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Zambia's Development Agreements and the Soaring Copper Prices

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Introduction

Since the discovery of copper deposits in Zambia during the 1930s, copper has spelled both doom and boom for the country's social, political and economic activities. Even after a significant decline in production over the last decade and half, the copper industry continues to be the major export commodity amounting to over 70% of export value and over 75% of total foreign exchange earnings.[1] From this, it is apparent that the copper industry still plays a critical role in the political economy and development of the country. This paper looks at the current mining contracts (development agreements as they are officially called) entered into between the Government of the Republic Zambia (GRZ) and the different mining companies working in Zambia. Assessment of these agreements is prompted by the recent increase in copper prices on the London Metal Exchange (LME) and the consequent move by GRZ to renegotiate the agreements. These contracts are examined from the point of view of the bargaining approach under which the agreements were formulated and adopted. The assumptions on which the bargaining theory is based are questioned in the light of the evidence emerging from the Zambian situation.

The paper consists of four parts. Part one looks at the context and content of the current development agreements highlighting the environment in which the contracts were signed. Fiscal implications of the current contracts in view of the operating fiscal regime and investment incentives are considered in the second part. In this part focus is on how the skyrocketing copper prices have benefited or failed to benefit the people of Zambia. This section also questions the common assumption that tax incentives result in increased foreign direct investments (FDI). The third part applies the bargaining theory to the context in which the mining contracts were bargained. A number of assumptions made by the bargaining theory are discussed from the political economy approach. The last section brings together all the key argu-

ments made. In looking at the evidence on the Zambian situation, it is apparent that the tax incentives offered by the Zambian government should be evaluated with caution. On the basis of available evidence, the correlation between incentives and FDI flows is not only unclear, but difficult to establish.

Development Agreements: Content and Context

Mining and Capital Investments in Zambia

Copper mining activities are capital-intensive, requiring huge upfront capital investments to acquire the necessary machinery, sophisticated technology and human resource. Since many of the developing countries cannot raise sufficient capital investments, most of the mining investments in these countries have relied on foreign direct investments (Robinson, 2005; CUTS, 2003). There are several factors that influence a country's attractiveness to FDI. Among these are the profitability prospects of the particular mining activity, or simply put, the expected rate of returns on investments. Due to the increasing mobility of capital, the pressure to attract and retain capital has increased especial in developing countries where domestic savings are low and competition for capital investments is high. Generally, the major sources of the required huge capital investment in mining are large Transnational Corporations (TNCs). Though there is little consensus on what factors influence the flow of FDI, it is generally agreed that "market size" and "access to natural resources" are key determinants (CUTs, 2003). In a world with competition for investment resources, it is the competitiveness of a particular investment venture that inspires a particular investment decision. In order to offer a competitive investment environment, many developing countries, which are often short of the needed capital investments, offer various incentives including tax concessions, exemptions and rebates. Most of these incentives are negotiated between a potential investor and the government resulting in some legally binding agreements or contracts. The development agreements in Zambia are an example. As part of the liberalization policy, promotion of private sector growth, and the effort to revamp the collapsing[2] mining industry, the Zambian government, during the late 1990s, entered into a number of mining contracts with different mining TNCs. Figure 1 below shows the companies with which the Zambian government has signed mining contracts since the privatisation of the public owned mining conglomerate, Zambia Consolidated Copper Mines (ZCCM).

Major Mining Companies in Zambia 2007

Name	Mother Country	Ownership	Location
Luanshya Mine	Switzerland	Enya	Luanshya Town
Chambishi Metals	Switzerland	Enya	Chambish Town
Chambishi Mines	China/SA	Non-Ferrous Metals	Chambishi Town
Chibuluma Mines	South Africa	Metorex	Kalulushi Town
Mopani Copper Mines (MCM)	Canada	Glencore (73.1%) First Quantum (16.9%) ZCCM-IH (10%)	Mufulira & Kitwe
Konkola Copper Mines (KCM)	UK, India	Vendata (51%) ZCCM-IH (49%)	Chingola, Chililabo, Lusaka
Bwana Mukubwa	Canada	First Quantum	Kansansi/Ndola
Lumwana Mine	South Africa/UK	Metorex/Vendata	Solwezi

Source: Compiled from Fraser & Lungu (2007:14).

