WINDFALL TAXES: A POISONED CHALICE?

A STUDY OF THE IMPLICATIONS OF RE-INTRODUCING WINDFALL TAXES ON FOREIGN DIRECT INVESTMENT IN THE ZAMBIAN MINING INDUSTRY

By

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Being a Directed Research essay submitted to the University of Zambia Law Faculty in Partial fulfillment of the requirements for the Award of the Bachelor of Laws (LLB) Degree.

UNZA **2011**

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ABSTRACT

The mining industry is an essential and integral component of Zambia's economic development. This industry, heavily dependent on Foreign Direct Investment, is seen as a vital source in the provision of revenue to the Zambian government, revenue used to develop the country. In an attempt to fully maximize revenue collection from the mining industry the government has entered into Development Agreements. This is principally aimed at attracting Foreign Direct Investment in the mining industry and hence the growth of the industry.

Development Agreements contain provisions which set the climate in which investments are made. These Agreements often provide concessions to investors. Some of the most common concessions are tax concessions as well stability periods during which time the government undertakes not to amend its laws to adversely affect the rights of the mining companies.

Given the fact that metal prices, including copper are subject to international market forces, there are times when the copper prices will dramatically increase with investors in the mining industry making unusually high profits. When this occurs there is always a call for the people, to benefit from their countries natural resources. The sought after benefits come in the form of imposition of new taxes, commonly referred to as windfall taxes with the intention being to capture a share of the above normal profits being reaped by the mining companies. The imposition of the windfall taxes in most cases is undertaken unilaterally, breaching the Development Agreements and ignoring the stability periods. The windfall taxes further come at a cost of deterring further foreign direct investment into the mining industry which is heavily dependent on such Foreign Direct Investment for its growth and indeed survival.

The study examines the implications on the amount of Foreign Direct Investment that would come into the mining industry in the event that windfall taxes are re-introduced. This will be taken in light of the previously signed Development Agreements and the previous introduction and subsequent cancellation of the windfall taxes. The study also analyses the consequences on the Zambian economy as a whole, in the event that windfall taxes are re-introduced. It is the recommendation of the study that a balance must be struck between the re-introduction of the windfall taxes, the need to protect Zambia's standing as a good investment climate and the interests of all parties concerned in the mining industry and the nation as a whole.

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I would be betraying my faith if I did not acknowledge and thank the God almighty from whom all is given for the role that he has played during my stay at University and indeed Law school. It is only through time and patience that this work has come to fruition. I continue to seek your guidance and favour, may your name forever be exalted. (Philippians 3:14.)

DEDICATION

This work is dedicated to the memories of my late parents, Mowa Xyzito Chitupila and Christine Mukuka Chitupila. For the love and compassion you always showed me. If only every child in this world could have a fraction of the love that you gave me.

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LIST OF ABBREVIATIONS

DAs	Development Agreements
EITI	Extractive Industry Transparency Initiative
FDI	Foreign Direct Investment
FMG. AX	Fortescue Metals Group
FQM	First Quantam Minerals
GFC	Global Financial Crisis
IMF	International Monetary Fund
KCM	Konkola Copper Mine
KDMP	Konkola Deep Mining Project
LCM	Luanshya Copper Mine
LMC	Lumwana Mining Company
LMFEZ	Lumwana Multi Facility Economic Zone
MCM	Mopani Copper Mine
MMD	Movement for Multi-Party Democracy
PRRT	Petroleum Resource Rent Tax
RSPT	Resource Super Profits Tax
UNIP	United National Independence Party
ZRA	Zambia Revenue Authority

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CHAPTER ONE

THE ZAMBIAN MINING INDUSTRY: FOREIGN DIRECT INVESTMENT AND WINDFALL TAXES

1.0 Introduction

Throughout the history of copper mining in Zambia the mining companies have been the major source of revenue to the government; they have done this through the payment of royalties, corporation taxes as well as windfall taxes[1]. Therefore, in an attempt to fully maximize revenue collection the Zambian government has entered into partnerships with mining companies, both local and foreign for the operation and management of the mines. This comes against the backdrop where the United National Independence Party (UNIP) government in power from 1964 to 1991, amidst declining copper prices in 1976 and reducing international trade struggled to operate the mines, making huge losses and increasing government expenditure[2].

With this in mind and the return of multi party democracy in 1991 coupled with the shift towards free market economy, the Movement for Multi-Party Democracy (MMD) government embarked on a privatisation program of the mining industry. The privatisation of the mining industry was facilitated by the enactment of the Mines and Minerals Act of 1995[3] (the 1995 Act). Of great importance is the fact that the 1995 Act permitted the government to enter into 'Development Agreements'. Development Agreements (DAs) in this sense refer to contractual agreements entered into and signed between a government and a mining company for the operation of a mine. In addition, DAs also referred to as State Agreements are seen as a visible signal of a state's support for and commitment to a project[4]. In this case project refers to mining projects.

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[1] J Lungu, The Politics of Reforming Zambia's Mining Tax Regime. Issue 8. Southern Africa Resource Watch, Johannesburg, 2009. Page 5

[2] United Nations Conference on Trade and Development. Investment Policy Review, Zambia. United Nations Publication, Switzerland, 2006. Page 3

[3] Act Number 31 of 1995

[4] D Grinlinton, Legal Aspects of Large Scale Mineral Developments: A Case Study of Western Australia. Centre for Petroleum and Mineral Studies, Dundee, 2004. Page 33

In the 1990's attempts to set an 'investor friendly' climate saw the MMD government enter into DAs with mining companies, committing to certain undertakings. The DAs in relation to mineral royalties for large scale mining licences were set at 0.6 percent of the gross revenue of minerals produced; companies were allowed to carry forward losses for periods of between 15 and 20 years on a 'first-in, first-out' basis. The agreements also reduced the corporation tax from the original 35 percent to 25 percent. Most important is that the government undertook not to amend any of these tax regimes after the agreement was struck formalized? for as much as between 15 and 20 years[5]. These 'stability periods' were a particularly important provision because until they had expired the terms of the DAs were assumed to be legally binding and overruled any existing or future national legislation. The provisions of the DAs were clearly in favour of the mining companies.

Coming from the background of low copper prices and loss making mines, it is important to note that despite the DAs being lopsided in favour of the mining companies, the underlying motivation was to make the Zambian mining industry attractive as an investment destination for Foreign Direct Investment (FDI). The aim was to attract FDI.

More than a decade after the DAs were signed, the prices of copper had increased dramatically hitting peak point in July 2008 at US \$ 8900[6] per tonne. This radical change in copper prices mainly fuelled by the construction needs of China prompted the Zambian government to reconsider the preferential tax regime that foreign mining companies had previously enjoyed[7]. The intention was clear and simple; to ensure that the Zambian public benefited from the high copper prices. The revenues received were intended to be used in the social sector to better the livelihood of the common Zambian.

Backed by high copper prices and partly influenced by the growing public pressure from both civil society and opposition political parties, the MMD 'new deal' government at the time led by the late President Mwanawasa announced plans to introduce a windfall tax. This was followed

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[5] S Musokotwane, Ministerial Statement on the Status of Mining Taxation. 2010. Page 4
[6] K Nshindano, The Impact of the Global Financial Crisis on the Zambian Economy. Henry Dillion, Paris, 2010. Page 55
[7] S P Ngambi, Stabilization Clauses and the Zambian Windfall Tax. Zambia Social Science Journal. Institute for Public Policy Research, Lusaka, 2010. Page 1

by the enactment of new mining legislation; The Mines and Mineral Development Act[8] (the 2008 Act). This act repealed the 1995 Act and with it the DAs signed between the Chiluba government and the mining companies in the 1990's.

The decision to introduce on 1st April 2008 windfall taxes and cancel the DAs was taken unilaterally, with stakeholders in the mining industry arguing that the cancellation of the DAs was illegal and would have a negative impact on the possible inflow of FDI. This view, at the time, was supported by Lumwana Mining Company (LMC) Corporate Affairs Manager Chishimba who stated,

> "Government is right to put up changes to the mining tax regime...but it is important to ensure that the investment climate remains favourable"[9].

Despite the protests, the government went ahead with the introduction of windfall taxes, the enactment of the new mining legislation and the cancellation of the DAs.

1.1 Statement of the Problem

The 2008 Global Financial Crisis (GFC) resulted in the cancellation of the introduced windfall taxes. This was in the face of declining copper prices[10], falling demand and closure of mines such as Luanshya Copper Mine (LCM) in late 2008 while other mines were put on care and maintenance as was the case for Mopani Copper Mines (MCM). Just as the case was in the 1990's privatisation, the MMD government now led by President Rupiah Banda, cancelled the windfall taxes in January 2009 barely a year after their introduction in an attempt to boost investment in the then ailing mining industry.

However, with the current economic recovery, copper prices, previously downbeat, have recovered to the relative highs prevalent during the pre-global financial crisis[11]. This coupled with copper production forecasts that are likely to exceed 720, 000 metric tonnes, a level of

[8] Act Number 7 of 2008
[9] R Mwila, Miners Concerned about Proposed Zambian Windfall Profits Tax. http:// www.mineweb.com. Accessed on 15th November 2010
[10] Copper Prices were at US $ 3000 per tonne in the first quarter of 2009; K. Kachingwe. Debate Over Windfall Tax. http://ipsnews.net/africa/nota.
[11] Copper Prices are now trading at US $ 9300 per tonne; London Metal Exchange, http://www.lme.co.uk/copper. Accessed on 20th December 2010

production that was last seen in 1973, puts Zambia in good sted to make financial gains from the copper resources. Put together, this has sparked the debate for the re-introduction of the windfall taxes[12].

Calls for the re-introduction of the windfall taxes have been led mainly by civil society and opposition political parties who argue that the Zambian people should benefit from their country's vast copper resources with revenues collected from windfall taxes to be used for investment in education, health and other social sectors to benefit the common Zambian.

what do you mean?

However, those against windfall taxes claim that windfall taxes reduce companies' initiatives to seek out profits. There exists the fear that in the event that windfall taxes are re-introduced, Zambia's tax regime would be seen as unstable and would serve as a disincentive towards attracting FDI. It is thought that the re-introduction of windfall taxes will adversely affect Zambia's ability to compete for FDI in the mining sector on the international market.

It is clear that there is tug of war between the parties calling for the re-introduction of windfall taxes and those in opposition of such re-introduction. Further it is the writers considered opinion

academic writers or just people generally

that most observers appear to have missed the 'woods for the trees' by not familiarizing themselves with the windfall tax regime as it stood previously, or the issues that caused concern in the mining industry. Consequently, there emerges the urgent need to understand the concept of windfall taxes, bringing to light the possible implications on the inflow of FDI, indicating whether such re-introduction would stifle FDI in the mining industry.

1.2 General Objective of the Research

The study examines and analyses the implications and consequences on the amount of FDI that would come into the Zambian Mining industry in the event that windfall taxes are re-introduced.

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[12] Reference is made to the Mine Workers Union of Zambia (MUZ) President, Mbulu who is quoted as saying that it would be ridiculous for government not to re-introduce windfall tax when mining companies are now making profits. The Post Newspaper, 25 June 2010

1.2.1 Specific Objectives

1. To bring to light the concept of FDI, focusing on taxation as a factor that determines whether a country is seen as an attractive investment destination. This shall be related to the investment in the mining industry of Zambia.

2. To de-mystify and unravel the controversy surrounding the concept of windfall taxes, identifying its potential advantages and disadvantages and how this would affect Zambia's ability to attract FDI in the mining industry.

