reactions from the mining owners with others threatening legal action against the government if it implemented the new law that increased higher taxes in the sector. Making a presentation before a parliamentary watchdog committee, the Chamber of Mines, a cartel of mining firms operating in Zambia, painted a picture of doom and gloom, warning of an economic recession with obvious consequences of rising unemployment, poverty and a serious damage to Zambia’s reputation as a favoured destination for foreign direct investment (FDI). The mining companies further argued that the new measures were going to make mining unsustainable. They counter proposed that while they where agreeable to the royalty rate being raised to 3 percent, this still needed to be graduated from 1 to 3 percent. How this was going to be applied has not been explained. The mining companies also objected to the 25 percent windfall tax in preference for 12.5 percent. They also made it very clear to the parliamentary committee on estimates and revenue that they would

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338 Re-Negotiated Mining Agreement available at www.minewatchzambia.com accessed on 25:01:09
341 Ibid
343 Ibid
344 Ibid
only accept the introduction of the windfall tax or the variable tax and not both. They further objected to the reduced capital allowance in preference for the status quo. This they stated would maintain the viability of mining investments and also maintain the ability of the companies to fund further investments.

By September 2008, only two mining companies had paid the windfall taxes for the quarter ending 30th June 2008. Government however, refused to re-negotiate the Agreements.

4.3 Windfall taxes: The Justification

A windfall tax is a one-off tax based on historical profits and not on the current and anticipated profits. The goal of a windfall tax is to retrospectively claw back some of those benefits received by the owners of the companies concerned and, in so doing, raise the revenue needed to finance a welfare-to-work scheme.

Regular fiscal measures such as royalties, or resource rent taxes are often implemented when the generation of economic rent, is expected. However, at times circumstances arise unexpectedly leading to the unanticipated generation of economic rent at the expense of consumers or society, in the absence of appropriate fiscal measures. For instance, this can occur as a result of unanticipated large changes in commodity prices, unexpected emergence of market power, or unexpected regulatory failure. These gains are referred to as windfall profits. Windfall profits are unexpected, occurring because of circumstances that were not foreseen at the time when existing fiscal and regulatory regimes were established.

345 Ibid
346 Ibid
347 Ibid
349 Ibid
350 It is an excess of revenue over cost. It is pure profit, which is to say profit in excess of the cost of capital (which is not “profit” in an economic sense but merely another cost of doing business)”
351 Crompton Rod et al 2006 Possible reforms to the fiscal regime applicable to windfall profits in South Africa’s liquid fuel energy sector, with particular reference to the synthetic fuel industry A discussion document for public comment
352 Ibid
When the price of copper rose on the world market, mining companies were only expected to pay taxes that had been negotiated. The regulatory framework was inadequate to deal with these unexpected high prices, while the government and country did not benefit from the rise in prices. As a way of capturing these unexpected profits, government imposed a windfall tax.

With increased investments in the sector coupled with current attractive copper prices on the international markets, copper is set to be firm for a while. According to Economics Association of Zambia (EAZ) review for the 2006, the price of copper sharply increased reaching historical levels of US$8,000 per metric tonne by May 2006. EAZ is of the view that the Zambian economy and ordinary Zambians did not directly benefit from these high copper prices. For instance, the EAZ points out that while Zambia exported about 30,000 tonnes of copper in one month at $7,500 per tonne giving an income of about $225 million in a month or $56.25 million a week, only $8 million was available on the market locally for ordinary Zambians to purchase, while $48.25 million ended up outside the country. It is such a scenario which has led some experts to suggest the imposition of windfall profit taxes on mining companies. Others have pointed out that windfall taxes were the country’s practical solution of benefiting from strong copper prices. Some economists have supported the call for the introduction of the tax as a way of improving the export earnings base for the country, stating that the current lucrative copper prices on the international market would not last for a long time and that the introduction of windfall taxes could enable the country to raise more revenue.

From an economic standpoint, the strongest argument for a windfall tax is that it has the potential to be non-distortionary. A one-off windfall tax levied on past profits should not change firms’ behaviour, since it does not affect future costs and prices.

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353 Windfall taxes: Solution to copper prices? Business Review, Times of Zambia Newspaper 2005
354 Ibid
355 Ibid
356 Ibid
357 Ibid
359 Ibid
Others have argued that the windfall tax is inadvisable for other reasons too. Perhaps the most significant is that it would be counter-productive for the long term national interest. A windfall levy would produce revenue for a cash-strapped Treasury, but it would send a dangerous message to the copper production sector. Producers need consistent tax signals from governments if they are to invest in long-term projects in a rational manner.

Infrastructure and essential service industries where market power is potentially a problem are generally subject to specific policy or regulatory measures that are based on, and appropriate to, a range of expectations about future contingencies. In the event that future outcomes fall outside of the range of expected scenarios it will often be considered that some form of intervention is required as circumstances have moved beyond what was ordinarily anticipated. The same argument applies to natural resource extraction industries when existing fiscal regimes did not anticipate the levels of resource rents that arose. The terms “windfall profits” and “windfall taxes”, as used in this paper, envisages an unexpected situation that occurred in the past, and which might still exist in the present. This is essentially a backward looking perspective that employs retrospective fiscal measures. However, when changed conditions and recognition of the existence of windfall profits create an expectation of sustained economic rent in future, longer-term forward looking fiscal measures could be implemented (or existing ones adjusted) as required.