Content of the Development Agreements

Negotiations for most of these mining contracts started in 1996 and were finalized between 1997 and 2000. Some of the companies have changed ownership over the past 8 years as the original owners sold the mines or part of their equity. Over the last decade, some of the original development agreements signed in 1997 or 1998 have been altered to accommodate the bargaining between GRZ and the subsequent buyers of the mines. Prior to the 2007 civil society groups' demand for renegotiation of the mining contracts, these development contracts were not accessible to the public[3] (Fraser and Lungu, 2006; Dymond, 2007). Most of these development agreements (if not all) were negotiated and signed, thus giving rise to the suspicion of corruption and fraud in the negotiation process. Thus, until recently it has been difficult for the Zambian people to get information on the exact content of these agreements. Furthermore, the agreements have only been made accessible to a few Zambians who have access to the Internet.

Despite the problems of accessing the mining contracts, there are two general observations that can be made. Firstly, the contracts offered exceptionally generous concessions especially to mining companies signing contracts after 2000. Commenting on these agreements the Luanshya Mines CEO agrees that "the Development Agreements for the two companies we own, Luanshya Copper Mines and Chambish Metals, I would say they are very fair, very reasonable…. It must be one of the most attractive places to invest in globally, in terms of mining ventures…." (in Fraser and Lungu, 2006). Observers, including Zambia's Minister of Finance and donor agencies have noted that the Zambian tax incentives are exceptionally, to the extent of being scandalously generous.

Secondly, a close look at the contracts reveals the significant difference in the terms of agreement between the earlier and later contracts. Earlier agreements had more stringent terms, which were a measure to ensure that government collected reasonable revenues from the mining activities taking place in the country. For instance, income tax in all the agreements signed in 1997 and 98 was 35% while the royalty tax was either 2% or 3% in accordance with the Mines and Minerals Act, which stipulates that royalty tax shall be charged at 3% of the value of extracted metals. In addition, all the contracts signed in 1997/98 required the mining companies to pay customs and excise duties on all imported assets unlike the 2000 contracts which have exempted most of the mining companies from paying customs and excise duties on imported assets to be used in development of mining infrastructure and operations. A standard provision on customs and excise duty for the post 2000 development agreement runs as follow:

> [mine] shall **be** entitled to exemption from customs and excise duties, and from any other duty or impost levied under the Customs and Excise Act in respect of all machinery and equipment (including specialized motor vehicles) required for the activities carried on or to be carried on in pursuance of the right or otherwise for the purpose of this investment in Mining prospecting (KCM Development Agreement, 2000:84).

In addition to this, later mining contracts have income tax at 25%, loyalty tax at 0.6% with a "Losses carry-forward" facility on the "first-in first-out" basis. The table below summarizes the comparison between the 1997/98 and later agreements with

regard to incentives offered. All these agreements have been locked-in for the "stability period"[4] of between 15 and 20 years.

Mineral Fiscal Regime in Retrospect

As noted above, this is not the first time that Zambia is faced with the issues of mineral tax. After independence, the country had to negotiate a mineral tax structure with the companies that owned and operated mines during the colonial administration. The post-independence mineral tax system had three elements:

i) Royalty tax of 13.5% on the LME copper price sales,
ii) Export tax of 40% of the "amount by which the LME price exceeded US$300 per long tonne"
iii) Income/corporate tax at 45% of the company's profit (Curry, 1984:39; O'Faircheallaigh, 1986: 54). This three-fold tax regime produced a total effective tax rate of 74.4% (O'Faircheallaigh, 1986: 56).

During the colonial era and before the Matero Reforms[5] in 1969, the mineral royalties accrued to the British South African Company and its subsidiaries which owned the mineral rights, (Kaunda, 1968). In his address, then Republican President Dr. Kaunda rescinded the mining company's perpetual mineral rights, introduced exploration and mining licenses, and a mineral tax based on the profitability of the mining industry (Kaunda, 1969). At the same time, the creation of two mining parastatals, Nchanga Consolidated Copper Mines (NCCM) and Roan Consolidated Mines (RCM), as joint companies with the private companies was announced. In 1970, following these changes, the Zambian government changed its tax system from a three-fold tax formula to a single formula which replaced the royalty, export and income tax of the previous regime with a 51% mineral tax together with a 45% tax on net profit amounting to a total effective tax of 73.5% (O'Faircheallaigh, 1986: 56). Although this raised the much-needed revenue for the government, most mining companies argued that such high tax on production and profit discouraged investments and growth of the industry (Curry, 1984).

