The Global Economic Crisis, Funding Public Services in Africa, and Concessions in the Mining Sector: The Case of Zambia

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1. Introduction

Most African economies rely on revenues from the export of natural resources to manage their economies. These revenues typically account for 70% or more of the government outlays[1] and so fund public services essential for maintaining and enhancing the quality of life in one of world's most poverty-stricken regions. The links between resource development and public services mean that the global economic crisis has affected Sub-Saharan African countries in ways not experienced by other countries. Put another way, Sub-Saharan countries didn't need to have banks speculating in fancy securitized assets in New York and London to be harmed by in the global economic downturn; falling export revenues pose a serious challenge to African governments.

Zambia is no exception and is blessed with abundant mineral resources such as copper, cobalt and gem-quality emerald. To develop the mining sector, the government privatized the sector in the early part of this decade and employed tax concessions in development agreements to increase investments, revenue and associated externalities in the sector. These agreements permitted mining companies to carry forward losses for between 15 and 20 years on a 'first-in, first-out' basis, taxed royalties at 0.6 per cent of gross revenue instead of 3 percent as stipulated by the Mines and Minerals Act, and provided a period (as long as 20 years) in which government would not amend the tax regime.[2]

These concessions influence the total amount of revenue earned by government to provide basic public services to the people and the poor in particular.[3] Successive governments have been criticized over the amount of revenue received from mineral production, after granting what some observers considered to be extremely generous incentives. In 2005, Zambia earned US$75million in revenue from copper mining but this represented less than 5 per cent of the value of copper mining and cobalt exports.[4] Also, between 2003 and 2006, mining companies earned about US$652million in profits but paid only $71million as taxes.[5]

1 Arbache (2009)
2 Lungu (2009)
3 According to the MDG Progress Report 2008, 51% of Zambia's population lived in extreme poverty as at 2006.
4 World Investment Report 2007, pg. 137
5 Simutanyi (2008)

Consequently, in April 2008, the government decided to reverse a number of tax concessions, though this was deemed as anti-competitive by some stakeholders in the industry. The reversals were expected to contribute an additional US$415 million to government revenue.[6] Nonetheless, the impact of the global financial crisis on the mining industry in the latter part of 2008 deemed it necessary for the government to again revise the tax regime in 2009. The crisis demonstrated the need for African governments to better manage the liberalization of their economies to take into consideration both global boom and bust periods.

The purpose of this paper is to investigate whether the tax revisions in 2008 achieved their intended objective and whether the reversals in 2009 were prudent, so shedding light on how Zambia might better manage a key feature of its openness to the world economy.

2. Trends in Zambia's mining industry

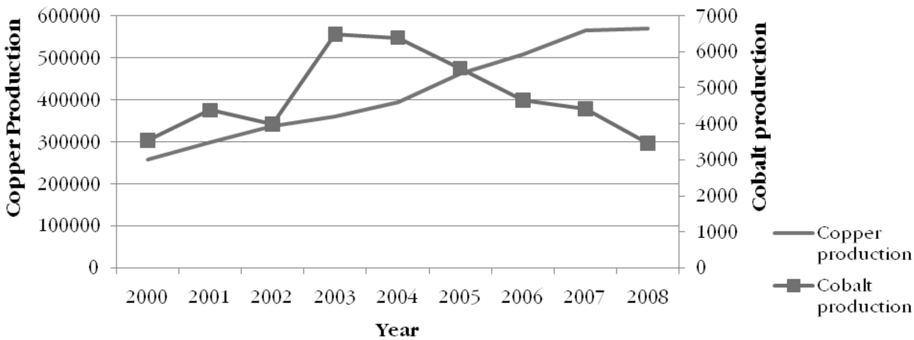
The mining sector is an integral part of the Zambian economy, employing about 50,000 workers (9 per cent of the labour force)[7], contributing about 71 per cent of total export earnings from 2001 to 2007[8] and between 6.2 percent and 11.8 percent in GDP growth from 2000 - 2005.[9] With a booming world economy and rising commodity prices, the Zambian economy grew strongly with a GDP growth rate of between 5 per cent and 6 per cent from 2002 to 2008, supported largely by the mining sector.[10] Privatization of the mining industry and worldwide increases in prices of minerals in 2006 also increased FDI inflows[11] and copper mining production (see figure 1). FDI inflows increased by 17 per cent from US$122million in 2000 to US$380million in 2005 and by 95 percent from 2005 (US$380million) to US$ 811.7million in 2007.[12] In 2007, FDI in the mining sector represented about 82 per cent (US$671million) of total FDI inflow of US$811.7million.[13] Export earnings have been favourable (see figure 2) because of high metal prices even in years when production levels decreased or fell below target.