3. To ascertain the actual impact that the re-introduction of windfall taxes would have on the amount of FDI coming into the Zambian mining industry.

4. To draw attention to and explore the likely impact on the economy as a whole in the event that windfall taxes are re-introduced, indicating whether Zambia would be seen as an unstable and unsafe investment country given the ease with which the tax regime could be changed.

5. Finally in view of the above, recommendations shall be made, striking a balance between the re-introduction of windfall taxes whilst at the same time ensuring that Zambia remains a favourable investment destination.

These objectives fit more in the school of business studies or economics rather than law

1.3 Rationale and Justification of the Research

The study is timely and important considering the importance of the mining industry to the economy of Zambia. The justification for the study is that there is a need to find the right balance or some middle ground, between the parties calling for the re-introduction of windfall taxes and those in opposition of such calls - to find the right equilibrium between the two competing interests. There remains an underlying and urgent needs to assess whether such calls either in favour of or against are justified, taking into consideration the interest, investment and importance of the mining industry to the various parties. The study therefore presents a well informed and thorough research paper on the possible implications of the re-introduction of windfall taxes on the mining industry relating it to FDI. This is the *raison d'être* of the study, making useful suggestions and recommendations to that effect.

1.4 Research Questions

1. Is FDI in the mining industry affected by windfall taxes?

2. Did windfall taxes achieve their intended purposes?

3. Have the local people benefited from the windfall taxes?

4. What impact did the windfall taxes have on the mining industry of Zambia before their cancellation which came as a result of the advent of the Global Financial Crisis?

5. Would the re-introduction of windfall taxes render Zambia an unstable and unfavourable investment destination?

6. Will the re-introduction of windfall taxes reduce the amount of FDI that would come into the mining industry, with the result that investment in the mining sector would cease?

1.5 Research Methodology

The study will be a qualitative one, based on both primary and secondary sources of information. The primary sources of information will include interviews with individuals who have written on and researched on the study area. Secondary sources of information will include statutes, textbooks, scholarly articles, magazine articles as well as the internet where text books and scholarly articles fall short.

1.6 The Concept of Foreign Direct Investment

One of the major arguments advanced against the introduction windfall taxes is that such taxes will negatively impact the inflow of FDI in the mining industry. To fully understand the possible impact on the inflow of FDI in the Zambian mining industry, it is important to firstly come to terms with the concept of FDI.

FDI is a term that continues to escape a single definition. Instead it has been defined differently by various persons and organisations. FDI has been defined as an "investment made by a resident of one economy in another economy, and it is of a long-term nature or of lasting interest"[13]. Another definition of FDI is that from the Balance of Payments Manual, which refers to FDI as an investment made to acquire lasting interest in enterprises operating outside of the economy of the investor[14]. According to this definition, the investor's purpose is to gain an effective voice in the management of the enterprise.

Reference should also be made to the definition of FDI as contained in Zambia's primary piece of legislation dealing with investment, the Zambia Development Agency Act[15]. The Act defines foreign investment as investment brought in by an investor from outside Zambia and further defines a foreign investor as a person who makes a direct investment in the country and who in the case of a natural person is not a citizen or permanent resident of Zambia and in the case of a company is incorporated outside Zambia[16].

A foreign entity or group of associated entities that makes the investment is termed the "direct investor". The unincorporated or incorporated enterprise-a branch or subsidiary, in which direct investment is made, is referred to as a "direct investment enterprise". A direct investment enterprise is referred to as an incorporated or unincorporated enterprise in which a single foreign

[13] United Nations Conference on Trade and Development Division on Investment and Enterprise. FDI Flows and Stocks. Volume 1. United Nations Publication, Switzerland, 2009. Page 35
[14]International Monetary Fund. Balance of Payments Manual 5th Edition. IMF Publication, Washington, 1993. Page 3
3_ 9
[15] Act Number 11 of 2006
[16]Section 3 of Zambia Development Agency Act, Number 11 of 2006

investor owns 10 percent or more of the ordinary shares or owns less than 10 percent of the ordinary shares, yet still maintains an effective voice in management[17].

The forms of investment by the direct investor which are classified as FDI are equity capital, the reinvestment of earnings and the provision of long-term and short-term intra-company loans (between parent and affiliate enterprises)[18]. In summation, FDI is the relation that exists between an investor and an investment enterprise through which investments are made in a country other than the country of the investor.

FDI is often associated with Foreign Portfolio Investment. Foreign Portfolio Investment basically involves buying a share or a security of an entity. It can be considered as merely an investment in a piece of paper– a share certificate – and this form of investment can easily be liquidated[19]. This form of investment is synonymous with mergers and acquisitions, which entails the transfer of assets from local firms to foreign firms[20]. Foreign Portfolio Investment though often associated with FDI is in certain respects different from FDI. Whereas Foreign Portfolio Investment concerns with the purchase of securities, FDI, on the other hand, involves more than just the purchase of securities. It concerns the amount of financing provided by a foreign owner, who also becomes directly involved in the management of the enterprise[21]. With FDI the intention is that of exercising control over an enterprise.

FDI may take the form of 'greenfield' investments[22]. Greenfield investment is where a parent company starts a new venture in a foreign country by constructing new operational facilities from the ground up. Further, FDI takes the form of 'turn key' investments, where an investor or foreign entity takes over an existing enterprise or entity with infrastructure already in place. This is synonymous with Mergers and Acquisitions.

There is only one reference to a legal definition and the rest are economic definitions

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[17] International Monetary Fund. Balance of Payments Manual. Page 3
[18] International Monetary Fund. Balance of Payments Manual. Page 4
[19] United Nations Conference on Trade and Development Division on Investment and Enterprise. FDI Flows and Stocks. Page 35
[20] http://www.investmentandincome.com/investments/foreigndirectinvestment. Accessed on 14 December 2010
[21] United Nations Conference on Trade and Development Division on Investment and Enterprise. FDI Flows and Stocks. Page 40
[22] http://www.investmentandincome.com/investments/foreigndirectinvestment. Accessed on 14 December 2010

Based on the above definition of FDI, LMC a Zambian mine can be said to be the perfect example of FDI (Greenfield investments) at work. LMC can be seen as a direct investment enterprise in which investments have been made by direct investors (Equinox Mining Limited) resulting in the establishment of the mine; building facilities and creation of employment.

1.7 The Origins of Windfall Taxes

A windfall tax, also referred to as super profit tax, is a tax assessed on a company or industry when unusually high profits are made[23]. High profits, often unexpected, are also referred to as "windfall profits". Windfall profits can be defined as follows, a windfall which is a sudden and unexpected piece of good fortune or personal gain and a profit which is an advantageous gain or return; benefit[24]. Put together a windfall profit is that profit which occurs unexpectedly as a consequence of some event not controlled by those who profit from it. Therefore a windfall tax is the tax that is charged on the windfall profits.

Historically windfall profits and consequently windfall taxes can be traced back to Britain. The British Government at that time decided that the colonist could not use lumber that was over one foot wide unless it was from a tree that was knocked down by an Act of God - a Windfall. The person who owned the property where the tree was blown down could then use that lumber or sell it hence make a profit. A Windfall Profit in this sense was when a storm came through and blew down several large trees; the owner of the land could then sell them and make a large profit[25]. The British Government in a move to ensure that it did not miss out on the large profits charged a tax on the large profits made. This came to be known as windfall tax.

Since then windfall taxes have been adopted and utilized by various countries, often targeting the excessive profits that are made, most commonly in the oil and mining industries. For instance, in April 1979 President Carter introduced a tax on oil production aimed at ensuring that the United States Government earned a share in the high profits being experienced at the time in the oil industry. President Carter when justifying the tax stated,

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[23] http://www.wisegeek.com/what-is-a-windfall-tax.htm. Accessed on 1 September 2010
[24] History of the Windfall Profit. http://hubpages.com/hub/Windfall_Profit. Accessed on 13 December 2010 same
[25] History of the Windfall Profit. Accessed on 13 December 2010

"Unless we tax the oil companies, they will reap huge and undeserved windfall profits"[26].

1.7.1 The Aims and Benefits of Windfall Taxes

Having outlined the origins of windfall taxes, the essay will now proceed to consider the aims of windfall taxes. In most cases windfall taxes are introduced against a backdrop of economic need, fairness and social justice. The principle aim of windfall taxes in any part of the world is to raise government revenue. Governments that introduce windfall taxes do so with the intention of increasing their revenue base and resource mobilisation. The intention is to ensure that the citizens of the country benefit from their natural resources. An increase in government revenue would allow the governments to invest the new found revenues in the social sector.

Reference can be made to the Zambian scenario where windfall taxes were seen as vital to the operations of the government. Magande, the then Minister of Finance speaking on the aims of windfall taxes stated,

> "The taxes are aimed at ensuring that Zambia benefitted from its vast copper mines and additional revenue"[27].

Magande further stated that the new revenues realised from the windfall taxes would allow the government to increase investments in education, health and other social sectors[28]. In Britain the Labour government introduced windfall taxes as a way of addressing the employment needs.

> "Our reform of the welfare state - and the programme to move the unemployed from welfare to work - is funded by a new and one-off tax on the excess profits of the privatised utilities."[29]

The new and one-off tax referred to were windfall taxes.

In view of the foregoing it can be said that the principle aim of windfall taxes is to ensure that the citizens benefit from the resources that provide the windfall profits. This is ensured by governments having increased revenues, which are then invested in the social sectors to improve education and health services, build and improve schools and roads. The revenues are further re-

[26] J Thorndike, 'Carter Explains the Tax'. The Washington Post, April 1979
[27] D Kaunda, Sharing the Copper Windfall. http://ipsnews.net/africa/nota.asp. Accessed on 3 December 2010
[28] D Kaunda, Sharing the Copper Windfall. Accessed on 3 December 2010
[29] L Chennells, Fiscal Studies: The Windfall Tax. JEL Classification, London, 1997. Page 1

invested in other sectors of the economy, thereby creating new jobs and ultimately improving the livelihood of citizens.

1.7.2 The Criticisms of Windfall Taxes

The aims and benefits of windfall taxes represent only one side of the argument in favour of windfall taxes. There remains the other side of the argument against the windfall taxes, the 'ugly side' of windfall taxes. One of the criticisms leveled at windfall taxes is the fact that there is the threat of job cuts. It has been argued that the companies or entities that are subjected to the windfall taxes would undertake certain measures to cover for the payment of the windfall taxes. These measures could entail job cuts so as to ensure that profits are not hit significantly by the payment of windfall taxes. The knock down effect of job cuts is the dwindling of employment, which would result in there being even less direct tax revenue to the Government.

Critics further argue that windfall taxes reduce the competitiveness and threaten further investments thereby acting as a disincentive to investment. It is argued that rather than re-investing the profits made, the profits would go towards payment of windfall taxes. This has the spillover effect of no job creation given that there would be no new investments undertaken. In relation to competitiveness, it can be said that windfall taxes have the impact of reducing competiveness. It would be difficult for a country that imposes windfall taxes to compete for investments with other countries that do not have windfall taxes. Chief Executive of BHP Billiton Marius Kloppers speaking on the introduction of windfall taxes in the Australian mining industry had this to say,

> "These proposals (windfall tax) seriously threaten Australia's competitiveness and investment"[30].