Since government raised sufficient revenue through this fiscal system, the government did not see any need to renegotiate this arrangement. However, problems in the sector caused mainly by the rise in input costs, shortage of foreign currency and

falling copper prices during the early 1970s, forced the government to reconsider its fiscal system and offered a number of incentives in the mining sector. By 1976, the revenue from the mining industry had fallen to 45% of total government revenue compared to over 60% in 1970. Investments in the sector dropped with the declining rate of returns on investments, and the Zambian government started to devise ways of making mining investments attractive. In a bid to attract foreign investors, the Zambian government found itself negotiating with TNCs offering incentives mainly in the forms of fiscal changes as well as foreign exchange relaxation. During the 1976 budget speech, the Minister of Finance declared, "in order to encourage higher foreign investment in the country, I have decided that… investors will be allowed to remit either 15 percent paid-up capital of their companies or 50 per cent of their profit whichever is less" (in Curry, 1984:46). This scenario however, instead of easing the foreign currency crisis, made the situation even worse as this measure created more demand for foreign currency against the Kwacha. As the crisis deepened, the Zambian government entered into bargaining with the mining companies, such that by 1976, new agreements and articles of association were being drawn up, and the mining companies tried by all means to extract "as much 'surplus as they could" (Burdette, 1977:491). Thus, the business of development agreements and investment incentives are not a 1990 phenomenon. Nonetheless, the current agreements, when compared to earlier mining contracts, reflect a weak fiscal regime and a corresponding generous incentive.

Development Agreements in Context

One of the reasons that explains the nature of the current development agreements is that the years preceding the signing of the 2000 contracts saw the lowest investments in the mining sector, and the forecast for the mining industry in Zambia was a depressing one. A report by the Zambia Chamber of Mines (2006) indicates that investments in 1998 dropped to less than 10% of the 1997 levels, and in 1999, investments in the industry was only half of the 1997 investments. Further, as the former Minister of Finance, Edith Nawakwi, notes, the projections on the price of copper was that prices would not rise for any foreseeable future and that the ore deposits of the base metals were very low. In view of this situation, the government's negotiating team was under pressure to make investments in the industry more attractive. Table 1 below indicates some of the key incentives offered to the mining sector in the development agreements.

Development Agreement Incentives in the Mining Sector

Name	Year of Contract	Corporate Tax (%)	Royalties(%)	Carry-forward of losses	Stability Period	Other Incentives	VAT
KCM	2000	25	0.6	Stability Period	20 year	Free forex, no power excise	At 0% input
MCM	2000	25	0.6	Stability Period	20 year	Free forex, no power excise	At 0% input
NFCA	1998	35/30**	*	10 year	15	Free forex, Duties payable	At 0% input
Ramcoz	1997	35/30**	2	10 years	15	Free forex, Duties payable	At 0% input
Kansanshi	1997	35/30**	Not exceeding 3%	10 year	15	Free forex, Duties payable	At 0% input
Chibuluma	1997	35/30**	2	10 year	15	Free forex, Duties payable	At 0% input
Chambishi	1998	35/30**	2	10 year	15	Free forex, Duties payable	At 0% input

Source: Various Development Agreements

* Royalty rate not specified in the contract. It is probably presumed that the royalties rate stated in the Mineral and Mines Act (3%) would apply.

** Income tax charged at the standard rate of 35%, but 30% for companies that were fully listed on the Lusaka Stock Exchange

Investors in the mining sector were offered generous incentives in terms of fiscal concessions with a net effective tax burden of 0% especially in the post 2000 development agreements as table 1 above indicates. Other than a 0% VAT, the mining companies enjoyed relatively low corporate tax of 35% and 2% royalty tax before 2000, and 25% income tax and 0.6% royalty tax for agreements signed after 2000.[6]

In addition, all mining companies and their foreign employees are free to remit foreign exchange as profit or income outside Zambia without any restrictions. This was a policy adopted in the absence of foreign exchange controls. The other key incentive offered to mining companies is the carry-forward of losses on the "first-in-first-out" basis for a period of ten years or the entire stability period. Effectively, this reduces taxable income since the companies are allowed to deduct their losses from the previous years activities before a tax is applied. A first-in-first-out mechanism means "losses made in year 1 of operations could be subtracted in subsequent years from taxable profits" (Fraser and Lungu, 2006). If a company has been operating at a loss for five years, it is allowed to carry-over these losses and deduct them from taxable income over the stability period for KCM and MCM,

and over 10 years for the other mining companies. Further, these companies were also allowed 100% deductions of capital expenditure in the year in which the investment was made (See Any Development Agreements).