Copper prices have increased by over 250 per cent from 2000-2007 (see figure 3) and continued to rise until the latter part of 2008. With more than a 60 per cent fall in copper prices in the second half of 2008, mining production suffered cutbacks and scaling back or suspension of expansion projects.[14] For example, the Luanshya Copper Mine suspended the construction of its US$354million Mulyashi mine while it reexamined its viability and the Luanshya Copper Mine shut down.[15] Copper production was estimated to reach 800,000 tonnes in 2008 and 1,000,000 tonnes by 2010[16] but

6 Zambia Budget Speech 2008
7 Musokotwane (2009)
8 Earnings from copper and cobalt accounted for the 71%.
9 Simutanyi (2008)
10 WTO Trade Policy Review Report by Zambia (2009); WTO Trade Policy Report by the Secretariat on Zambia (2009)
11 Zambia Investment Policy Review (2006)
12 Zambia Economic Reports, 2003 to 2007
13 Zambia Economic Report (2007)
14 WTO Trade Policy Report by the Secretariat on Zambia (2009)
15 Lusaka Times (2008)
16 IRIN (2009)

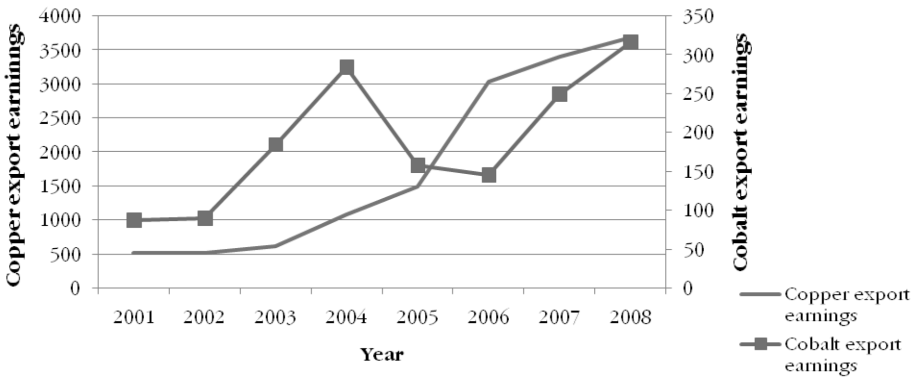
further declines in exports are expected in 2009 because increases in copper production will not be enough to offset the decreases in copper prices.[17] The industry is expected to recover in 2010.

Figure 8.1 Copper and cobalt production in metric tonnes (2000 – 2008)



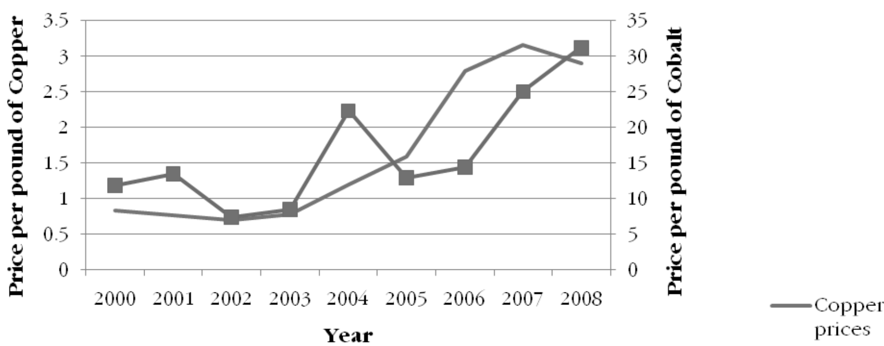
Source: Zambia Economic Reports, 2003 - 2008

Figure 8.2 Copper and cobalt export earnings in US$millions (2001 – 2008)