4.4 **Scope of the tax**

Basically, in countries such as the UK where this has been used by the government, a windfall tax is a one-off tax on the excess profits of a company often applied against the assumption that excess profits have arisen because, in the case of privatised companies, such firms have been

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360 A windfall tax is an easy solution – but a wrong one, The Independent, 1st August 2008, available at www.independent.co.uk
361 Ibid
60 Ibid
363 Ibid
364 Ibid
365 Ibid
366 Ibid
sold off too cheaply and regulated too lightly thereby enabling them to exploit their market power.\textsuperscript{367} In Zambia, the same could be said of the privatised mines. At the time of privatisation, the companies where sold cheaply due to the state they were in and also, due to the low copper prices on the world market. These privatised companies have also been regulated too lightly, with reduced taxes, undeclared profits or production.

These elements encapsulate the arguments behind the tax. They are intimately related, since if regulation had been stricter in the years immediately following privatisation, the initial prices paid would have turned out to be a better reflection of the value of those mines.\textsuperscript{368}

It was estimated that the tax is expected to raise US$400million from the affected companies every year.\textsuperscript{369}

While it was the intention of the Government to raise funds from revenue collected from the mining windfall tax, as articulated in Chapter 1, copper is a cyclical product, with periods of high and low prices. In late 2008 the prices of copper on the world market declined to such a level that it was uneconomical to operate the mines. Some mines were closed down, while others slowed down operations and laid off most of their workers. The decline coincided with the change in the tax regime. On 28th March 2009, Zambia’s parliament agreed to abolish the controversial 25 per cent windfall tax to cushion the copper mining companies from the weak metal prices from the global financial crisis.\textsuperscript{370}

It has been argued by most economists that the best time to have imposed the mining windfall tax was in 2005, when the prices of copper on the world market increased.\textsuperscript{371} Because copper is a cyclical product, the government should have acted fast to capture the windfall profits. Zambia lost an opportunity to benefit from the high copper prices and it remains to be seen whether, the

\textsuperscript{367} Ibid
\textsuperscript{368} Ibid
\textsuperscript{369} President Mwanawasa On windfall taxes , Times of Zambia, 2008
\textsuperscript{370} Zambia’s Parliament approves scrapping windfall Tax, Reuters News available at www.reuters.com/article/rbssIndustry_MaterialsUtilitiesNews/idUSLS38868720090328 accessed on 31.3.09
\textsuperscript{371} Zambia has lost $2bn from delayed taxation on mines
country will see some benefit from the increased levels of taxation despite the removal of the windfall tax.

4.5 Conclusion

In conclusion it can be said that incentives, especially tax incentives continue to form a larger part of policies for FDI promotion in Zambia. The rationale for using incentives is derived from the belief that they help compensate for a country’s negative investment climate in terms of physical and human infrastructure, poor macroeconomic policies, and general investment regulatory framework not in favour of FDI. Although tax incentives continue to dominate developing countries’ efforts of attracting FDI, they have been largely challenged by policy makers, economists and academics for not being effective and efficient means of attracting FDI. It has been argued that factors such as outlined above are more important in attracting FDI.

What is evident from the analysis of the incentives granted to mining companies in Zambia is that tax incentives have high revenue costs to developing countries considering the desperate demand for revenue in their budgets. Granting tax incentives means that a country has to forego some or all of the revenue which is due to the country. The host country must strike a balance; if the benefits of FDI do not outweigh the costs of revenue foregone then the whole investment issue becomes nothing but a drain of the country’s resources. The lesson that can be learnt from the above discussion is that competition amongst developing countries for FDI by using tax incentives represents a race to the bottom scenario. Countries are increasingly competing to grant more and more generous tax incentives that in the end leaves no benefit to the country as one would have expected.

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372 Nyika paper Part II available
www.chr.up.ac.za/academic_pro/llm2/documents/Nyika%20Paper%20Part%20II.doc accessed on 1.04.09
373 Ibid
374 Ibid
375 Ibid
376 Ibid
377 Ibid
Chapter 5

5 Historical Background of Copper Mining In Chile

This Chapter is a comparative analysis of the Chilean implementation of the windfall profits as a solution to capture the boom in the copper prices over the years, and how this has been implemented and utilized.

Copper mining has long been the mainstay of Chilean exports and at present, it accounts for almost a third of all foreign trade.\(^{378}\) Chile is the largest world producer of copper.\(^{379}\) In 1996, Chile produced 28% of the world’s copper. The copper belt in Chile is the largest and highest grade deposit in the world. This copper belt shared with Argentina and Peru contains 30 per cent of the world’s identified copper reserves.\(^{380}\) The major mines and processing plants are in the northern half of the country. The copper belt and the Solar de Atacama are the sites of the most mining activity in Chile. As of 1996, Chile contained 32 either privately or publicly, that is, state owned mines whose primary product is copper. CODELCO or the state owned corporation currently produces 48 per cent of Chile’s copper.\(^{381}\) Its largest mine is El Chiquicamata or Chiqui located at an elevation of 2700 meters and is 1200 kilometers north of Santiago making it the northern most CODELCO mine.\(^ {382}\)

The mining industry especially copper is very important to Chile’s GNP, exports, foreign exchange and ability to obtain foreign investment.\(^{383}\) In 1995, mining contributed 8 percent of Chilean GNP with copper contributing about 7 percent of that total.\(^{384}\) Copper constituted 82 per

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\(^{379}\) Vicuna Orrego Francisco 1973 Some International Law Problems Posed by the Nationalization of the Copper Industry by Chile, *The American Journal of International Law*


\(^{381}\) Ibid

\(^{382}\) Ibid


\(^{384}\) Ibid
cent of mining exports with total value at US$6,500,000. Historically, from 1974 – 1995, mining has attracted 56 percent of total foreign investment in the Chilean economy.