Most of these incentives are not offered to other industries like Agriculture, Manufacturing and Tourism. In the case of the agricultural sector, the exemption of the sector from VAT makes the sector bear a higher tax burden as the FIAS Report explains:

> VAT exempt status hurts farmers because their effective [tax] burden rises sharply without the ability to reclaim VAT on inputs. The Zambia National Farmers Union (ZNFU) calculates that increases in costs of production of wheat as a result of exemptions from VAT amounts to [US162] per ha and thereby reduce profit margins from 11% to 4% …..(2004, vii). In the case of mining firms, the FIAS Report notes that due to "relatively low tax rates and significant incentives, the mining sector enjoys an METR[7] of around 0%" (2004

Incentives in these agreements are locked in "water tight" contracts which do not allow the government to make any changes or additions to the said contracts over the stability period. The standard phrasing of the agreements is:

> GRZ… undertakes that, for the stability period, it shall not by general or special legislation or by administrative measure or decree or by any other action or inaction whatsoever (other than the act of nationalization…) vary, amend, cancel or terminate this agreement or any other related agreements or the rights and obligations of the parties under this Agreement … provided that this agreement and any other related agreements may be varied, amended, cancelled or terminated as expressly provided therein (KCM *Development Agreement*, Section 13 (2)).

Because of clauses like this, it is difficult for the government to change its tax system to ensure that the government and the people of Zambia get a fair share of the benefits from mining. These incentives were offered under the assumption that incentives in the form of tax concessions directly result in the increased flow of FDI.

But as it shall become clearer later, there is no plausible empirical evidence to support this assumption. In a review of tax regime in the SADC region, Robinson (2005) questions the effective impact of such incentives on FDI flow.

Induced Pressure to Sale

The other reason for this scandalously generous offer on the part of the Zambian government is that at this time the government was allegedly under pressure to privatize the almost collapsed mining giant, ZCCM. Much of the pressure is said to have been exerted by the IMF and World Bank, which made the privatization of the mines one of the conditions for accessing balance of payment support loans as well as project assistance funds. According to the Finance Minister at that time, when most of these contracts were being negotiated, the government was not only put under pressure to privatize, but it was made to believe that the copper industry was no longer a very attractive venture.

> We were told by advisers, who included the International Monetary Fund and the World Bank that not in my lifetime would the price of copper change. They put production models on the table and told us that there [was] no copper in Nchanga mine, Mufulira was supposed to have five years' life left and all the production models that could be employed were showing that, for the next 20 years, Zambian copper would not make a profit. [Conversely, if we privatized] we would be able to access debt relief, and this was a huge carrot in front of us – like waving medicine in front of a dying woman. We had no option (in Dymond, 2007:6).

Fraser and Lungu (2006) also recognize the IMF/World Bank pressure to privatize as one of the main reasons for the over generous investment incentives offered to mining companies in 2000 and subsequent contracts. While the pressure from the IMF and the World Bank to privatize Zambia's mining conglomerate cannot be denied in the context of the huge foreign debt burden[8] and the repayments arrears that Zambia had at this time, it is not easy to determine how much this pressure pushed the government into offering the generous incentives in the mining sector. Privatisation of the public owned mining conglomerate was part of the wider programme of structural reform which emphasized the liberalisation of the economy as a way of correcting the structural and policy errors in low-income countries (Collier

and Gunning, 1999). Nevertheless, the pressure to adopt these programmes arises from the fact that access to aid and other forms of support in low-income countries was conditional upon a country's compliance with these programmes. Adoption of structural adjustment programmes was not only a requirement made by the IMF and World Bank, but also by bilateral lending agencies. In the Zambian case, it is reported that at the "1998 Paris Club meeting of international donors, it was conveyed to Zambian authorities that they would not support the balance of payment crisis, unless Zambia liberalised its economy" (CUTS, 2003: 21). In this sense, the pressure from international financial institutions and donor community to sell off the mines was a reality.