Source: Bank of Zambia Annual Reports 2007, 2008; Zambia Economic Reports 2003 - 2007

Figure 8.3 Price per pound of copper and cobalt in US$ (2000 – 2008)



Source: Bank of Zambia Annual Reports 2007, 2008; Zambia Economic Reports 2003 - 2007

17 African Economic Outlook 2009 (Production from the Lumwana Copper mine is expected to exceed reductions in output from older mines. Two new copper smelters are also to start processing copper ore)

3.The fiscal regime relating to the Zambian mining sector

The sector is regulated by the Mines and Mineral Development Act of 2008 following the repeal of the Mines and Mineral Act of 1995. The changes to the tax regime in April 2008 included:

- An increase in the corporate income tax rate from 25 per cent to 30 per cent.
- Introduction of a variable profit tax of 15 per cent which is above 8 per cent of the gross income
- A windfall tax was introduced of 25 per cent when copper prices are $2.50 per pound but below $3.00 per pound, 50 per cent for the next 50 cents increase in price, and 75 per cent above $3.50 per pound.
- A withholding tax of 15 per cent.
- An increase in royalty tax from 0.6 per cent to 3 per cent and a reduction in the capital allowance rate reduced from 100 per cent annually to 25 per cent annually.

However, due to the present unfavourable world economy, the Zambian government proposed a number of fiscal concessions in the 2009 budget in an effort to save the industry from collapse. The concessions included:

- The removal of the windfall tax introduced in 2008
- 100 per cent capital allowance on machinery and equipment
- The treatment of hedging income as part of mining income.

These are in addition to the exemption from customs and excise duties and any other duty or import levied under the Customs and Excise Act, in respect of all machinery and equipment required for investing or prospecting in mining.

The windfall tax was imposed with the objective of increasing revenue accruing to the government from the mining sector. The tax effectively increased mining taxes from an average of 31.7 per cent to 47 per cent[18] and generated debate for and against its imposition. Some companies threatened to take legal action against the government while other stakeholders commended the government for the effort to increase mining revenue. The mining companies commented that profits should be reinvested to promote innovation and the tax would result in a preference for lower profits.[19] Yet, while favourable metal prices from 2003 up to the latter part of 2008 had resulted in high levels of profits for the mining companies - for instance, profits of Zambia's largest copper mine, Konkola Copper Mines, increased from US$52.7million in 2005 to $206.3million in 2006[20], while another mining company, First Quantum, increased its net earnings from US$4.6million in 2003 to US$152.8million in 2005[21] - mining companies are criticized for not reinvesting enough profits in innovation and into mining communities.[22]

18 Shacinda (2008b)
19 Economics Association of Zambia (2009)
20 Economics Association of Zambia (2009); Simutanyi (2008)
21 Mwitma and Kabemba (2007)
22 Simutanyi (2008)

4.Did the change in fiscal regime in 2008 achieve the desired results?

Essentially, the tax revision in 2008 did not yield the expected benefits. Only one-third of the estimated US$415million from the new mining tax regime was collected as revenue[23] because mining companies resisted payment of the tax and also claimed to have encountered high production costs.[24] As at September 2008, only 2 mining companies had paid the windfall tax for the quarter ending June 2008.[25] At the end of 2008, only 3 mining companies (out of about 14) paid the windfall tax while two companies paid company tax.[26] A number of reasons can be advanced for the government's inability to achieve much revenue from its tax increases. Difficulties with administration of the new fiscal regime were partly to blame for the revenue shortfall of 65 per cent in mining tax collection.[27] Also, lower metal prices played havoc with revenue generation. In 2008, all mining companies paid royalties but revenue from mineral royalties declined by 7.1 per cent as a result of low metal prices.[28] Thus, the government did not achieve its aim of increasing revenue from the sector because of non-compliance by the mining companies and administrative challenges. The Bank of Zambia Quarterly Media briefings reported rising copper and cobalt earnings due to rising metal prices, for the first and second quarters of 2009, but estimates on mining revenue collected is unavailable.