Between the 1850’s and 1880’s Chile became the largest copper producer and exporter in the world but production more than halved by the end of the century as the nitrate industry boomed. This was due to several factors including the depletion of the higher grade veins, competition with the nitrate producers for both shipping space and coal supplies and the generally antiquated methods used by the copper industry. This changed at the beginning of the 20th Century with the entrance of mainly American capital and the development of methods to treat the massive low grade copper deposits that had become the mainstay of the industry.

Chilean copper production has tripled since 1977, going from 1.03 million metric tonnes per year in 1977 to 3.1 million tones in 1997. In the year 2000, production increased to over 4 million metric tonnes. Roughly, 50 per cent of copper production is by state companies CODELCO and ENAMI while the other half is produced by foreign companies and small domestic and medium size businesses.

Copper production at CODELCO dropped from 83 per cent to 48 per cent from 1981 to 1999. This was due to government’s strong push for privatisation and foreign investment as well as the hegemony of neo- liberal ideology in Chile. Chile has made significant progress in the refining of copper, domestically, increasing its refined out put from 64 per cent in 1977 to nearly

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385 Ibid
386 Ibid
387 Vicuna Orrego Francisco 1973 Some International Law Problems Posed by the Nationalization of the Copper Industry by Chile, The American Journal of International Law
388 Przeworski Joanne Fox The Decline of the Copper Industry in Chile and the Entrance of North America Capital (online) available at http://books.google.co.uk/books accessed on 21:04:09
389 Ibid
390 Ibid
391 Ibid
392 Riesco Manuel et al 2002 Pay your Taxes: Perspectives on Corporate Taxation and Social Responsibility in the Chilean Mining Industry Paper done for the International Institute for Environment and Development
393 Ibid
394 Ibid
85 per cent in 1999.\textsuperscript{395} The government remains the dominant player in the mineral and copper industry. It controls the copper mining by ownership of copper producing companies, processing facilities, by developing laws as well as marketing. \textsuperscript{396} The complete nationalisation of the mines took place under the left wing Unidad popular government. It involved three huge mines known as “La Gran Minera” and three smaller operations.\textsuperscript{397} The Chilean owned small companies were not affected. Nationalisation took place through constitutional amendment. The state became the sole owner of all mineral deposits in Chile. Nationalisation was part of the strategy of achieving political independence through economic independence. This was carried out against the wishes of the companies. The United States of America responded by cutting Chile off from credit and setting up an unofficial trade blockade making it difficult for Chile to import the necessary capital goods for mines while various other forms of retaliation such as sabotage were carried out by the companies and their right wing supporters in Chile.\textsuperscript{398}

Since the coup in 1973, Chilean mining law and policy has been re-oriented towards attracting foreign capital and reducing the role of the state in mining activity as well as the economy as a whole.\textsuperscript{399} The shift in mining policy towards privatisation and the adoption of foreign capital is the result of several different complex forces, such as the ideological belief in the natural superiority of private economic activity over state or public economic activity.\textsuperscript{400} Chile today has a thin veneer of democratic activity, although it is tightly controlled by the military and police forces. This gives the elite and their policy makers carte blanche to implement their policies. Chile like Zambia, has also experienced substantial pressure from the multilateral institutions such as IMF, to privatise and open the economy.\textsuperscript{401} The multilateral institutions have

\textsuperscript{395} Palmer W. Thomas Jr. 1920 A Study of The Mining Law of Chile. University of Pennsylvania Law Review and American Law Register Vol. 69, No. 1
\textsuperscript{396} Ibid
\textsuperscript{397} Chilean Nationalisation of Copper Wikipedia the free encyclopedia (online)available at http://en.wikipedia.org/wiki/Chilean_nationalisation_nationalisation_of_copper accessed on 28:04:09
\textsuperscript{399} This has been witnessed by a 40% drop in CODELCO’s share in the national copper output
\textsuperscript{401} Ibid
considerable power in Chile because of the enormous public and foreign debt run by the military government.\textsuperscript{402}

In 1977, Chile adopted decree law 1748 concerning foreign investment in mining which provides \textit{inter alia} the clear contractual obligations of the state and mining companies, provision for the repatriation of profits and a new tax code.