Low Copper Prices

Pressure to privatize was re-enforced by the low copper prices at the LME with the projections indicating that the prices were not going to rise in any foreseeable future and that the remaining deposits would cost more to extract and were of low quality. Prices of copper on the LME dropped from $2 300 per tonne in 1997 to about $1 500 in 1998 and remained at this level until 2004 when prices started to rise again (see Figure 2 below). So factors of *impatience* and *desperation* also played themselves on the government. These factors were re-enforced by the urgency to rid the government of the floundering mining parastatal which was alleged to be costing government more than US$1 million a day (Dymond, 2007). According to the bargaining theory, this situation weakened the government's position to negotiate mining contracts which can result in government and the people of Zambian having a fair share from the mineral resources. However, there is an assumption, as we shall see later, that the government under this pressure did not act in its own interest. Reports of corrupt practices in the sale of the mines and the contract processes only point to the much ignored factor that the government negotiating team had individual interests to safeguard in the process.

Tax Incentives and FDI

From the government's perspective, incentives were offered to create a "positive investment environment" (Ministry of Mines and Mineral Development, 1998). Most of the incentives offered have been in the form of fiscal concessions as well as other administrative exemptions which were meant to make it easy for investors to

come into the country and do business. In common parlance, the government spared no effort to create a 'business friendly environment" although it is apparent that this friendly arm was mainly extended to the foreign "big business". This is noted by a study conducted by the Foreign Investment Advisory Services (FIAS, 2004) of the World Bank's International Finance Corporation (IFC), which reports that the current tax regime does not favour small scale firms mainly because the small scale firms are exempt from VAT and therefore are not eligible for VAT rebates., x).

Impact of Development Agreements

Outcome of Incentives

A critical question that has not often been addressed in the debates on investment incentives is the end product of these generous offers. Since the 1980s, low income countries policymakers have increasingly embraced the position that offering incentives to investors result in increased flow of foreign direct investments. Surprisingly, current evidence on the topic suggests that it is not an automatic case that incentives will definitely increase FDI flows. A 2002 *World Investment Report* indicates that there is no clear evidence to link incentives to increased FDI flow especially for developing countries. The Report notes that, "In spite of the substantial liberalizing measures of the past decade, developing countries still attract less than a third of world FDI flows, and these flows remain highly concentrated. In 2001, the five largest host countries in the developing world received 62 per cent of total inflows and the 10 largest received three-quarters (2002: 9). In the case of developing countries, incentives alone appear to be inadequate in attracting foreign investment. A study conducted by Robinson on the corporate tax regime in SADC, concludes that though countries in the region, like other developing countries, are quick to offer tax incentives as a way to attract FDI, the "outcome of low taxes, that is higher levels of capital investment, is also questionable in literature." (2005:724).

By and large, "while tax incentives can enhance a country's attractiveness, if other factors are unfavourable, these will be insufficient to significantly increase inflows of FDI" (CUTs, 2003:10). A report by FIAS (2004) on Zambia also observes that incentives are not a primary mover of investment flows as assumed in conventional policy debates. Often most developing countries in their frantic effort to attract FDI, rely on tax incentives as the only policy instrument to raise sufficient investment capital from TNC. The Zambian investment policy is one example.

During the privatization of state owned enterprise, the government relied mainly on tax incentives as the key parameter for creating a "business climate" (FIAS, 2004:6) or a business friendly environment especially when it came to attracting investors into the floundering mining industry during the 1990s. In order to attract investors to the mining industry, the government went to the extent of repealing the 1991 Investment Act to create legislative framework for offering generous incentives (CUTs 2003). The surprising thing though is that traditionally, investment into the copper industry, and indeed all resource-based industries, are not attracted by incentive but by the existence of high economic returns or the prospects of such. Historically, "FDI in the mining sector in Zambia, … was not attracted by fiscal incentives but by the potential high returns that it offered" (CUTs, 2003:15).