Proponents of windfall taxes have argued that the revenues realised would be used by the government towards the social sector. However critics of windfall taxes point to the fact that the industries that are subjected to the windfall taxes are already engaged in helping improve the social sector. This is through the corporate social responsibility programmes. For instance in the

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[30] M Murphy, Mining Companies Rail against 'Revenue Grab' Tax. http://brisbanetimes.com.au. Accessed on 13 December 2010

Zambian mining industry LMC is in the final phase of seeing through its pledge to spend K4 billion on the local area, including plans to launch the Lumwana Multi Facility Economic Zone (LMFEZ) to diversify the local economy in Solwezi away from dependence on mining. This is a great initiative that should be supported through lower taxation, and stands threatened by windfall taxes.

Lastly critics of the windfall taxes argue that despite the fact that windfall taxes are consumption based, there is no guarantee that the revenues so raised would be effectively and efficiently used[31]. This is more so in the case of developing countries where there is rampant financial abuse and corruption. This is compounded by the fact that the authorities do not fully account for the use of the revenues realised. Take for example Zambia, the finance minister speaking on the revenues from windfall taxes had stated that the money (revenue from the windfall taxes) from the mining companies 'was in this year's budget'[32]. It would be far much more helpful if the government could point specifically to where in the budget the revenue from the windfall taxes had been allocated. This would go some way in justifying the windfall taxes.

1.8 Conclusion

This chapter has provided the foundations upon which the study shall be based. The chapter has briefly set the backdrop upon which the windfall taxes were introduced into the Zambian mining industry, the events that led to the cancellation of the windfall taxes and now the calls for their re-introduction. In addition the chapter has identified the conflict between the competing groups with respect to the re-introduction of windfall taxes. The concept of FDI and the little understood windfall taxes have been discussed, shedding more light as reference in the coming chapters shall be made to them. Lastly the scene has been set for the next chapter that specifically focuses on the introduction of windfall taxes in the Zambian mining industry and the impact that the windfall taxes had on the FDI inflows.

This introductory chapter shows little or no contribution as a legal paper It is purely economic or business related

[31] F Muma, Zambia: Pitfalls of Windfall Tax. http://www.lusakatimes.com. Accessed on 21 May 2010
[32] 'Only Three Mining Companies have paid Windfall Taxes'. Times of Zambia. 4 February 2009

CHAPTER TWO

THE INTRODUCTION OF WINDFALL TAXES IN THE ZAMBIAN MINING INDUSTRY

2.0 Introduction

Prior to and after the introduction of windfall taxes in the mining industry there had been speculation both within the mining industry and the nation as a whole as to the impact of the introduction of windfall taxes. This chapter considers the legislation that paved the way for the cancellation of the DAs and consequently the introduction of windfall taxes. The chapter further considers the impact that the GFC had on the mining industry. Lastly the chapter considers whether the windfall taxes served their intended purpose before going on to consider the factors that led to the cancellation of the windfall taxes.

2.1 Changes in the Legal Regime Regulating the Mining Industry

In light of the previous chapter one, there is no doubt in the mining industry and the business community as a whole that the tax regime under the 1995 Act was highly favourable to the mining companies with government offering generous tax concessions in the 1990's. In an attempt to rectify the situation, the MMD government under the leadership of the late president Mwanawasa proceeded to change the legal regime regulating the mining industry. The result was the enactment of the 2008 Act.[33] The 2008 Act repealed the 1995 Act introducing a more onerous and regulated legal regime.

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[33] Act Number 7 of 2008

2.1.1 Cancellation of the Development Agreements

Arguably the most notable impact of the enactment of the 2008 Act was the cancellation of the DAs previously signed between the government and the mining companies. Section 160 (1)[34] reads as follows;

> "A development agreement which is in existence before the commencement of this Act shall, notwithstanding any provision to the contrary contained in any law or in the development agreement, cease to be binding on the Republic from the commencement of this Act."

The implication of Section 160 (1) is that all DAs signed between the government and the mining companies were now cancelled. The provisions of the signed DAs no longer have legal validity. Such provisions related to the mineral royalties that were set at 0.6 percent, the corporate tax which was set at 25 percent and perhaps most importantly the stability periods during which time the government undertook not to vary, amend, cancel or terminate the signed DAs. These provisions originally provided for in the 1995 Act provided the basis for the provisions of the DAs.

For instance, Clause 13 of Part D of the DA between the government and Konkola Copper Mines (KCM) on the stability period read as follows:

> "GRZ further undertakes that, during the Stability Period, it shall not by general or special legislation or by administrative measures or decree or by any other action or omission whatsoever vary, amend, cancel or terminate this Agreement….."

With the enactment of the 2008 Act this provision like all other provisions of the DAs lost their legal validity. A closer look at the section (Section 106 (1)) cancelling the existence of DAs seems to indicate that the intention of the legislators above all was to ensure that the provisions of the DAs that related to the fiscal regime under the 1995 Act and stability periods were cancelled. This paved the way for the introduction of the new fiscal regime in the mining industry. The intention of the cancellation of the DAs was to do away with the provisions of the DAs which were lopsided in favour of the mining companies. Above all the intention was to put in place a new fiscal regime that would ensure that Zambia benefitted from its vast mineral resources.

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[34] Mines and Mineral Development Act Number 7 of 2008

2.2 The Introduction of the Windfall Taxes

As indicated in the preceding chapter the prices of copper had increased dramatically in July 2008. This increase in copper prices coming off the back of increased construction needs of China and India. Despite the increase in copper prices, it was widely felt that Zambia was not benefitting from its mineral resources and particularly the copper price boom. For example in 2005, the country's mining industry sold minerals worth over US $ 1.17 billion but government collected only US $ 11 million in tax[35]. One of the underlying reasons for the failure of government to realise financial gain from the copper price boom was the previously signed DAs that were lopsided in favour of the mining companies.

The first half of 2008 saw copper prices remain consistently high and with this came the growing perception by both civil society and opposition political parties that Zambia was not benefitting from its mineral resource. There was growing public pressure on the government to put in place measures that would ensure Zambia benefitted from the copper price boom. In April 2008 the government bowing to public pressure introduced a modern system of taxes and royalties that was expected to generate significant resources from a hitherto under-taxed sector.

In essence the Zambian government introduced a new fiscal regime (tax regime) for the mining industry. The new tax regime was expected to add an extra nine percent to the government's domestic revenue collection[36]. The expected additional domestic revenue was according to the Finance Minister at the time, Magande expected to be US $ 415m in the 2008/9 financial year[37].

The newly introduced fiscal regime's primary purpose was to reverse the old tax concessions that resulted in little revenue collection from mineral sales. The changes in the fiscal regime included an increase in the mineral royalty to 3 percent (from 0.6 percent), an increase in the corporate

[35] M Sturmer, Let the good times roll? Raising Tax Revenues from the Extractive Sector in Sub-Saharan Africa during the Commodity Price Boom. Deutsche Nationalbibliografie, Bonn, 2009. Page 8

[36] D Green, A Copper-Bottomed Crisis? The Impact of the Global Economic Meltdown on Zambia. Oxfam International, Oxfam, 2009. Page 6

[37] African Analyst. Breaking the Curse: A Case for Transparent Taxation. Volume 5, Issue 1. Open Society Institute of Southern Africa, Johannesburg, 2010. Page 23

income tax to 30 percent (from 25 percent), and the introduction of either a variable profit tax or a windfall tax[38].

Of particular importance are the windfall taxes which were set 25 percent when copper prices were US $ 2.50 per pound but below US $ 3.00 per pound, 50 percent for the next 50 cents increase in price, and 75 percent above US $ 3.50 per pound[39]. This could also be interpreted to mean that the tax had been set at 25 percent for a copper price of more than US $ 5,512, 50 percent for more than US $ 6,614 and 75 percent for more than US $7,716[40].

It is important to note that windfall tax and variable tax did not apply at the same time. The variable tax only came into effect when there was no windfall tax. The windfall taxes had the effect of increasing mining taxes from an average of 31.7 percent to 47 percent[41]. Lastly it should be brought to light that the windfall taxes were charged on the revenues of the mining companies. This should not be mistaken for a charge on the mining companies' profits. Revenue should be seen as the sums of money received by the mining companies from copper sales and did not take into consideration the subtraction of expenses (costs) incurred during production of copper.

As stated in chapter one the intention of the newly introduced fiscal regime, especially the windfall taxes was to increase government revenue thereby allowing government to increase investments in education, health and other key social sectors. The intention was to ensure that Zambia benefitted from its copper resources, the country's economic lifeblood. This is summed up by the International Monetary Fund (IMF) statement on the potential of the introduced fiscal regime:

> "this (the fiscal regime) is supposed to increase state revenue to 21% of GDP by 2008-2010, from currently 18.7% and create the fiscal space for development spending on infrastructure and human resources"[42].

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[38] M Sturmer and P Bulloch, Government Revenues from the Extractive Sector in Sub-Saharan Africa. Bundesanstalt fur Geowissenschaften und Rohstoffe, Hanover, 2009. Page 65
[39] 2008 National Budget speech by Finance Minister Ngandu Peter Magande
[40] M Sturmer and P Bulloch, Government Revenues from the Extractive Sector in Sub-Saharan. Page 65
[41] R Thompson, Zambia: Mining Journal special publication. Albert House, London, 2010. Page 9
[42] International Monetary Fund, Zambia. Selected Issues. IMF Publications, Washington DC, 2008. Page 12

2.3 The Impact of the Windfall Taxes on the Mining Industry; Foreign Direct Investment

The greatest fear of the introduction of windfall taxes was that the tax would cripple FDI inflow into the mining industry. Speaking on the windfall tax KCM Head of Operations Baid stated,

> "the new taxes will make Zambia uncompetitive, unattractive and will lead to destruction"[43].

The mining companies' responses to the windfall taxes further supported the above view of the impact of windfall taxes. Responding to the introduction of the tax KCM stated that the new taxes could destabilise long-term expansion and recapitalisation plans[44]. Similarly, First Quantum Mines (FQM) indicated that the taxes would prevent the company from expanding its mining units[45].

However contrary to the belief that windfall taxes did affect the inflow of FDI into the mining industry is the fact that investments in the mining industry actually continued and increased even after the new tax. Reference is made to the Greenfield investment project; Lumwana Mine by Equinox Minerals Limited in North Western Province. This investment is said to have cost a total of US $ 800 million with the mine coming into full operation in June 2008[46].

In a somewhat contradictory move (this being in light of KCM's response to the new tax) KCM announced that its new smelter at Nchanga would launch in June 2008. In addition KCM Communications Advisor Equamo announced that a new mine at Konkola Deep Mining Project (KDMP) in Chililabombwe would be completed on schedule in 2010[47]. Completion of the mine was to be complete on schedule in spite of the new tax introduced. The costs for the KDMP and Nchanga Smelter initially forecast at about US $800 million increased to $1 billion[48]. This is a further illustration of growing investments in the face of the new tax. FDI inflows into the sector

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[43]S Shacinda. Foreign mines ask Zambia for tax break-Minister. http://www.mineweb.com. Accessed on 27th December 2010

[44] R Chisanza, Mining Companies Face Taxing Problem. http://www.mg.co.za/article/2008-02-18-mining-companies-facetaxingproblem. Accessed on 27 December 2010

[45] R Chisanza, Mining Companies Face Taxing Problem. Accessed on 27 December 2010

[46] Equinox Mineral Limited Report. Veritas Securities Limited. October, 2008. Page 5

[47] A Fraser, KCM announces New Mine in Konkola Deep Project. http://www.boursier.com. Accessed on 27 December 2010

[48] A Fraser, KCM announces New Mine in Konkola Deep Project. Accessed on 27 December 2010

continued in spite of the tax increases, with about US $ 2 billion in investment pledges in the third quarter of 2008[49].