In 1982, when the economy collapsed, government ended up socializing all private debt including the banks.\textsuperscript{403} The state copper company was the bedrock that earned enough foreign exchange to stave off complete collapse.\textsuperscript{404}

In 1981 a new mining law was passed to promote the development of new mining ventures as well as the streamlining of existing mining legislation.\textsuperscript{405} The ultimate goal of this legislation was to help double copper production within ten years. This has since been achieved. This law established exploration and exploitation concession regulations. The mining code grants rights for private individuals to own mining concessions and to be protected from expropriation by the government.\textsuperscript{406} Any compensation by the government would entitle the owner of the concession to full compensation to be established by judicial review.\textsuperscript{407} The aim is to reduce the perception of political risk as a guaranteed arrangement for compensation is in place.\textsuperscript{408}

Towards the end of the nineteenth century, most of the rich, high grade ore began to become depleted. As a result foreign extraction and processing methods had to be brought in to mine and process the lower grade ore.\textsuperscript{409} These methods were imported mostly from Great Britain which already had a developed copper industry.\textsuperscript{410}

Since the denationalization in the early twentieth century, the copper industry has been dominated by the conflict between the need for Chile to subjugate mining to the development
needs of the country as a whole that is, to a national economic strategy for development and the imperatives of the individual mining companies.\footnote{Ibid}

The first attempt to subjugate copper to national development imperatives occurred in 1925 when the government imposed a 6 percent tax on top of the 6 percent that already existed.\footnote{Ibid} Until then the government had adopted a laissez-faire policy with a 6 per cent flat tax on profits.\footnote{Ibid} This new tax was designed to increase the “Returned Value” of the copper industry. Returned Value was a concept invented by nationalist Chilean economists and adopted by the government to designate the amount of value that stayed or returned to Chile from copper exports.\footnote{Ibid} The returned value of copper exports had henceforth been very low because of the vertical integration of the copper industries, the lack of forward/backward linkages in mining and the government’s laissez faire policy.\footnote{Ibid} Either Chile had to increase production and therefore increase the absolute level of returned value or simply increases the share of returned value.

\section*{5.1 Legal Framework}

All foreign investment in Chile is governed by decree law drawn up in 1974, shortly after the coup de tat. This law is designed to liberalise foreign investment and provide a stable legal and political framework for foreign investors. The Chilean government has subsidized and continues to subsidise the mining industry including and especially copper.\footnote{Ibid} Technical and financial support is given to the mining companies owned by the state.\footnote{Ibid} Large investments in processing, facility expansion and infrastructure improvement are financed and directed through CORFO, the state industrial holding company that co-ordinates the mining industry as a whole.\footnote{Ibid}

\footnote{Ibid} \footnote{Ibid} \footnote{Ibid} \footnote{Ibid} \footnote{Ibid} \footnote{Ibid} \footnote{Ibid} \footnote{Pawlett Sam (ed) 1999 Copper in Chile Pen-L: 10927 available at \url{http://archives.econ.utah.edu/archives/pen-1/1999m09.c/msg00068.htm} accessed on 4:1: 2009}
The Chilean Mining Code gives the state absolute, exclusive, inalienable and imprescritible ownership of all mines. However, anyone may prospect for and establish concessions or mining rights for the search or mining of minerals. In addition to the Mining Code, foreign investors have to observe the law that deals with foreign investment and investment contracts. This *inter alia* provides for tax invariability for 10 years from start of production, that is, if the state changes tax rules, the investor who adopts this guarantee is not required to comply with the new rules, access to the foreign exchange market and the right to return capital actually brought into the country without being taxed. In return, foreign investors have to pay a combined tax rate of 42 per cent compared with the current 35 per cent. Companies can choose which tax regime to use; either the 36.6 percent effective tax rate or the 49.5 percent rate with a 20 year Stabilization agreement. The rate of royalty payable varies from mineral to mineral but may not exceed 5 per cent, while 15 per cent is the rate of corporate income tax. Only the distribution of profits and dividends are taxed.

In 1991, the government changed the tax regime by increasing the rate of tax payable and the changes needed to ensure a steady flow of tax revenues were introduced. The effective tax rate bore a strong link to the profitability of the sector, a mechanism for the host government to siphon away a fraction of any windfall gains above a basic target rate of return. Government, in its review, allowed CODELCO to capture windfall profits through the profit-tax link.

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420 Ibid
422 Ibid
423 Ibid
424 Comparative Fiscal Regimes in Mining 2007 Mongolian Civil Society Coalition for Extractive Industries Transparency Initiatives available at [www.eiti.mn/eng/content/view/18/27](http://www.eiti.mn/eng/content/view/18/27) accessed on 23:04/09
425 Ibid
427 Chile NVP Year 2008 Developing strategies that work, Country Experiences presented at the ECOSOC Annual Ministerial Review
428 Auty Richard 1993 *Sustaining Development in Mining Economies* - The resource curse thesis, Published by Routledge, Taylor and Francis Group
429 Ibid
profits of the entrepreneurs were taxed by 10% in the first year, by 15% in the second and third year and by 10% in the fourth year.\footnote{The 1991 Tax Reform in Chile}