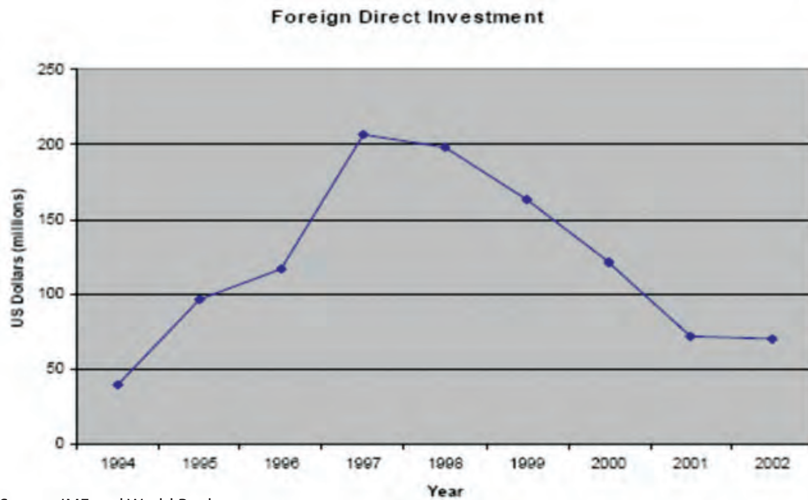
In view of this, the assumption which prevailed during the negotiations of the development agreements that fiscal incentives will result in increased FDI are difficult to understand. Commenting on the role of tax incentives in the mining sector in Zambia, Curry (1984), questioned the assumption that reducing tax rates makes the investment in mining attractive. Curry argues that while the impact of such incentives on investments is not obvious, it is obvious that such concessions shift the tax burden to the poor households. In Curry's view, often the tax incentives results in unnecessary revenue sacrifice, adding that "investment might not respond to such an incentive because mining investments are induced by change in levels of economic activity in the country to which output is destined" (1984:50). Thus, the prudence of the tax incentives, while hailed by many at the time when they were offered, needs to be accessed in the context of their impact.

What Does the Evidence Say?

In terms of the net FDI flow, it is clear that investments in the mining sector did not directly respond to the incentives offered if one considers the fact that FDI flow in Zambia declined at the time when the most generous incentives were being offered as indicated by figure 2 below.

Although FDI flow increased from below US$ 50 million in 1994 to over US$200 million in 1997, the flow of investment declined sharply at the time when generous tax incentives were offered to foreign investors from 1996 to 2001. Overall, "FDI flows into Zambia [remained] low in absolute terms, amounting to only $71 million

FDI Flow into Zambia 1994-2002



Source: IMF and World Bank

FDI Flows as % of GDP (Selected Countries)

	1979-84	1985-90	1991-96	1997-2001
Zambia	0.7	3.3	2.01	4.5
Kenya	0.2	0.3	0.2	0.6
Tanzania	n.a.	0.1	1.1	2.2
Uganda	0	0	1.4	2.7
Mozambique	0	0.2	1.7	6.8
Cote d'Ivoire	0.6	0.5	0.7	2.7
Ghana	0.2	0.2	1.7	1.3
Vietnam	n.a.	0.1	7.8	5.5
Honduras	0.5	1.1	1.4	3.3
South Africa	0.002	0.0003	0.003	2.2
Sub-Saharan Africa	0.7	0.8	1.3	2.6
Low income	0.2	0.4	1.1	1.1
World	0.5	0.8	0.9	2.6

Source: IMF and World Bank (in FIAS, 2004:5).

inflows during 2002, or about 2% of GDP….. (FIAS, 2004:4). Declining flows of FDI into Zambia is regardless of the fact that the larger chunk of the inflows have been "associated with the mining sector" where generous incentives have been offered (ibid).

In terms of the regional FDI/GDP ratio, Zambia at first glance appears to be one of the top recipients of investment flows as the figure below indicates, but the high ratio for Zambia is due to the small size of GDP (US$7.5 billion in 2005 PPP).

The conclusion drawn from the above scenario in a Report by FIAS is that "although the government has undertaken a range of policy reforms in the past years, it is clear from the data presented above that the impact and effectiveness of the reforms have been limited in terms of attracting investments" (2004:5).

In particular reference to the mining industry, it has been noted that despite the several incentives offered the sector has not seen real growth in investments except in the last two years when copper prices soared to all time high. Most of the investments are opportunist investment which Robinson (2005) refers to as the "vanishing tax payer" and most appropriately as "warehouse investors". The slightest shock in the market, triggers outflows of FDI leaving the country wretched, as was the case in 2001 when Anglo-American pulled out of KCM (CUTs, 2003).