The continued investment in the mining industry strongly suggests that the mining companies still find copper mining in Zambia to be good business, this even after the new tax. Olson, Bigsten and Mulenga take the view that investment in the mining industry would still continue even with the new tax. They argue that it is very hard to believe that a mining company like FQM with long experience of investments in developing countries would be unaware of how easily a fiscal regime can be changed and consequently withhold further investments[50].

2.4 Did Windfall Taxes Serve the Intended Purpose?

From the onset it must be borne in mind that the primary purpose of the windfall taxes was to raise government revenue. In this sense only one-third of the estimated US $ 415 million from the new mining tax regime was collected as revenue[51]. With particular reference to windfall taxes revenue, as at the end of 2008, only three mining companies (out of eight) paid the windfall taxes which amounted to K 126 Billion[52]. Specific figures indicate that Kansanshi Mine paid over K 109 billion, Africa Mining Corporation paid more than K 8 billion while Chibuluma Mine paid K 7 billion[53].

Clearly the government did not raise the anticipated revenue from the new fiscal regime, especially in the case of windfall taxes. A number of reasons can be advanced for the government's inability to achieve the anticipated revenue from the new fiscal regime. For instance difficulties with administration of the new fiscal regime by the Zambia Revenue Authority (ZRA) were partly to blame. At the time of the introduction of the windfall taxes, the ZRA's capacity to review and verify cost information supplied by the mining companies was

[49] N Gyan, The Global Economic Crisis, Funding Public Services in Africa, and Concessions in the Mining Sector: The Case of Zambia. African Centre for African Transformation, Accra, 2009. Page 170
[50] O Olsson, A Bigsten and S Mulenga, The Political Economy of Mining in Zambia. Routledge Press, London, 2009. Page 17
[51] African Economic Outlook. OECD Development Centre, Paris, 2009. Page 171
[52] N Gyan, The Global Economic Crisis, Funding Public Services in Africa, and Concessions in the Mining Sector: The Case of Zambia. Page 171
[53] 'Only Three Mining Companies have paid Windfall Taxes'. Times of Zambia, 4 February 2009

lacking. It is only now that the ZRA's capacity to review and verify cost information is in the process of being built up[54].

Low metal prices which were a result of the effects of the GFC also had an effect on revenue generation. In 2008, all mining companies paid royalties but revenue from mineral royalties declined by 7.1 percent as a result of low metal prices[55]. In light of the above, it can be said that government did not achieve its aim of increasing revenue from the sector because of non-compliance by the mining companies with regard to payment of the new taxes, administrative challenges and the effects of the GFC.

The revenues realised from the windfall taxes were meant to be invested in the social sector. However the additional revenue raised from the new fiscal regime was not included as part of the 2008 budget, with the revenues realised instead being included as part of the 2009 budget. However even then there was no clarity as to where specifically the revenue had been allocated to or on what social sector investments it would be spent on. It is therefore not clear as to whether the revenues realised were spent on the social sector or merely put together with all other revenues in the 2009 budget and spread out across all sectors of the economy.

Quite clearly the windfall taxes did not serve their intended purpose. The taxes introduced in good faith ended up not fulfilling their intention and true potential. This was due to a combination of factors such as non compliance by the mining companies, administrative challenges and the effects of the GFC and the lack of clarity as to the use of the realised revenues.

2.5 Cancellation of the Windfall Taxes

Just as the introduction of windfall taxes caused controversy so did the cancellation of the windfall taxes. On the one hand Musokotwane, Finance and National Planning minister justified

[54] Economics Association of Zambia. Memorandum to the Estimates Committee on Mineral Taxes. September, 2008, Page 2
[55] Republic of Zambia. Economic Report. Ministry of Finance and National Planning. http://www.scribd.com. Accessed on 12th November 2010

the cancellation of the windfall taxes explaining that the tax would have the effect of forcing the mining companies to close. On the other hand the Deputy Minister of the Ministry of Mines and Mineral Development Nkata indicated that the decision of government to cancel the windfall taxes was taken amid the GFC and the need to save the mining industry from collapse[56].

In October 2008 at the height of the GFC the mining companies began to feel the knock down effect, this coming on the back of falling demand mainly from China and India. Copper prices on the London Metal Exchange fell by close to 57.8 percent in just five months from July to November 2008 (from US $ 8930 per tonne to US $ 3760 per tonne)[57]. Copper prices even fell as low as US $ 2,900[58]. One of the direct effects of copper price falls was the reduction of earnings from copper sales. Revenue earnings in 2009 tumbled to US $ 2.9 billion from US $ 3.6 billion recorded in the previous year despite increased output[59].

With copper prices falling and revenue from copper sales dwindling, the mining companies put in place measures to ensure their survival. LCM reacted by suspending the construction of a US $ 354 million mine claiming to be re-examining the project's viability amid the GFC[60]. In addition MCM suspended operations putting the mine on 'care and maintenance'. KCM, Zambia's leading copper producer, through its Senior Communications Manager Sam Equamo revealed that it was looking at cost cutting measures with the aim being to maintain output while keeping operations viable amid dropping global copper prices.

With the copper prices remaining consistently low, mining operations became unprofitable. In addition to the above measures, mining companies embarked on the process of retrenchments and laying off of miners and staff deemed unnecessary. A total of 8,500 out of 30,000 mining jobs in the mining sector were lost[61].

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[56] B Nkata, State reveals reasons for abolishing Windfall Tax. http://www.lusakatimes.com. Accessed on 27th December 2010
[57] K Nshindano, The Impact of the Global Financial Crisis on the Zambian Economy. Page 56
[58] D Green, A Copper-Bottomed Crisis? The Impact of the Global Economic Meltdown on Zambia. Page 4
[59] Bank of Zambia. 2009. Annual Report. http://www.boz.zm/AnnualReports. Accessed on 12th December 2010
[60] Business Monitor International. Zambia Mining Report Q2 2009. May 2009
[61] D Green, A Copper-Bottomed Crisis? The Impact of the Global Economic Meltdown on Zambia. Page 4

The Zambian economy is closely tied to the mining industry and therefore with the mining industry slowly grinding to a halt the economy as a whole equally began to slow down. In January 2009 an effort to save the mining industry from collapse and consequently the Zambian economy saw the 2009 budget announce yet further amendments to the fiscal regime regulating the mining industry. This time the amendments saw the cancellation of the windfall taxes introduced in April 2008. With the exception of the windfall taxes the fiscal regime as it stood in April 2008 remained intact. The move was part of government efforts to shield the mining industry from the impact of the GFC.

Arguably the decision to remove the windfall taxes in 2009 could have been premature. This is because windfall taxes under the previous fiscal regime only fell due when copper prices exceeded US $5,500 per tonne[62]. For the most part of the GFC copper prices had not risen to levels that would have triggered the windfall taxes therefore raising questions as to whether the cancellation of the windfall taxes was premature.

2.6 Conclusion

This chapter has looked at the introduction of windfall taxes in the Zambian mining industry. The chapter has considered the effects of the change of legal regime that regulates the mining industry with particular emphasis on the cancellation of the DAs. The chapter goes on to outline the factors that led to the introduction of windfall taxes indicating what impact windfall taxes had on the Zambian mining industry. It has been shown that contrary to misguided public perception, the windfall taxes introduced in 2008 did not stifle the inflow of FDI to the mining industry. In addition to the above, it has been shown that the windfall taxes did not live up to their billing. Lastly it has been shown that the cancellation of windfall taxes was not because of their impact but rather because of the impact of the GFC. In order to fully understand windfall taxes and their impact, the next chapter shall look at the Australian approach to windfall taxes.

[62] D Green, A Copper-Bottomed Crisis? The Impact of the Global Economic Meltdown on Zambia. Page 4

CHAPTER THREE

WINDFALL TAXES: THE AUSTRALIAN APPROACH

3.0 Introduction

In order to fully understand the implications of re-introducing windfall taxes on the Zambian mining industry, it is important to make a comparative analysis. With this in mind, this chapter shall look at the Australian mining industry and the approach taken towards the introduction of windfall taxes. The chapter will therefore begin by looking at the introduction of windfall taxes in the Australian mining industry before going on to consider the aims, benefits and limitations of windfall taxes in Australia. In addition to the above, this chapter shall consider the impact of the GFC on the mining industry and investments thereto. Lastly the chapter highlights the lessons learnt in the Australian mining industry whilst at the same making comparisons to the Zambian mining industry.

3.1 Introduction of Windfall Taxes in the Mining Industry

From the onset it is important to note that Australia's mining sector is defined to include both petroleum and minerals industries[63]. However, for the purposes of this study the focus shall be on the minerals industry. Furthermore, it is important to note that windfall taxes in Australia are commonly referred to as Resource Super Profits Tax (RSPT). Prior to the introduction of RSPT, there was already in existence a tax regime in the mining industry. The tax regime was based on the fact that ownership of resources on land was vested in the state and as such the state imposed taxes and charges on the extraction of resources[64].

The taxes and charges imposed by the state were referred to as *ad valorem* royalties. *Ad valorem royalty* is an output based royalty whereby the government collects a constant percentage of the

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[63] L Hogan, Mineral Resource Taxation in Australia: An Economic Assessment of Policy Options, ABARE Research Report 07.1. Australian Government Department of Industry, Tourism and Resources, Canberra, 2007. Page 12

[64] S Reinhardt and L Steel, A Brief History of Australia's Tax System. Paper Presentation to the 22nd APEC Finance Ministers' Technical Working Group. Vietnam. 15 June 2006. Page 10

value of production[65]. The amount payable for the *ad valorem* royalties varied depending on the type of minerals extracted and the place of extraction. For instance in Western Australia, the *ad valorem* royalty rate varied according to the extent of processing, 7.5 percent for bulk material, 5 percent for concentrate material and 2.5 percent for metal. In Queensland, an *ad valorem* royalty generally applied at a fixed rate of 2.7 percent.[66] *Ad valorem* royalties also applied in New South Wales (at 4 percent)[67].

With the steady increase of mineral prices on the world market, it was felt that the Australian government and consequently the Australian people were not benefiting much from the payment of royalties. The royalty system was seen to be inefficient and not able to allow Australians to share in the above-normal profits being reaped in the mining sector. As a result the Australian government undertook an economic assessment of resource taxation policy options in Australia's mining sector. The major focus of the economic study was to assess the potential net economic benefits of extending a profit based royalty such as the Petroleum Resource Rent Tax (PRRT) system to the mining industry.

> "The PRRT is levied at a rate of 40 percent; general project expenditures are accumulated at the long term government bond rate plus 5 percent; exploration expenditure is transferable between projects within the same company and is immediately deductible; and a 150 percent tax deduction applies to exploration expenditure in designated high risk frontier areas"[68].

The economic assessment referred to as the ABARE report found that there would be benefits of moving from output-based royalties to a regime that was profits-based[69]:

> "From the economic analysis and project simulations in this study, it is apparent that extending a profit-based royalty such as the Australian Government's petroleum resource rent tax to onshore mineral resources (possibly excluding low value non-metallic minerals) is likely to result in significant efficiency gains, although this would be achieved at a higher administrative cost."