On June 16, 2005 a new law\footnote{Law 20.026} was promulgated, which establishes a specific tax on mining activities. A 3 percent royalty on revenues of all privately owned mines was imposed as well as a tax consisting of a sliding scale according to copper production from nothing below 12,000 tonnes per annum to 5 per cent above 50,000 tonnes per annum on production in excess of 12,000 tonnes per annum.\footnote{Ibid} Foreign companies that signed a Decree Law 600 contract before 1st December 2004 and are still liable to a 42 per cent are not affected by this.\footnote{Ibid} The most important of these laws are organisation start up expenses, interest expense, technical assistance, tax losses and asset depreciation which may be accelerated.\footnote{Cochilco, legislation\url{http://www.cochilco.cl/english/normativa/fr_normativa.html} accessed on 28:04:09}

\section*{5.2 Effect of Mining on the Economy}

Permissive mining legislation has enabled most private mining companies to avoid paying any taxes.\footnote{Manuel Riesco 2000 Corporate Social Responsibility and the Mining Industry in Chile, Draft paper prepared for United Nations Research Institute for Social Development, UNRISD within the Research Area ‘Business Responsibility for Sustainable Development’} Private companies extracted and exported 20.8 million tons of copper between 1993 and 2002, roughly the equivalent of two years of world consumption.\footnote{Ibid} Sales amounted to more than 34 billion US dollars, with net earnings of roughly half of that sum. Meanwhile, private companies have paid just 1.7 billion US dollars in taxes, while accumulating 2.6 billion dollars in tax credits, thus holding the Chilean state liable for a net 900 million US dollars.\footnote{Ibid} At the same time, copper overproduction associated with the Chilean copper boom of the 1990s resulted in a severe and prolonged decline of world copper prices.\footnote{Ibid}
Economic growth decreased slightly in 1999 due to depressed copper prices. Mining and Mineral products account for 8.5 per cent of Chile’s GDP and nearly half of Chile’s total earnings of which 80 percent is attributable to copper. Investment in Chile’s mining sector has grown substantially over the past decade with mining related investment spending increasing to $2 billion in 2001. According to Chile’s state Copper Commission (COCHILCO), investment in the mining industry during the period 2004 – 2008 was estimated to reach US$ 15.2 billion. Almost 50% of this total will be invested by CODELCO the state copper mining company, with US$11.6 billion being invested in copper projects (new and expansion of existing projects). In 2006, CODELCO contributed 9.2 billion dollars to the state coffer – over 20 percent of state revenue. In 2007, the state received approximately US$16billion from CODELCO profits and taxes on private mining companies. Taking a medium-term approach, fiscal policy has focused on ensuring financial sustainability and the capacity to satisfy the needs of the population during times of crisis, on long-term budgetary restrictions and on efficiency in public administration. In addition to fostering stability of social policies, fiscal policy has increased public saving during periods of boom. It has also enhanced the credibility of Chile's fiscal authorities as issuers of international debt, improving access to external financing during periods of negative external shocks and minimizing the contagion effect of international crises. It has reduced the economy's need to rely on external financing.

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439 Mining In Chile (online) available at http://www.portalresources.net/s/MiningInChile.asp accessed on 23:02:09
440 Ibid
441 Ibid
442 Mining In Chile: Overview(online) available at http://mbendi.com/indy/ming/sa/cl/p0005.htm accessed on 24:02:09
443 Ibid
445 Ibid
446 Development strategy: fiscal and social policies to improve the quality of life of the entire population
2008 Developing strategies that work, Country Experiences presented at the ECOSOC Annual Ministerial Review
447 Chile NVP Year 2008 Developing strategies that work, Country Experiences presented at the ECOSOC Annual Ministerial Review
448 Ibid
The country’s tax legislation is both conceptually faulty and permissive, and, as a result, mining companies largely avoid paying taxes. Consequently, Chile like other mineral resource rich countries has not experienced sustained economic development. Sudden wealth may have detrimental effects on social and political life, leading to or supporting corruption, authoritarian government, human rights abuse, or armed conflict. The solution is to find better ways to capture and manage mineral wealth and to ensure that it is invested for lasting benefits in support of national or local development.

Sound and stable macro-economic policies have resulted in a healthy investment climate. Chile has also successfully reduced dependence on its principal resource copper by diversifying its export base. The combination of a rich mineral endowment and suitable government policies has provided an impressive boost to the economic growth of Chile.

Debate on how resource rich countries can benefit from revenue derived from such resources have heated up because of the high international prices of copper seen since 2003. According to a COCHILCO (Chilean Copper Commission) report, the average price of copper for 2007 was 323 cents of a dollar per pound on the London Metal Exchange. This is 5.9 per cent higher than the average for 2006 and is the highest nominal value in history and the third highest in real terms after 1966 and 1969. While predictions for 2009 were made, estimating the world copper prices to show a drop, there has been a drastic reduction in the price of copper on the London Metal Exchange.