Hidden Cost

In terms of outcome, it should be acknowledged that there have been increases in the production of copper since 2001. Further, a number of new mines have been set up, old mines have been expanded or recapitalised. But this outcome cannot be attributed entirely to the incentive impact. In fact much of the recent increase investment in the mining sector in Zambia is a direct response to the rising price of copper on the world market. As Fraser and Lungu have noted, the "investment boom … only …started in 2004, after the world copper price explosion started" (2006:20). Certainly more exploration, refurbishing recapitalization and expansion of mining activities have occurred and should be acknowledged as a success given the level of investment at the time of the sale of the mines. Production increased from 250 000 tonnes in 1998 to over 450 tonnes in 2005. Productions figures are expected to rise as operations at the new Lumwana Mine

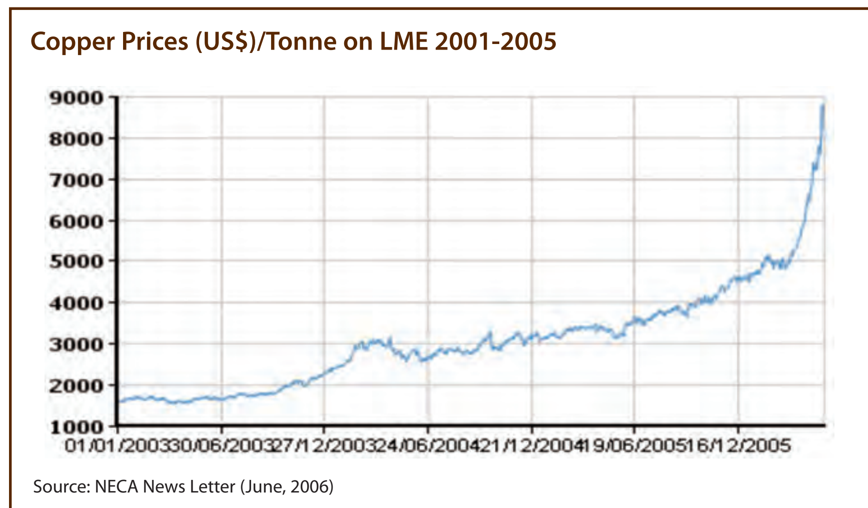
take root. Investments increased from US$55 million in 1998 to over US$350 million in 2005 (Chamber of Mines, 2006).

However, there are costs to these successes. One of the long-term costs of the increased copper prices and the corresponding investments is that the attractive mining industry and its high returns led to the neglect of other less lucrative sectors such as agriculture, tourism, and manufacturing. In the long-run, this leads to the situation where the mining industry functions as an enclave amidst lowly developed and neglected sectors. A cost that arises from this development is that a well-developed copper enclave fails to create forward and backward linkages to support balanced growth. As has been the case in Zambia in the past, and to a certain extent in the present, failure to create linkages between the mining industry and other sectors in the economy has resulted in a monoeconomy resting on the vulnerable mineral crutch of a single commodity. When the price of copper falls, the entire economy crumbles. While this is often not seen as a cost created by the rising price of copper, it has been a major constraint in Zambia's development. Related to this is the issue of resource-based industry being capital intensive offering little pull to small firms in terms of technological transfer and other positive externality. The mining industry being capital intensive "only generates modest, spontaneous positive spillovers and backward linkages to the local economy" (CUTs, 2003).

Other costs that should be taken into account in the current copper price boom include the occurrence of the famous "Dutch Disease" where the currency appreciates due to the huge inflow of foreign currency resulting from growth in traditional exports. Rapid appreciation of the local currency resulting from high copper prices can make the non-traditional export industries become less competitive thus entrenching the dependency on copper.[9] This situation highlights the vulnerability of the economy especially given the volatility of commodity prices on the world market. More worrying in the current situation is the fact that resources such as copper are non-renewable requiring prudent management and planning. Other costs include the damage to the environment, casualisation of labour, and impoverishment of local communities (Fraser, and Lungu, 2006; Dymond, 2007). While these costs may be known, they are often not factored into the cost-benefit equation. The rising price of copper and other minerals is only understood in terms of the higher income it generates.