[65] L Hogan, Mineral Resource Taxation in Australia: An Economic Assessment of Policy Options, ABARE Research Report 07.1. Page 10

[66] L Hogan, Mineral Resource Taxation in Australia: An Economic Assessment of Policy Options, ABARE Research Report 07.1. Page 15

[67] L Hogan, Mineral Resource Taxation in Australia: An Economic Assessment of Policy Options, ABARE Research Report 07.1. Page 10

[68] L Hogan, Mineral Resource Taxation in Australia: An Economic Assessment of Policy Options, ABARE Research Report 07.1. Page 3

[69] C James, A Solution to the Resource Tax Issue. Business News. Switzer Media and Publishing, Basel, 2008. Page 7

Following the recommendations of the ABARE report Kevin Rudd, the Prime Minister at that time, announced the introduction of a 40 percent tax on mining profits starting in 2012. The expectation was that the new taxes would raise US $ 11.1 billion in its first two years. The new tax would tax miners' profits at 40 percent after projects have reached a rate of return in excess of the government bond rate (at the time it was about 6 percent). Corporate taxes would be charged at 28 percent[70]. The RSPT would be deductible for purposes of calculating the corporate income tax. It was widely reported at the time that the net effect of the new tax would be to raise the effective tax rate on Australia's mining industry from 40 percent to 57 percent[71].

Justifying the RSPT, Kevin Rudd explained that Australians had been shortchanged during a 10-year resources boom in which profits soared by US $ 81 billion but only US $ 10 billion flowed into national coffers. He further stated,

> "BHP Billiton is 40 percent foreign owned, Rio Tinto is more than 70 percent foreign owned, that means that these massively increased profits built on Australian resources, are mostly in fact going overseas"[72].

The response by the mining companies to the RSPT was swift and resoundingly negative. Fortescue Metals Group (FMG.AX), Australia's third largest iron ore exporter, initially threatened to withdraw US $ 15 billion dollars in projects over the tax and later followed through with the threat by later suspending two mining projects that had been undertaken[73]. Likewise Xstrata followed suit and suspended two mining projects. Both FMG.AX and Xstrata cited the uncertainty surrounding the RSPT as the reason for the suspension of the mining projects. In addition to FMG.AX and Xstrata, Rio Tinto, arguably Australia's largest mining company announced that it would have to revise all investment plans intended for the Australian mining industry[74].

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[70] M Genasci, Australia's "Super Profits Tax": A High-Stakes Proposal for Australia and the Developing World Alike. http://www.treasury.gov.au/documents/1156/PDF/01_Brief_History.pdf. Accessed on 20th January, 2011

[71] M Genasci, Australia's "Super Profits Tax": A High-Stakes Proposal for Australia and the Developing World Alike. Accessed on 20th January, 2011

[72] K Chulu, Caritas Challenges Government to Re-Introduce Windfall Tax. The Post Newspaper. 13 May 2010

[73] T Albanese, Rio Tinto Australia Fears Mining Taxes May Spread. http://www.phongpo.com/2010/05/26/rio-tinto-australia-fears-mining-taxes-may-spread/#more-1255. Accessed on 12th January,2011

[74] T Albanese, Rio Tinto Australia Fears Mining Taxes May Spread. Accessed on 12th January, 2011

As if not enough, Rio Tinto went on to approve an expansion of its iron ore activities in Canada, with an initial investment of US $ 400 million. The project had been on hold since 2008, however Rio Tinto gave the go ahead because of the 'attractiveness of investing in Canada' and the need to evaluate the impact of the proposed 40 percent mining tax on its Australian operations[75]. Rio Tinto was of the view that with the introduction of the RSPT, Australia was no longer an attractive investment destination with preference being given to Canada.

The fallout from the RSPT continued with the result that billions of dollars were wiped away from the Australian mining companies' market value. Furthermore it was reported that more than US $ 14 billion was wiped away from the value of mining shares[76]. Perhaps the greatest fallout from the RSPT was the resignation of then Prime Minister Kevin Rudd. The resignation was as a result of a media campaign led by Australia's largest mining companies, BHP Billiton and Rio Tinto, waging an intense vociferous public-relations battle against the RSPT[77]. With the mining industry in turmoil, approval ratings dwindling and elections looming (elections which the Labour party led by Kevin Rudd were expected to lose), the Labour Party called for Kevin Rudd's resignation of which he obliged and installed Julia Gillard as new Labour leader and Prime Minister. Julia Gillard now installed as Prime Minister moved quickly to engage into dialogue with the mining companies with the objective being to end the uncertainty in the mining industry.

As a result of the dialogue, on 2nd July 2010 Julia Gillard announced a sweeping revision of Kevin Rudd's RSPT proposals. Following Gillard's revision, the RSPT would only apply to iron ore and coal, rather than all minerals and the RSPT would not apply retrospectively. Under Kevin Rudd's proposal the plan was to tax mining operations on the basis of their book value, Ms Gillard's revised version would instead assess mining operations at market value, which meant that long-running and profitable mines will not be hit as hard as had been feared. The tax only kicks in when a mine's rate of return exceeds 12 percent, compared with 6 percent under the original proposals. More importantly, the rate of tax on those 'super profits' will now be only 30

[75] J Bishop, Ground Control to Major Rudd. http://www.nationaltimes.com.au/opinion/politics/blogs/the-bishops gambit/ground-control-to-major-rudd/20100511-uuwz.html. Accessed on 19th January, 2011
[76] J Bishop, Ground Control to Major Rudd. Accessed on 19th January, 2011
[77] M Genasci, Australia's "Super Profits Tax": A High-Stakes Proposal for Australia and the Developing World Alike. http://www.treasury.gov.au/documents/1156/PDF/01_Brief_History.pdf. Accessed on 20th January, 2011

percent, not 40 percent[78]. Lastly the revisions of the RSPT allowed mining companies to claim a 25 percent 'extraction allowance' which will push the effective rate down to just 22.5 percent[79].

Safe to say that the revised RSPT worked wonders as it has brought about the return of certainty in the Australian mining industry, the return of FDI (Xstrata announced straight away after the revision of RSPT that it would reinstate a big copper investment) and perhaps more importantly for Prime Minister Julia Gillard it has seen the approval ratings of Labour Party improve.

3.2 The Aims, Benefits and Limitations of RSPT in Australia

As was the case for the Zambian mining industry, the aim of RSPT is to enable the government collect a reasonable return on the windfall profits made by the mining companies while at the same time ensuring that administrative costs are not excessive and industry output remains relatively efficient. The Australian government's intention is to obtain a 'fair share' of any windfall profits in the mining sector for all Australians. The basis of a 'fair share' is premised on the fact that all minerals are owned by the State on behalf of the people and mining companies are allocated only a mining lease to extract the resources[80]. If there are windfall gains, Australians should share in those gains.

The benefits of the RSPT as stated by the then Prime Minister Kevin Rudd would be to use the extra revenue to build additional hospitals, schools and roads, in essence to improve the social sector. However unlike the Zambian windfall taxes, the RSPT was intended to go further. In addition to the above, the RSPT would be used to pay for retirement benefits as well as company tax reductions.

Kevin Rudd further explained that because of the absence of corporate social responsibility on the part of the mining companies, it had become inevitable that the government would have to impose the RSPT that would in turn provide the needed resources to improve the social sector.

[78] Gillard gets Out of a Hole; Australia's Mining Tax. The Economist online. http://www.economist.com /blogs/newsbook /2010/07/ australias_mining_tax. Accessed on 19th January,2011. p
[79] Gillard gets Out of a Hole; Australia's Mining Tax. Accessed on 19th January, 2011
[80] C James, A Solution to the Resource Tax Issue. Page 7

However, the explanation given by Kevin Rudd seems to have been a misjudgment on his part. This is because in response to Kevin Rudd's explanation, figures indicate that, Xstrata, since the commencement of operations in 2002, had invested US $ 45 billion in Australia exceeding the US $ 44 billion it had earned[81].

The introduction of the RSPT was not without any consequence. As stated above most mining companies, prior to the revision of the RSPT by Julia Gillard had suspended their mining projects and withheld further FDI. Speaking on the RSPT, Xstrata Chief Executive Officer Mick Davis had this to say,

> "the proposed tax will significantly impair the cash flows available to sustain our operations and has introduced great investment uncertainty."[82]

Arguably the greatest consequence of the RSPT was the fact that investments were being directed to other countries such as Canada which were suddenly seen as 'investor friendly'. Australia suffered a loss of FDI into the mining industry.

3.3 The Impact of the Global Financial Crisis on the Mining Investment Thereto

Contrary to popular belief and unlike Zambia, the mining industry in Australia is not the largest sector. It is only when compared with other advanced economies that the significance of the mining sector is seen as source of export revenue. The mining sector is therefore dwarfed by the service sector which is the largest sector. For instance, around 11 percent of the workforce or 1.2 million people are employed in the retail sector alone, making the retail sector the single largest employer in the Australian economy[83].

Having established that the service industry is the largest sector, it follows that during the time of the GFC the Australian government's main emphasis was solely focused on ensuring that this sector did not collapse, that the economy should remain strong in the face of the GFC. The priority was to ensure that job losses did not escalate and that companies in the service industry

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[81] B Loughnane, Ground Control to Major Rudd. http://www.liberal.org.au/Latest-News/Blog/2010/05/Ground-control-to-Major-Rudd.aspx. Accessed on 21st January, 2011
[82] J Bishop, Ground control to Major Rudd. Accessed on 19th January 2011
[83] S Kennedy, Australia's Response to the Global Financial Crisis. Paper Presentation. 24 June, 2009. Page 9

remained operational. To this effect the Australian government on 3rd February 2009 announced a US $ 42 billion stimulus package titled the 'Nation Building and Jobs Plan'[84].

A closer look at the stimulus package easily reveals that the mining sector was not covered under the stimulus package. The mining sector, largely dominated by foreign owned companies was seen as falling into the private sector. As such the mining companies were left to ride out the effects of the GFC.

As the GFC took hold, the demand for mining commodities began to fall. This was on the back of reduced construction in China and India, which in turn meant reduced demand for mineral commodities. At this point, the mining companies began to feel the impact of the GFC. For instance, Mount Gibson Iron citing the falling demand for commodities announced that it had cut its sales target for the 2008-09 business year to 5 million tonnes from 7.2 million tonnes, after defaults on iron-ore purchases from Chinese buyers[85]. In addition the company revealed plans to shed nearly 200 jobs, or one third of its workforce.

Even the Global mining giant Rio Tinto made some cutbacks to cushion the impact of the GFC. These cutbacks included job cuts as well as the suspension of investment projects as it looked to ride out the effects of the GFC. The slowdown of mining companies trickled down to the support industries. Worley Parsons, Australia's largest engineering group, withdrew 250 workers from two mining sites where it was hired as a contractor. This was because of production cuts and a slowdown in the mining industry. It was further expected that 70 out of 250 workers would lose their jobs[86].

The impact of the GFC was therefore threefold; job cuts, production cuts and suspension of investment projects. Related to these three would be the cut back in sales targets. It is important to note that the Australian government did not have a hand in the mining industry during the

[84] S Kennedy, Australia's Response to the Global Financial Crisis. Page 9
[85] T Cook, Australia: Labor Government Forced to Revise Economic Forecasts as Global Crisis Deepens. http://www.globalresearch.ca/index.php?context=va&aid=10895. Accessed on 20th January, 2011
[86] T Cook, Australia: Labor Government Forced to Revise Economic Forecasts as Global Crisis Deepens. Accessed on 20th January, 2011

GFC. Unlike the Zambian government, there was no knee-jerk reaction from the Australian government. No tax concessions or suspensions were offered to the mining companies. Rather the focus was on the service sector with the mining industry left to weather the effects of the GFC on its own.