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449 Riesco Manuel et al 2002 Pay your Taxes: Perspectives on Corporate Taxation and Social Responsibility in the Chilean Mining Industry Paper done for the International Institute for Environment and Development
450 Financing Social Policy 2005-2009 paper done by UNRISD
451 Ibid
452 Ibid
453 Maxwell Phillip 2004 “Chiles’ recent Copper driven prosperity : Does it provide lessons for other mineral rich developing countries” Minerals and Energy, vol.19(1) 16-31
454 Ibid
455 Riesco Manuel et al 2002 Pay your Taxes: Perspectives on Corporate Taxation and Social Responsibility in the Chilean Mining Industry Paper done for the International Institute for Environment and Development
456 Ibid
The very high prices of the copper boom lasted from 2003 – 2008, an unprecedented record in copper mining. Due to the high prices, the industry’s contribution to GDP measured at the above prices rose from 8.3 per cent in 2003 to 23 percent in 2006.459

The Mining Ministry’s public report for 2007 states that mining development has brought about considerable poverty reduction.460 This is due to the specific tax on mining approved in 2005, together with the direct revenue that comes from the mines owned by the government through CODELCO. Chile also has in place prudent fiscal policies and savings from the windfall copper revenue generated by record prices.461 The proportion of those living in extreme poverty fell from 17.4 per cent in 1987 to 4.7 per cent in 2003.462 Mining has brought more and better jobs, development of physical infrastructure, opportunities for companies to supply goods and services and the incorporation of new technology among other benefits.463 Proposals have also been made by the political as well as social sectors on how to make the most of the copper boom by improving education, investing in public capital goods (mainly in the health sector) supporting small and medium-sized businesses.464

5.3 Capturing the Windfall Profits

Resource wealth has brought unstable nations to their knees by spawning war or corruption.465 Wealthy nations have also been known to have had problems handling commodity booms, which can drive up currencies, batter their exporters and produce unsustainable surges in imports.466

459 Ibid
460 Maxwell Phillip 2004 “Chiles’ recent Copper driven prosperity: Does it provide lessons for other mineral rich developing countries” Minerals and Energy, vol.19(1) 16-31
461 Chile and OECD, 2008, Latin America Economy Watch
462 Ibid
463 Guerero Antonio 2009 Slumping Copper Prices take Shine Off Growth Global Finance (online) available at http://www.allbusiness.comeconomy—economie-conditions-growth/1
465 Chander Anupan 2007 Can Chile Avoid Dutch Disease, Globalisation (online) available at http://www.typepad.com/services/trackback/6a00d834525b9169e200d8354a38e869e2
466 Ibid
Chile is trying to innoculate itself. The government is saving what it calculates as windfall profits from its state owned copper company and windfall taxes from privately owned mines.\textsuperscript{467} The policy of soaking away windfall copper profits pushed 2007’s fiscal surplus to another historic high leaving it in a solid position to weather global economic volatility.

Windfall profits from sales of copper, a key component to infrastructure development and expansión have been strictly managed by the Chilean government under policies focused on saving for leaner times.\textsuperscript{468}

5.4 \textbf{Comparative analysis: Zambia and Chile}
While appreciating that Zambia and Chile have different historical backgrounds, political and economic, it is important to note that both in fact are poverty stricken countries with a large mineral endowment which has not been exploited to boost the economies of these countries.

Zambia is still grappling to find a solution to this problem. Despite having a suitable investment climate, it is doubtful that the macro economic policies in place together with the available institutions are adequate. It is also doubtful whether there is in fact prudent use of available resources.

Chile on the other hand has made tremendous strides in achieving sound economic policies that go with the overall objective of economic development. The Chilean experience may provide guidance for mineral rich developing nations seeking to follow a similar path.

The establishment of the state owned copper producer CODELCO, in 1970 has made an important contribution to government revenues.\textsuperscript{469} The mixed private and public ownership of the mineral sector has aided the Chilean government to reap the benefits of mineral

\textsuperscript{467} Ibid
\textsuperscript{468} Chile Posts Record Fiscal Surplus in 2007 \textit{Chile Investment Review}, International Press Selections Reuters 2008
\textsuperscript{469} Maxwell Phillip 2004 “Chiles’ recent Copper driven prosperity : Does it provide lessons for other mineral rich developing countries” \textit{Minerals and Energy}, vol.19(1) 16-31
exploitation.\textsuperscript{470} In Zambia, the government does not have full ownership and control of the mines, but only has a percentage equity ownership. This is held through an investment Holding company ZCCM-IH which has very little (if any) influence over the mines.

Limited government spending during windfall periods increased the credibility of the government.\textsuperscript{471} Windfall gains were successfully saved for periods when the copper prices would drop and to reduce public debt.\textsuperscript{472} Part of these proceeds have also been invested abroad in other currency (as such the flows do not enter the economy directly), the stock funds and the Treasury enhanced.\textsuperscript{473} Chile has in place a tax regime which provides adequate rates of taxes to be payable, which are also sufficient during periods of high copper prices. Zambia on the other hand does not have adequate laws prescribing adequate rates of tax. The flexibility in the mining laws for investors to negotiate lower rates of taxes vitiates the very essence of the law.