On the other hand, FDI inflows into the sector continued in spite of the tax increases, with about US$2 billion in investment pledges in the third quarter of 2008.[29] The continued inflow shows that investment was not drastically affected by the windfall tax and might confirm the evidence from studies that fiscal incentives are not the major determining factor of FDI, but also other factors such as infrastructure, labour skills and political stability. Also, even though investment has slowed down in 2009, there is some investment activity in the sector. The government and the Zhonghui Mining Group signed a US$3.6 billion exploration deal (over the next five years) in July, while the China Nonferrous Metal Mining Company has acquired and re-opened the Luanshya Copper Mine at an estimated US$50million.[30]

Table 8.1 Targeted Additional Mining Revenue and Collections (billions of Kwacha[31])

	Target Revenue in 2008	Collection[32] in 2008	Variance	Percentage of Variance
Additional Mining Revenue	917.4	319.5	(597.9)	(65.2)
Company tax	300.5	22.2	(278.3)	(93.6)
Windfall tax	502.1	126.1	(376.0)	(75.9)
Mineral Royalty	114.8	171.2	56.4	49.1

Source: Ministry of Finance and Economic Planning, cited in Zambia Economic Report 2008.

23 African Economic Outlook (2009)
24 Zambian Economist, 10 September 2008
25 Lungu (2009)
26 Zambia Economic Report (2008)
27 In the 2009 budget K319.5billion was collected in revenue compared with an estimated K917.3 billion representing a 65% under collection rate.
28 Zambia Economic Report (2008)
29 Bank of Zambia Quarterly Media Briefing, November 2008
30 Lusaka Times (2009); Ngandwe(2009)
31 Kwacha is the national currency of Zambia
32 Preliminary figures

5. Likely impact of new fiscal measures

Following the enforcement of the 2008 mining tax regime and the global financial crisis, mining companies have complained about high production costs and asked the government to reduce fuel prices, electricity tariffs and mining taxes, including the windfall tax.[33] Mining companies specifically rejected the taxes, claiming they had not been consulted and threatened legal action against the state for going against signed development agreements.[34] An official of Konkola Copper Mines, Zambia's largest mining company, explained that the new taxes could destabilize long-term expansion and recapitalization plans.[35] Similarly, First Quantum Mines said the taxes would prevent the company from expanding its mining units.[36] Thus, the government abolished the windfall tax because it added to the cost of production of mining companies and discouraged investment.[37] However, the government has admitted that it does not have an accurate estimate of the production costs of mining companies and has commissioned a study to verify the cost.[38] Arguably, without knowing actual production costs, the decision to remove the tax in 2009 could have been premature. This is because since copper prices have not yet risen to levels which would trigger the windfall tax, verification of the production costs of mining companies could have been completed before a decision was taken. What is certain is that the government would lose revenue with the abolishment of the tax and not achieve the intended objective of increasing revenue.

On the other hand, other changes to the tax regime could have beneficial impacts. Capital allowance is an incentive to encourage investment in capital equipment such as machinery and vehicles. Inadequate equipment is a factor affecting mineral production.[39] Granting of capital allowance allows businesses to reduce their taxable profits by a certain percentage of the cost of equipment. Prior to 2008, mining companies enjoyed a capital allowance rate of 100 per cent, which was changed to 25 per cent in 2008 and then reversed back to 100 percent in 2009. The 25 per cent rate ensured that the cost of machinery and equipment was recouped over 4 years, while a 100 per cent capital allowance allows mining companies to write-off the costs of their machinery and equipment in a year. This concession greatly lowers the effective cost of acquiring machinery and equipment and, provided mining companies actively take up this incentive, Zambia is likely to benefit since it will contribute to higher production levels and higher export earnings. However, mining companies could take advantage and continuously buy equipment in order to reduce their taxable income, thereby reducing revenue available to the government.