3.4 Lessons Learnt in the Australian Mining Industry and Comparisons with the Zambian Mining Industry

The greatest lesson learnt in the mining industry is that the fiscal regime could not be unilaterally changed. The Australian government could not simply change, vary or alter the fiscal regime as it wished. As indicated above there were consequences (suspension of mining projects and loss of FDI to Canada) where there was unilateral change of the fiscal regime. Instead of unilateral change of the fiscal regime, there is now a shift towards dialogue between the state (in this case the Australian government) and the mining companies.

With particular reference to the shift towards dialogue, the Zambian government prior to the introduction of windfall taxes did not engage into any form of dialogue with the mining companies. With the renewed calls for the re-introduction of windfall taxes, the Zambian government in an attempt to avoid the potential consequences that Australia suffered, should take a leaf from the Australian government's actions and engage the mining companies in dialogue prior to any decision over the re-introduction of the windfall taxes (this will however be discussed in greater detail in the following chapter).

Related to this is the fact that any change in the fiscal regime must be well thought out and researched as was the case with the ABARE report that recommended the establishment of the RSPT. Comparisons reveal that the change in the fiscal regime in the Zambian mining industry was not as well thought and planned as was the case in Australia. This is evident from the fact that no economic assessment report of the standard of the ABARE report was undertaken, neither was there any form of dialogue between the Zambian government and the mining companies prior to the introduction of windfall taxes in the Zambian mining industry.

In addition to the above, it is worth noting that the Australian government unlike the Zambian government did not hurry into altering the fiscal regime regulating the mining industry in the wake of the GFC. Rather the Australian government let the mining companies ride out the impact of the GFC. There is need for foresight, the ability to look beyond the present situation. The GFC was never going to last indefinitely and was always at some point going to come to an end.

However it must be noted that as indicated earlier, the mining industry in Australia is not the largest sector and therefore did not receive the amount of attention as did the service industry which is the largest sector in Australia. In contrast, the mining industry in Zambia is the largest sector and without a shadow of doubt the most important sector. Just as the Australian government moved to protect its largest sector (service industry) so did the Zambian government when it cancelled the windfall taxes in a move that was thought to relieve the mining companies of the impact of the GFC.

3.5 Conclusion

The focus of this chapter has been to consider the Australian approach towards the introduction of RSPT whilst at the same time drawing comparisons to the Zambian mining industry. The chapter has considered the introduction of RSPT in the Australian mining industry, indicating the effects that such introduction had on the mining industry. Furthermore, the chapter has outlined the aims, benefits and limitations of RSPT in Australia while also bringing to the fore the impact that the GFC had on the mining industry and investments thereto. It has been established that the introduction RSPT without the consultation and dialogue of the mining companies had a negative effect on the mining industry, with the result of loss of FDI in the sector. It is only after dialogue with the mining companies that the RSPT was accepted and agreed to by both parties; the government and the mining companies. The emphasis being on the fact that a state cannot unilaterally change, alter or vary the fiscal regime or else risk the potential loss of FDI and uncertainty in the mining sector. Lastly the chapter has outlined the lessons learnt in the Australian mining industry based on the above considerations, making a comparative analysis with the Zambian mining industry.

CHAPTER FOUR

IMPLICATIONS OF RE-INTRODUCING WINDFALL TAXES ON FOREIGN DIRECT INVESTMENT VIS-À-VIS THE MINING INDUSTRY

4.0 Introduction

Thus far the preceding chapters have looked at the introduction and cancellation of windfall taxes in the Zambian mining industry, going on to make comparisons with the introduction of RSPT in Australia. This chapter being the penultimate chapter will consider the calls for the re-introduction of the windfall taxes. The chapter will therefore begin by looking at the calls for the re-introduction of windfall taxes, citing the arguments for and against such re-introduction. The chapter will go on to consider the potential dangers of re-introducing windfall taxes on the mining industry. Lastly in order to get a broader perspective of the implications of re-introducing windfall taxes, the chapter will also look at the potential dangers of such re-introduction on the economy as a whole.

4.1 Calls for the Re-Introduction of Windfall Taxes

Almost always the introduction of any form of tax is not without controversy. This is because the introduction of taxes affects the interests of various parties in an economy. On the one hand is the party introducing the tax and on the other is the party to whom the tax will be applicable. In this sense the calls for the re-introduction are no different, with calls for the re-introduction of the taxes bound to be surrounded with controversy. On the one hand are the Zambian people backed by the opposition political parties and the civil society calling for the re-introduction of windfall taxes while on the other hand are the mining companies and the government opposing any such re-introduction of windfall taxes. As such a number of arguments have been advanced in favour of and against the re-introduction of windfall taxes.

The factors contributing to the calls for the re-introduction of windfall taxes are as follows:

4.1.1 Rise in Copper Prices, Increased Production and Growing Demand for Copper

The last twelve months have seen the price of copper dramatically shooting up from the previously low prices prevalent during the GFC. This rise in copper prices has coincided with the global economic recovery. It is upon the basis of increased copper prices that the calls for the re-introduction of windfall taxes are being made. These calls for the re-introduction of windfall taxes have been heightened by recent events where the copper price broke the US $ 10, 000 barrier on the London Metal Stock Exchange[87].

The calls for the re-introduction have further intensified following recent publications from the Bank of Zambia (BOZ). An official statement from BOZ Head of Public Relations Kanguya Mayondi reads,

> "Metal export earnings rose by 79.6 % to US $ 6, 003.4 million (about K 29 trillion) in 2010, from US $ 3, 343.1 Million (K 15 million trillion) recorded in 2009, largely due to an upswing in the average price of copper on the international market and increased output"[88].

Figures indicate that copper output increased by 22 percent to 822, 676 metric tonnes in 2010 from 674,096 metric tonnes in 2009[89]. The last twelve months have therefore seen a steady rise in copper prices as well as the increase in copper output from the mining companies. This has alarmed those calling for the re-introduction of windfall taxes. The argument is that the mining companies are again making excessive windfall profits and that there is no tax in place to ensure that the Zambian people benefit from the windfall profits.

Furthermore at the time of the cancellation of the windfall taxes the government advanced reasons for the cancellation of the tax as being the effects of the GFC and the need to save the mining industry from collapse. In addition reasons such as the copper price being low and the windfall taxes possibly having the effect of forcing the mining companies to close down were advanced.

However as indicated in the second chapter the government's decision to cancel the windfall taxes was premature the reasons advanced for such cancellation falling short of genuine. The

[87] http://www.ime.co.uk/copper. Accessed on 13th February 2011
[88] C Sinyangwe, Gross Revenues by Mining Firms Increase. The Post Newspaper. 2nd February 2011
[89] C Sinyangwe, Gross Revenues by Mining Firms Increase.

government's decision to cancel the windfall taxes has come back to haunt it. This is because the calls for the re-introduction of windfall taxes are being based on the fact that the copper prices have now reached an all time high as well as the fact that the GFC is nearly at an end with economic recovery continuing which implies that the mining companies are no longer in danger of collapse.

As if not enough the calls for the re-introduction of windfall taxes have further been exasperated by recent market predictions by Standard Bank on copper demand. Standard Bank predictions estimate that for the year 2011 global demand for copper will far exceed supply. As a result of fast growing demand Standard Bank Head of Commodity Walter De Wat said the copper market would be in deficit for the year 2011 and 2012. He is quoted as saying,

> "We estimate deficit to be 385, 000 metric tonnes for 2011 and 465, 000 for 2012, so demand is clearly growing faster than supply at this stage and mining companies will not meet this global demand. Demand will remain strong until 2013 and after that we do not see demand falling; it will be a case of supply start catching up with demand."[90]

Where demand exceeds supply the price of the commodity will increase. Likewise, the copper price would equally be expected to increase in the coming years of increased demand. The knowledge that copper prices will increase further puts forward the case for the re-introduction of the windfall taxes.

4.1.2 <u>Tax Evasions by the Mining Companies</u>

A recent pilot audit sanctioned by the government revealed irregularities and discrepancies in production and revenue figures that MCM submits to the ZRA for tax administration. The pilot study stated that the taxes being paid by the mining firms and not just MCM were not consistent with production volumes and the revenues from copper sales[91]. The pilot study goes on to indicate that during the period of the audit, the labour cost for MCM was estimated at US $ 50 million against the 'unexplainable figure of US $ 90 million'[92].

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[90] K. Chulu, Standard Bank Predicts Massive Copper Demand. The Post Online. Http://www.postzambia.com/postread-read_article.php. Accessed on 12th February 2011

[91] C Sinyangwe, Mopani Pilot Audit Reveals Tax Payment Irregularities. The Post Newspaper. 9th February 2011

[92] C Sinyangwe, Mopani Pilot Audit Reveals Tax Payment Irregularities.

In essence the pilot audit was accusing MCM and the mining companies at large of manipulating their profit figures as well as inflating their costs of operations in an attempt to reduce the tax amounts payable to the ZRA. The parties calling for the re-introduction of windfall taxes claim that the tax is easier to administer with the taxes being charged on the revenues of the mining companies and not the profits. The argument here is that if the revenues of the mining companies are taxed, there will be no chance of lost revenue as is the case with taxes being charged on profits that are often manipulated.

The pilot audit report goes on to lay bare the incapacity of the ZRA to verify records submitted by mining companies for tax administration. The pilot audit was simply stating that in the event that mining companies do manipulate their profit figures and cost of production the revenue authorities would be unable to recognise such manipulation. This gives credence to the calls for the re-introduction of windfall taxes given that the taxes would be based on revenues and would not be subject to manipulated figures. The tax would be easier to administer for the tax authorities and as such the question of their capacity to verify records submitted would not arise.

Lastly the pilot audit accused MCM of being hostile towards the audit with audit queries going unanswered despite the audit exercise being undertaken in accordance with the law, the ZRA Act[93]. Such accusations do little to improve the image of mining companies in the eyes of those who argue for the re-introduction of windfall taxes.

4.1.3 Politics in an Election Year

Zambia is expected to go to the polls for purposes of electing both Presidential and Parliamentary Members some time later in the year. One of the election factors are the windfall taxes. It is quite clear that the ordinary Zambian would like to improve his or her standard of living and with this in mind the opposition political parties have taken advantage of the current government's reluctance to impose the windfall taxes. The opposition political parties are using the windfall taxes as a campaign pledge, stating that they would re-introduce the windfall taxes, gaining revenue and using that revenue to improve the standard of living of the ordinary

[93] Zambia Revenue Authority Act, Chapter 321 of the Laws of Zambia

Zambian. Therefore in an attempt to gain support from the Zambian electorate, the opposition political parties have led the calls for the re-introduction of windfall taxes.

The calls for the re-introduction of windfall taxes have not been without opposition. Some members of the public maintain that the solution to the reduced revenue from mining companies lies not in re-introducing the windfall taxes but rather in increasing the ability of the ZRA to collect revenue.

Others that oppose the windfall taxes point to the fresh agreement that the Zambian Government has entered into with the mining companies. The agreement is said to provide that in consideration of the government not adjusting its tax laws to re-introduce the windfall taxes the mining companies will clear the K 1.4 trillion in tax arrears from the 2008 tax regime. Introducing windfall taxes in light of this new agreement would leave Zambia in a precarious position.

Irrespective of the calls for or against the re-introduction of windfall taxes, there still remains an urgent need to assess the potential dangers of re-introducing the windfall taxes on the mining industry.

4.2 Potential Dangers of Re-Introducing Windfall Tax on the Mining Industry

It almost goes without saying that the re-introduction of windfall taxes will have some notable impact on the mining industry. The most notable impact is likely to be felt in the mining industries investment opportunities as well as the possible legal implications should the windfall taxes be re-introduced.