Chile has a state-owned and managed “copper stabilization fund” which was established in 1985, into which it saves part of state copper revenues during high price cycles, which are distributed during depressive cycles.\textsuperscript{474} CODELCO’s total tax bill amounted to an annual average of 396.4 million US dollars.\textsuperscript{475} CODELCO is a state-owned company, and as such, must pay a royalty of 10 per cent of sales directly to the military and a special 12 per cent surtax, over and above the normal 15 per cent tax every company operating in Chile must pay on profits.\textsuperscript{476} This fund has greatly reduced the impact of copper price fluctuations. The reduced vulnerability to world price changes also has positive effects on the real exchange rate and on government revenues.\textsuperscript{477} In the absence of an especially dedicated fund to save copper prices, gains from copper form part of the general revenue of the government and can be used as governments wishes.

\begin{itemize}
\item \textsuperscript{470} Ibid
\item \textsuperscript{471} Ibid
\item \textsuperscript{472} Ibid
\item \textsuperscript{474} Riesco Manuel et al 2002 Pay your Taxes: Perspectives on Corporate Taxation and Social Responsibility in the Chilean Mining Industry Paper done for the International Institute for Environment and Development available at cep.cl/UNRISD/UNRISD_CSR( Varios_Viejos/Mining_CSR_Chile.doc
\item \textsuperscript{475} Ibid
\item \textsuperscript{476} Ibid
\item \textsuperscript{477} Ibid
\end{itemize}
5.5 Conclusion

It is quite clear from the analysis provided in this Chapter that proactiveness on the part of the government, in putting in place adequate legislation, sound macro-economic policies, creating an investor friendly climate, having effective institutions in place are all factors that can help a mineral endowed country reap the benefits from its natural resources. These factors do not work in isolation, as we have seen from the Zambian scenario. It is evident that Chile’s investment policies are not just meant to attract foreign direct investment but that there is some benefit flowing to the ordinary man. Chile is also looking ahead to the future; in times of high commodity prices on the world market, the legislation in place can capture the windfall profits. It has taken charge of the situation by allowing government ownership of the mines, and government decides how the resources are to be used. While private investors usually have a tendency not to give a proper account of production and the books of account, and are not compellable to publish the same, Government through taxes, raises additional revenue and compete with the private investors in the economic affairs of the country, especially that these industries have an impact in shaping the economy.
Chapter 6

6. CONCLUSION

The conclusion will give recommendations on how proper implementation of the copper mining windfall combined with the existence of other factors can lead to meaningful development and economic growth for Zambia.

The aim of this paper was to show the use, effectiveness and efficiency of tax incentives as instruments for promoting or attracting the inflow of FDI in developing countries and especially Zambia. In particular, it analysed how imposition of a mining windfall tax can capture the windfall profits that come about as a result of unanticipated high prices of copper on the world market.

It has been demonstrated that windfall profits may be temporary or cyclical in nature, called economic profits or more structural or permanent in which case they will be referred to as economic rent.\textsuperscript{478} Certain principles (simplify taxation of company’s, provide predictability in tax policy, time consistency in tax policy) ought to be born in mind when imposing a windfall tax, these must not be compromised.\textsuperscript{479}

Taxation of pure economic rent of a structural nature does not affect Company’s behaviour; the taxation of rents of a short/cyclical nature will affect company’s behaviour and has an impact on resource allocation, resulting in distortions.\textsuperscript{480} A distinction being made between permanent and temporary rents. Taxing a windfall is non distortionary since it can only be imposed ex post, after a windfall.\textsuperscript{481}

In considering whether or not to implement a windfall tax, a proper analysis must be made whether current prices reflect a structural or permanent change that would justify a new fiscal

\textsuperscript{479} Ibid
\textsuperscript{480} Ibid
\textsuperscript{481} Levmore Saul 1993 The Case for Retroactive Taxation 22 Journal of Legal Studies
intervention.\textsuperscript{482} If it is not possible to come to a definite conclusion, it would be inadvisable to proceed with a windfall tax. Gains could be shared through royalties, state equity stakes or normal corporate tax income.\textsuperscript{483}

Windfall taxes are imposed as they provide a guide to capital allocation.\textsuperscript{484} Societal capture of windfalls does not affect incentives to engage in productive activity and therefore does not discourage effort or enterprise.\textsuperscript{485} Windfall taxes are also said to redress the perceived regulatory imbalances.\textsuperscript{486} They allow nascent regulatory institutions to do their job. Further, they redistribute profit earned by a specific industry.\textsuperscript{487} There is no private market mechanism for redistributing windfalls because parties experiencing gains are unlikely to report their good fortune.\textsuperscript{488} As has been shown, investors do not provide financial records or records of production. The state comes in to distribute the windfalls. Leaving windfalls where they fall means that few individuals experience large gains while most receive nothing.\textsuperscript{489} As such, risk averse citizens will not find appealing the idea of leaving windfalls where they fall.\textsuperscript{490} They will prefer to capture them and distribute them evenly over the entire citizenry.\textsuperscript{491}

Windfalls also raise additional revenue for the fiscus.\textsuperscript{492} By raising revenue via a non-distortionary tax, windfall captures reduce dead weight losses.\textsuperscript{493} It will also reduce the tax bill

\begin{footnotesize}
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\item \textsuperscript{482} National Treasury, 2007 Windfall Taxes on the Liquid Fuels Industry: Response to the Task Team Report on Windfall Profits in the Liquid Fuels Industry, available at www.treasury.gov.za/publications/other/windfall2007080602
\item \textsuperscript{483} Ibid
\item \textsuperscript{484} Ibid
\item \textsuperscript{488} Ibid
\item \textsuperscript{489} Ibid
\item \textsuperscript{490} Ibid
\item \textsuperscript{489} Ibid
\item \textsuperscript{491} Levmore Saul 1993 The Case for Retroactive Taxation 22 Journal of Legal Studies
\end{itemize}
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of the vast majority that do not enjoy significant windfalls.\textsuperscript{494} It is, therefore, a less burdensome means of raising revenue.