In addition, the law which prevented hedging losses being deducted from mining income was reversed. Mining companies who make a loss from hedging the prices of metals on the international market are now able to deduct this amount from their taxable income, thus reducing revenue to government. Critics of this concession

33 Shacinda (2008c)
34 Lungu (2009); Shacinda (2008)
35 Chisanza (2008)
36 Shacinda (2008)
37 Zambia Budget Speech (2009); Zambian Chronicle (2009)
38 Parliamentary Committee on Estimates (2009)
39 The Lumwana Mine in July 2009 cited inadequate equipment as a factor hindering mineral production.

claim hedging income should not be added to mining income because it is not a mining activity and will spurn other industries. However, allowing hedging losses to be deducted from mining income is a provision which restores an earlier provision in the development agreements signed between the mining companies and the government.[40]

Thus the potential outcome of the new fiscal regime is a reduction in revenue for government, further diminishing the likelihood of attaining higher revenue from the mining industry and jeopardizing the provision of public services. The government of Zambia provides a large proportion of services such as health and education. The 2009 budget allocated about 30% of government expenditure to the health and education sectors and increased the allocation to the sectors by 12.9 per cent and 24 per cent respectively. The government was to purchase essential drugs, medical supplies, educational materials, and improve health and educational facilities. Already, the revenue collection target for the first half of 2009 has not been achieved. Total revenue and grants decreased by 24.8% due to the poor performance of trade taxes, budget support and grant receipts, and targeted tax revenue was below target by 7.3%.[41] Ministries, Provinces and Spending Agencies (MPSAs) thereby did not receive their full budgeted allocations and revisions would have to be made to prioritize certain activities.[42] Surely, basic services provided by the government will be affected.

6. The importance of other factors in the mining sector

To attract foreign direct investment into a country or a sector, other contributing factors such as political stability, infrastructure and a skilled work force are required. Zambia has made great strides in attracting foreign direct investment into the country and the mining sector in particular. By mid-2008, investment in the sector was about US$4bn.[43] Zambia is a politically stable country which has undertaken major reforms in tax regulation and administration and improved its investment code. Nonetheless, poor infrastructure and intermittent electricity supply which lead to increased production costs are a deterrent to investment. Inability to meet production targets in many years are usually attributed to flooding, and inadequate electricity. According to Reuters, the Lumwana Mining Company Limited announced in July 2009 that it will be unable to produce the estimated 170,000 tonnes of copper due to inadequate equipment and flooding.[44] Also, the company had lost $1.8 million in revenue (500 tonnes of copper) due to a nationwide power blackout.[45] Hence, pertinent infrastructure which will encourage an increase in production and revenue should be put in place.

40 Economics Association of Zambia (2009)
41 Musokotwane (2009b)
42 Musokotwane (2009b)
43 Zambia National Commission (n.d)
44 Reuters, 8 July 2009
45 Reuters, 8 July 2009

7. Conclusion

The Zambian government, like other African governments including Tanzania, Kenya and Uganda,[46] has chosen to grant further concessions in certain sectors of their economies in these difficult times, instead of becoming protectionist and turning inward. This may seem an imprudent choice, since African governments have been criticized by some for over-liberalizing their economies. However, it could be argued that these governments do not have much of a choice. Faced with rising debt, a depreciating currency and a quickly eroding international reserve, Sub-Saharan African governments are often limited in ways to attract investment as well as keep pertinent businesses operational. The offering of certain concessions which might erode earlier gains made could be the answer to minimizing the effect of the global financial crisis on the mining sector. Without the added impact of the crisis, the government of Zambia would have been in a much better situation in negotiating with mining companies regarding the imposition of taxes.

In addition, for investment and long-term planning to be encouraged in the sector, the fiscal regime must be stabilized. The frequent changes and unpredictability in the fiscal regime makes it difficult for mining companies to plan for the long-term, as well as tempts them to find ways of avoiding taxes they deem as punitive. While there might not have been enough consultation between government and stakeholders before the 2008 fiscal regime was effected, the government must thoroughly re-examine both the 2009 and 2008 mining tax regimes with all stakeholders in order to ensure that benefits which must accrue to the people of Zambia are not sacrificed. Furthermore, it is necessary for the taxes to be properly administered by the revenue authorities so as to facilitate collection and minimize tax avoidance. When the crisis is over, the government may want to take a second look at the fiscal regime by carefully evaluating the windfall tax and its associated advantages and disadvantages. The government may consider a reduction of the threshold prices for copper and re-institute the windfall tax. From the Zambian experience, other African governments need to carefully balance liberalization of their economies with the developmental objectives of the country. Contracts signed with foreign interests should incorporate potential changes in the prices of minerals and prevailing circumstances.

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46 Global Trade Alert Database (2009)

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