4.2.1 The Impact on the Investment Opportunities for Zambia

In order to fully understand the impact that re-introducing windfall taxes would have on the investment opportunities it is important to consider the factors that attract investment. For the purposes of this research the factors that attract investment to the mining industry will be restricted to taxation.

FDI is sensitive to taxation in a host country[94]. As such higher tax rates have a significant negative impact on FDI flows. Reference is made to De Mooij and Ederven who state that on average, a 1 percentage point increase in the tax rate reduced FDI by 3.3 percent[95]. In essence a country that has a high tax rate is unlikely to attract large volumes of FDI. Related to the above is the need for a host country to have a good tax system. A good tax system is very important as it is a factor often considered by investors as they assess their investment options. According to James[96], a good tax system is one that is stable and uniform. Therefore when deciding whether or not to invest, companies consider not only the expected rate of return but also the associated risks of a new project. An important risk consideration is the perceived stability of a tax regime over time[97].

In the space of just two years (2008 to 2009) Zambia has adjusted its tax regime on not less than two separate occasions. The tax regime relating to the mining industry was initially adjusted to introduce windfall taxes in 2008 and later adjusted to cancel the windfall taxes in 2009. This is an indication of the absence of stability in the tax regime and according to Sornarajah is one of the factors that hinder investment[98]. Further the windfall taxes that were introduced were in essence an upward adjustment in the tax rate and as such would theoretically serve to reduce the FDI in the mining sector. However as was shown in the second chapter the increase in the tax rates did not hinder the inflow of FDI from the already existing investors in the mining industry.

It must however be noted that the increase in the tax rate could have a negative impact on the exploration activities. Exploration activities entail the identification of areas of mineral potential and in some instances can take up to ten years often involving the heavy investment of

[94] S James, Incentives and Investments: Evidence and Policy Implications. World Bank, New York, 2009. Page 5
[95] D Mooij and E Enderveen, "Taxation and Foreign Direct Investment: A Synthesis of Empirical Research," International Tax and Public Finance, New York, 2003. Page 28
[96] S James, Incentives and Investments: Evidence and Policy Implications. World Bank, New York, 2009. Page 5
[97] P Mitchell, Taxation and Investment Issues in Mining. Advancing the EITI in the Mining Sector. Henderson International PTY, London, 2007. Page 29
[98] M Sornarajah, The International Law on Foreign Investment. Cambridge University Press, Cambridge, 2008. Page 407

infrastructure facilities[99]. In addition the time between exploration and commercial production can be considerable, often up to twenty years. Other than the heavy investment of infrastructure there is the investment of capital to undertake the exploration activities. Exploration activities are often costly requiring significant amounts of capital. During the 1970s about US $ 12 million was spent for each mine discovered in Australia and US $ 30 million for mines discovered in Canada.[100] Today this amount has increased twenty four times with investments for exploration escalating to US $ 800 million[101].

Given the fact that exploration activities are risky not always resulting in commercial production and the heavy amount of investment, investors look for investment destinations that are stable. They look for investment destinations that have stable tax regimes that will not change the tax regime in the middle of exploration activities. This is because the capital investments are usually provided as risk capital requiring re-payment to the institutions that give out such risk capital. The mining companies begin exploration activities having undertaken great expense with calculations to repay the risk capital obtained at specific times. The change of tax regime often has the effect of disturbing re-payment schedules which in turn makes exploration expensive for the mining companies.

Keeping in mind that Zambia has adjusted its tax regime twice within the space of two years and therefore likely to be seen as an unstable investment destination, the potential re-introduction of windfall taxes is likely to negatively impact on exploration activities. This is because no investor would be willing to invest large amounts of capital and infrastructure to undertake exploration activities at a certain tax rate and later on during exploration be subjected to new tax rates. The re-introduction of windfall taxes will give Zambia the perception of an unstable investment destination and as such no investor would undertake the risky exploration activities in such an investment climate. This would have the effect of hindering the growth in the mining industry as a whole as no new investments would come into the mining industry.

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[99] R Bosson and B Varon, The Mining Industry and the Developing Countries. Oxford University Press, New York, 1977. Page 25

[100] R Bosson and B Varon, The Mining Industry and the Developing Countries. Page 31

[101] LCM initially invested US $ 800 million for exploration activities for the Lumwana Mine in North Western Province.

The re-introduction of windfall taxes would therefore not necessarily negatively affect the current mining companies but would have a damaging impact on the potential exploration activities in the mining industry. The uncertainty in the Zambian mining industry perhaps explains the absence of world mining giants BHP Billiton and Rio Tinto in the mining industry. The only form of activity that BHP Billiton has undertaken is exploration of copper and gold in Mumbwa, Central Province. It must be pointed out that even this form of activity has been limited to a joint venture in which Blackthorn Resources owns 60 percent of the joint venture while BHP Billiton owns only 40 percent of the joint venture[102].

4.2.2 Legal Implications of Re-Introducing the Windfall Tax

At the time of the introduction of windfall taxes in 2008 the mining companies reacted by threatening legal action while at the same calling for arbitration proceedings and dialogue with the government. However with time the mining companies dropped the threat of legal action while no action was ever commenced for arbitral proceedings. As a result of the mining companies withdrawal from legal action and/or arbitral proceedings there remains uncertainty as to the possible outcome had the mining companies gone ahead with the legal action or arbitral proceedings.

The mining company's basis at the time for wanting to commence legal action or arbitral proceedings was the breach of stabilisation clauses by the Zambian government. The introduction of windfall taxes was thought to be a breach of the provisions of the stablilsation clauses signed between the mining companies and the Zambian government which sought to prevent the government during the stability period from taking any legislative or administrative action that would vary, amend, cancel or terminate the DAs or the rights and obligations of the parties under the DAs. The contention of the mining companies was that the DAs were still valid and binding on the Zambian government. On the other hand it was the government's contention that as a sovereign state it was entitled to vary, amend or cancel its laws as and when it wanted.

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[102] X Tiong, Australian Mining Firm Halts Exploration Works in Zambia. www.englishnews.cn. Accessed on 18th January 2011

Given that up to date there has been no legal pronouncement (by the courts or arbitral tribunals) on the status of the DAs, the contention of the mining companies remains that the DAs are still valid and binding on the government and as such should the windfall taxes be re-introduced there would be nothing to stop the mining companies from legally challenging such re-introduction. As indicated above no legal action or arbitral proceedings were ever commenced and as such it remains uncertain the possible outcomes should the mining companies challenge the re-introduction of windfall taxes. Indications of the possible outcome should the mining companies seek to challenge the re-introduction could be drawn from existing case law on the challenge of breach of stabilisation clauses and the sovereignty argument.

In **Sapphire International Petroleum Ltd. v. National Iranian Oil Co. (NIOC)**[103] the arbitral tribunal in arriving at its decision relied upon the principle of *pacta sunt servanda* which entails that contractual undertakings must be respected. This was in respect of the early termination of the concession agreement between Iran and Sapphire International Petroleum Ltd with the arbitral tribunal concluding that the termination of the concession agreement did impose a duty on the state to compensate the Sapphire International Petroleum Ltd.

The case of **AGIP v. Popular Republic of Congo**[104] gives further illustration of arbitral tribunals' attitudes towards breach of stabilisation clauses. In this case AGIP agreed to the sale of half of its capital to the Congolese government with the sale being reduced into an agreement. The agreement was meant to ensure that AGIP was not subject to the nationalisation activity of the oil sector and as such included a number of stabilisation clauses. In spite of this, the Congolese government nationalised AGIP. The arbitral tribunal in respect of stabilisation clauses pointed out that:

> These stabilisation clauses, freely accepted by the Government, do not affect the principle of its sovereign legislative and regulatory powers, since it retains both in relation to those, whether nationals or foreigners, with whom it has not entered into such obligations, and that, in the present case, changes in the legislative and regulatory arrangements stipulated in the agreement simply cannot be invoked against the other contracting party.

[103] (1967) 35 I.L.R. 136
[104] (1982) 21 I.L.M. 726

In **Texaco Overseas Oil Petroleum Co./California Asiatic Oil Co. v. Libya**[105] there was a stabilisation clause between the government of Libya and Texaco Overseas Oil Petroleum Co. which read as follows:

> The Government of Libya will take all steps necessary to ensure that the company enjoys all the rights conferred by the concession. The contractual rights expressly created by this concession shall not be altered except by the mutual consent of the parties.

It was held that the clause did not in principle impair the sovereignty of the Libyan State. The arbitrator was of the view that Libya's sovereign powers remained unhindered and could be exercised on persons other than those to whom it had already entered into contract with. The arbitrator also considered the principle of *pacta sunt servanda* indicating that a sovereign state can bind itself to a contract with an investor.

The above cited cases uphold the argument that stabilisation clauses are binding on a state while at the same time indicating that stabilisation clauses do not affect a states sovereign right to amend, vary or change its laws. The stabilisation clause only prevents the state from amending, varying and changing its laws in respect of the parties with whom it has entered into contract and not other parties with whom it is yet to enter into contract with.

The case of **LIAMCO v. Libya**[106] can be contrasted with the above cited cases as this case upholds the sovereignty argument. The arbitral tribunal was of the view that upholding the idea that stabilisation clauses are binding on a state amounts to an intrusion of a State's sovereignty. According to the arbitral tribunal stabilisation clauses do not affect the State's sovereignty. The holding in the case of LIAMCO is supported by the case of **Amoco International Finance v Iran**[107] where the arbitral tribunal held that sovereignty, commonly used as an important tool of economic policy by many countries, both developed and developing, cannot easily be considered as surrendered. The arbitral tribunal's decisions in theses case indicates that stabilisation clauses are not binding on a state and therefore a state can amend, vary or change its laws as and when it wants.

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[105] (1978) 17 I.L.M. 1
[106] (1986) 62 ILR 141
[107] (1987)15 Iran-US Claims Tribunal Reports 189

The cases cited above do not strike a balance between the rights of the state and those of the investor. In this connection reference is made to the landmark case of **Aminoil v. Kuwait**[108] where the arbitral tribunal speaking on stabilisation clauses stated the following:

(a) A stabilisation clause will only be binding on a state if it expressly mentions as being prohibited the actions undertaken by a state. For instance if a stabilisation clause expressly mentions and prohibits nationalisation, any state action to nationalise would render that state liable for breach of the stabilisation clause.

(b) Stabilisation clauses are there to protect against the confiscatory taking. Confiscatory taking is the taking of the investors' interest in an investment project without the payment of compensation.

(c) If a stabilisation clause is to run for a reasonable period of time then such stabilisation clause would be binding on the state. In the Aminoil case the stabilisation clause was to run for a period of 60 years which was held to be unreasonable. In contrast a stabilisation clause that is to run for a period of say ten years would be more than a reasonable period of time and such stabilisation clause could possibly be binding on a state.

In light of the above cases and particularly upon the authority of the Aminoil case, in the event that windfall taxes are re-introduced the arbitral tribunals are likely to look favourably upon the mining companies' challenge of the windfall taxes. The DAs signed between the mining companies and the Zambian government fall short of expressly providing against the introduction of windfall taxes instead stopping at the prohibition of legislative and administrative action that would adversely affect the interests of the mining companies. There is therefore no express prohibition against the introduction of windfall taxes.

However given that stabilisation clauses are there to protect against the confiscatory taking and the fact that the Zambian government did not offer any payment of compensation at the time of

[108] (1982) 21 ILM 976

introducing the windfall taxes, the government would be found liable to pay compensation to the mining companies.