The foregoing provides efficiency reasons for capturing windfalls: if properly implemented they improve social welfare. It should however be noted that windfall taxation should be imposed judiciously as windfall profits are uncommon and by definition are not recurring events.\textsuperscript{495}

Although tax incentives continue to dominate Zambia’s efforts of attracting FDI, they have largely been challenged by policy makers, academics and economists for not being effective and efficient means of attracting FDI.\textsuperscript{496} Granting tax incentives means that a country has to forego some or all of the revenue which was due to the country.\textsuperscript{497} If the benefits of the FDI do not outweigh the costs of revenue foregone, then the whole investment issue becomes nothing but a drain of the country’s resources.\textsuperscript{498}

It is clear that developing nation’s competition for attracting FDI using tax incentives does not add any value to their economies. However they still continue to use them. Zambia has promulgated favourable laws and policies to create a favourable investment climate. It however, failed to capture the windfall profits that came with the rise in the copper prices as has been outlined above. This begs the question, what should Zambia (and other developing countries do) to avoid being caught up and losing out.

\textbf{6.1 Recommendations:}

It is important that the country addresses other problems/challenges that make them not attract foreign capital inflow. The following recommendations if properly implemented provide a guideline as how a country can benefit from its resource wealth;

\textsuperscript{494} Ibid
\textsuperscript{495} Ibid
\textsuperscript{496} Nyika paper part II
\textsuperscript{497} Ibid
\textsuperscript{498} Ibid
1. Deliberate measures must be taken to improve the macroeconomic policies of the country through reduced external debt which impacts on the balance of payments, improve human and physical infrastructure such as education, transportation/road network and telecommunication networks. A windfall tax alone, cannot be used to improve social welfare, it will work in the wider context of other economic policies.

2. In considering whether or not to implement a windfall tax, a proper analysis must be made whether current prices reflect a structural or permanent change that would justify a new fiscal intervention. Some countries, such as South Africa, have established Task Teams to look into whether there are windfall profits and recommend possible interventions by Government.

3. Reforms must be undertaken to the tax system of the regime well in advance, by creating efficiency and transparency in tax collection. Ideally this should combine some upfront revenue with sufficient progressivity to provide government with an adequate share of economic rent under variable conditions of profitability. This can be achieved through a tax based system combining a corporate income tax with a rate of return based resource rent (or a progressive profit tax) and desirably a royalty to secure some upfront revenue.

4. The period for tax holidays (which have a distortionary effect) should be reduced so that existing investments are used to foster fiscal stability, build infrastructure and spend on health, education and training for the labour force.

5. Since the rationale for using tax incentives is that they help to compensate for a country’s negative investment climate in terms of political risks, countries must be proactive in the dissemination of accurate information so that investors do not negotiate for incentives on the basis of risk which may be non-existent.


500 Baunsgaard Thomas 2001 A Primer on Taxation IMF Working Paper WP/01/139

501 Ibid
6. Regional groupings should be encouraged which may agree on acceptable rules for the promotion of FDI and not left to individual countries.

7. The capacity of a country to competently administer a complex taxation based system must be taken into account when designing the fiscal regime, and attempts should be made to keep the legislation and administration as simple as possible while maintaining sufficient safeguards to counter tax avoidance.\textsuperscript{502}

8. Mineral extraction will have intergenerational consequences that should be taken into account. Extraction of minerals reduces the net wealth of a country to the detriment of future generations.\textsuperscript{503} This can be addressed through the establishment of a separate fund for the revenue generated from mineral extraction to be invested for future generations. A stabilization fund can also be established for the revenue that is captured during windfall periods that can be used to improve the social welfare in times when prices are down. Stabilisation Funds provide a basis for resource rents to support long term development beyond the exhaustion of finite resources.\textsuperscript{504}

The proponents of windfall taxes claim that such a tax would not distort economic decisions or markets because the profits to be taxed are both abnormally high and unanticipated.\textsuperscript{505} By this reasoning when a company’s profits are unusually high, government can tax those higher profits without reducing the resources needed to finance ordinary expenses and investment, and consequently, without constraining a company’s ability to generate normal rates of return.\textsuperscript{506} It is further claimed that taxing unanticipated profits will not distort investment and production decisions, because unanticipated profits cannot be a factor in the company’s decisions and investments.\textsuperscript{507} Based on this reasoning, a tax on windfall profits seems to provide a unique way...

\textsuperscript{502} Ibid
\textsuperscript{503} Ibid
\textsuperscript{504} Possible Reforms to the Fiscal Regime applicable to windfall profits in South Africa’s Liquid Fuel Energy Sector with particular Reference to the Synthetic Fuel Industry 2006 - A discussion document for public comment.
\textsuperscript{505} Shapiro Robert and Pham Nam 2005, The Economic impact of a Windfall Profit Tax for Savers and Shareholders, Investors Action Foundation.
\textsuperscript{506} Ibid
\textsuperscript{507} Ibid
of raising substantial revenues without distorting economic efficiency. Proper implementation of a windfall tax, taking into account the recommendations outlined above will achieve sustainable economic development, improve social welfare and enhance the flow of foreign direct investment to a country.
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