Furthermore the stabilisation clauses between the government and the mining companies were to run for a period of fifteen years, which period of time is relatively practical. Thus upon the authority of Aminoil the stabilisation clauses could be valid and binding and therefore entitling the mining companies to some form of compensation. Therefore should the windfall taxes be re-introduced and the mining companies seek arbitral proceedings, the Zambian government is likely to be required to pay compensation for breach of the stabilisation clauses.

4.3 Potential Dangers of Re-Introducing Windfall Taxes on the Economy as a Whole

The re-introduction of windfall taxes as stated above would have the effect of making Zambia an unstable and unfavourable investment destination with the possible loss of FDI. However the loss of FDI will not be restricted to the mining industry but also to other industries that are reliant on FDI such as the tourism, energy and the service sector. The fear of investors would be that even in these industries their investments would not be safe. For a country that depends on FDI for the provision of jobs, industry and foreign exchange earnings this would negatively impact the developmental prospects of the nation as a whole.

4.4 Conclusion

This chapter has considered the possible implications of re-introducing windfall taxes on FDI in the mining industry. The chapter has looked at the calls for the re-introduction of windfall taxes stating the reasons behind such calls. In addition the potential dangers of re-introducing windfall taxes have also been considered. It has been found that while such re-introduction may not affect the already existing mining companies, it does negatively impact on the exploration activities. Furthermore it has been shown that should the mining companies seek arbitral proceedings they are most likely to be successful. Lastly in order to give a comprehensive understanding of the impact of re-introducing windfall taxes the chapter has assessed the potential dangers of re-introducing windfall taxes on the economy as a whole. This chapter has come to the conclusion that not only would the re-introduction of windfall taxes have a negative impact on FDI and Zambia as an investment destination but it would also negatively impact the economy of Zambia as a whole.

CHAPTER FIVE

CONCLUSION AND RECOMMENDATIONS

5.0 Introduction

This chapter will make conclusions on the study thereafter making recommendations. Upon the basis of the preceding four chapters this chapter shall provide a conclusion on the re-introduction of windfall taxes in the Zambian mining industry and the effect of such re-introduction on the amount of FDI that would come into the mining industry. The chapter shall further extend the conclusion to consider the effects of the re-introduction of windfall taxes on the economy as whole. Recommendations shall follow thereafter, the aim being to find a lasting solution to the calls for the re-introduction of windfall taxes while at the same time ensuring that the flow of FDI into the mining industry and the economy as a whole remains uninhibited.

5.1 General Conclusions

Forty six years after independence the mining industry remains Zambia's economic lifeblood and indications are that it shall remain so for the years to come. With this in mind it almost goes without saying that Zambia must harness this industry, must ensure that this industry grows and must therefore ensure that the flow of FDI continues. At the same time there emerges the need to ensure that the Zambian people fully benefit from their natural resources. Often this means that measures must be put in place to ensure that Zambian people benefit from their natural resources. One of the ways of achieving this is through the imposition of windfall taxes, aimed at increasing revenues from the mining industries that are later used for the social sectors to benefit the Zambian people. However the problem that arises is that measures such as windfall taxes can if not handled carefully have a damaging impact on the investment climate and above all the perception of a country as an investment destination, in this case Zambia.

As a consequence of the above the study set out to look at the implications of re-introducing windfall taxes on FDI in the Zambian mining industry. The study initially began by setting the foundations upon which the study would be undertaken, highlighting the concept of FDI and windfall taxes. It was upon this basis that the actual introduction of windfall taxes in the mining industry has been considered. The focus there being on the legislation that introduced the windfall taxes and consequently led to the cancellation of the DAs signed between the mining companies and the government.

It was found that contrary to popular belief the windfall taxes did not have the effect of crippling the amount of FDI that came into the mining industry with figures instead indicating that investments actually grew at the time that the windfall taxes were introduced. It was however found that the windfall taxes did not serve their intended purpose and in the end were cancelled barely a year after their introduction amid the growing impact of the GFC. The windfall taxes were therefore not cancelled because of their impact on the mining industry but rather because of the impact of the GFC.

In an attempt to ensure a broader perspective, a comparative analysis was undertaken with the Australian mining industry that also introduced windfall taxes, known as RSPT. It emerged that the introduction of RSPT in Australia followed a comprehensive study referred to as the ABARE Report. The introduction of RSPT in Australia like Zambia was not without controversy and it was only after dialogue between the mining companies and the government that the RSPT was actually agreed to. It has been established that the introduction of RSPT could not be implemented unilaterally without dialogue and in this sense was contrasted with the Zambian scenario where the government introduced windfall taxes without dialogue with the mining companies with the result that up to today, windfall taxes have not been accepted. It was also found that the aim of the RSPT was the same as that of the windfall taxes, to re-invest the revenues realised in the social sector.

In light of the above, due consideration has been given to the calls for the re-introduction of windfall taxes stating the reasons behind such calls. The potential dangers of re-introducing windfall taxes have also been assessed with the finding that while the re-introduction of windfall taxes may not necessarily negatively affect the already existing mining companies they would negatively impact on the exploration activities. Furthermore it has been found that the legal implications of the re-introduction of windfall taxes could see the mining companies seeking arbitral proceedings with the result that the Zambian government would be likely to be asked to pay some form of compensation to mining companies for breach of contractual agreement.

Given that taxation is a pull factor in FDI attraction it has been found that the re-introduction of windfall taxes would in fact have a negative impact on FDI attraction in the mining industry and Zambia as an investment destination. The re-introduction of windfall taxes would result in a great deal of uncertainty in the mining industry as it would imply the absence of a stable tax regime which of course is one of the determinants of FDI attraction. This would result in a negative perception of Zambia as an investment destination which would spill over to negatively impact the economy of Zambia as a whole as investors would be unwilling to invest in other sectors of the economy given the uncertainty of the investment climate. The question then that emerges is, how can the windfall taxes be re-introduced without negatively affecting the inflow of FDI in the mining industry while at the same time ensuring that the Zambian people benefit from their natural resources?

5.2 Recommendations

In light of the above it is quite obvious that some middle ground must be found, middle ground that serves to ensure that FDI continues in the mining industry while at the same time ensuring that the Zambian people receive a fair share of the windfall profits. With this in mind the essay shall make recommendations that when applied would ensure a balance between the competing interests and above all ensure that Zambia's appeal as an investment destination remains unblemished.

5.2.1 Dialogue

It has emerged from the study that the decisions previously taken in the mining industry have lacked the consultation of all interested parties. It is therefore recommended that the process of dialogue be encouraged between the government, mining companies and stakeholders. Related to this is the realisation that governments' decision to ignore the calls for the re-introduction of windfall taxes in the hope that they will die down serves none of the interested parties' interests. In this sense dialogue means that any decision that is to be taken relating to the mining industry must be preceded by consultations of all interested parties. Each of the interested parties must be allowed to express their opinion with the decisions taken being reflective of all parties input. Dialogue has the effect of lending legitimacy to any action undertaken following consultation and precludes any of the parties from later on rejecting or disapproving of any decision taken following dialogue.

The idea of dialogue further entails that government must not only be seen to be seeking consultation but must also listen to the other parties. It must be noted that dialogue has the greater advantage of promoting trust amongst the government, mining companies and stakeholders which is essential for the development of the mining industry.

5.2.2 Re-Negotiate the Development Agreements

Having established that the arbitral tribunals' decisions would most likely uphold the validity of the DAs, it is recommended that instead of any unilateral action to amend, cancel or vary the DAs, there should instead be a re-negotiation of the DAs. In between the time that the DAs were initially signed to date a number of factors have since changed. Among those factors are the prices of the copper which in turn has resulted in calls for the DAs to reflect the changes that have occurred. As such a re-negotiation of the DAs is encouraged. This is more so when it is considered that the DAs provided re-negotiation clauses also referred to as variation clauses[109]. The re-negotiation clauses provide the ideal opportunity for the government on behalf of the Zambian people and the mining companies to re-negotiate the DAs for the mutual benefit of all parties.

It is therefore recommended that the DAs be adjusted to specifically provide for windfall taxes. However in an attempt to strike a balance the windfall taxes should be set at 12.5% as opposed to

[109] For the DAs of KCM and MCM see Clauses 26 and 27 respectively.

the desired 25% and the threshold for the activation of windfall taxes should be raised from the desired US $ 5512 to US $ 7000. The recommended rates would see the mining companies give up something while those calling for windfall taxes would equally be giving up their desired rates of windfall taxes. It is further recommended that the newly negotiated tax rates be enacted into law.

The re-negotiation of the DAs would have two advantages. Firstly re-negotiations entail that the government will not unilaterally change its tax rates and as such can improve investor confidence given that Zambia would be seen as willing to re-negotiate which is preferable to unilateral actions that result in investors losing out and could arguably amount to creeping expropriation. Secondly the tax rates if enacted into law have the potential of creating a stable tax regime. This is because it would cater for the interests of both parties and would only kick in at a certain price threshold. In essence this means that in the event that copper prices fell below the recommended US $ 7000 there would be no need to again alter the law as the windfall taxes would not apply. A stable tax regime is essential for the continued attraction of FDI in the mining industry.

5.2.3 The Zambia Extractive Industry Transparency Initiative

The Extractive Industry Transparency Initiative (EITI) is an initiative that aims to ensure transparency in the mining industry of a given country thereby improving investor confidence[110]. Zambia is an EITI candidate country, and has until 14 May 2011 to complete the validation process. The validation process ensures that a country is compliant with the EITI rules and regulations. Zambia being an EITI candidate country is therefore required in the implementation of EITI rules and regulations to do the following:

1. Regularly publish all mining payments by mining companies to government and all material revenues received by government from mining companies to a wide audience in a publicly accessible and comprehensive manner.

[110] http://eiti.org/za. Accessed on 14th March 2011

2. Ensure that the payments and revenues received are reconciled by a credible, independent administrator, applying international auditing standards.

3. Ensure that civil society is actively engaged as a participant in the design, monitoring and evaluation of this process and contributes towards public debate.

It is recommended that Zambia ensures that it completes the validation process of EITI. This is because the full implementation of EITI would provide the benefits of an improved investment climate by providing a clear signal to investors and international financial institutions that the government is committed to greater transparency. EITI also assists in strengthening accountability and good governance, as well as promoting greater economic stability. These are some of the factors considered when deciding to invest in a country and therefore would help improve attract investors to Zambia. Furthermore in the event that windfall taxes are re-introduced, the EITI will serve to reassure investors that Zambia still remains a favourable investment destination based on other investment factors.

5.2.4 Increase the Tax Base for Government Revenues

The calls for the re-introduction of windfall taxes reveal a greater underlying problem for the government that is the failure to provide revenues for the development of the country. Windfall taxes are therefore perceived as a short cut to revenue generation and as such it is recommended that the government finds alternative means of revenue generation. This could be done by increasing the tax base and taxing other sectors of the economy (including the informal sector which is rarely taxed) and thereby relieving the mining industry of being the single most important source of revenue generation with the result that calls for new taxes every time copper prices rise would diminish.

5.3 Conclusion

The final chapter has provided an overview of the entire study drawing a conclusion while at the same time effectively making recommendations. The importance of FDI in the growth of the mining industry cannot be overly emphasised and as such the recommendations made seek to strike a balance between the interests of the government, mining companies and stakeholders. Observance of the recommendations would ensure the re-introduction of windfall taxes while at the same ensuring that Zambia remains an attractive investment destination. However the failure to observe and implement the recommendations would largely result in the continued perception of windfall taxes as 'nothing more than a poisoned chalice'.

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