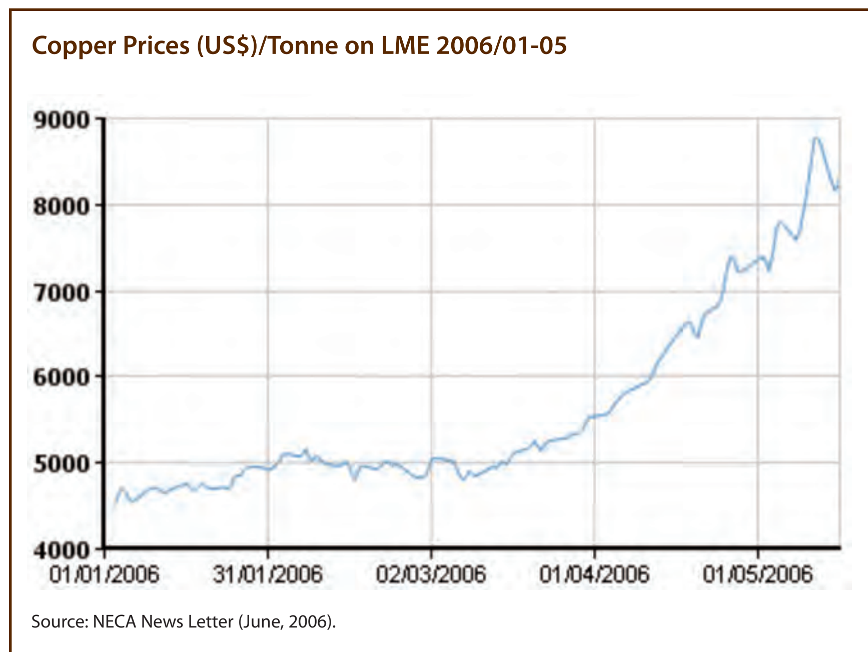
Unfortunately, the current high copper prices have translated into little benefit for the people of Zambia. As the figure below shows, while the price of copper remained fairly constant from 2000 to 2003, it began to rise in 2003 breaking through the US$3000 per tonne.

Copper Prices (US$)/Tonne on LME 2001-2005



Source: NECA News Letter (June, 2006)

Copper Prices (US$)/Tonne on LME 2006/01-05



Source: NECA News Letter (June, 2006).

Since then the price has been steadily rising until February 2006 when prices increased rapidly. As the figure below shows, in January 2006, copper prices soared from US$5000 to US$8 800 in May.

What Benefit for Zambia?

Studies done so far indicate that it has been difficult to determine the exact revenue of each of the mining companies, mainly due to the fact that these companies have not disclosed their net profits or gross revenues. However, there is indication Zambians are not benefiting from this windfall. Most of these companies have recorded high gross profits since the price of copper began to climb in 2003. For example First Quantum's annual profit climbed from US$4.6 million in 2003 to US$152. 8 million in 2005, and its shares have had more than 1000% return since 2000 amounting to an average annual rate of return of 200% (Fraser and Lungu, 2006: 21). Some of these gains have been declared in the company's annual report (ibid). Similarly, KCM's operating profit was reported to have increased from US$52.7 Million in 2005 to US$206.3 Million in 2006 indicating a growth rate of more than 400% (ibid.). But while the mining companies make these profits, government revenue has not shared in the fruits of this boom mainly because government revenue is stifled and locked by the development agreements. In the current arrangement, although KCM generated a revenue of over US$1billion, it was only required to pay tax amounting to US$6.1 Million to the government (Dymond, 2007:7). It is not clear at this stage if these revenues are actually remitted to the government. For instance Dymond reports that all the mining companies were expected to pay royalties amounting to US$3.8 million, during the 2004/05 fiscal year, but a report from the Ministry of Finance indicates that the mining companies together paid royalties amounting to US$1.57 million (ibid).

There are other loopholes in the current arrangement which make it difficult for the government to receive a fair share from these revenues. Although the government did incorporate the "price participation" mechanism which states that when the price of copper exceeds an agreed amount (between US$ 2 700-2800 per tonne in 2000), then the government would receive a particular percentage (25% in the case of KCM) on the exceeding sale (Dymond, 2007), the outcome of this mechanism has been disappointing mainly because "the payment to government is …deductable by the companies for income tax purposes" (Fraser and Lungu, 2006:15) thereby reduc-

ing the taxable income for the government. Not only that, it has been reported that even this low amount is "rarely" received by the government (ibid). Further taxable income is lost through the transfer pricing mechanism whereby the subsidiary companies in Zambia sell copper products to their parent companies abroad at a price set by the two companies. The net effect is that this reduces the tax liabilities of the local mining companies by reducing the profit attributable to the subsidiary companies. Since most of the subsidiary companies have their parent companies in the developed world, transfer pricing effectively results in the "shift of profits to developed countries where parent companies operate… (Curry, 1984:49).

Further the Minister of Mines has acknowledged the fact that some of the mining companies are not honouring the generous agreements: "Some mine investors have not been honouring their part of the development agreements that have to do with health and safety, environment, labour and immigration," Machila said. "The mining companies have been getting away with non-compliance with those aspects of the development agreements" (Mineral Watch Zambia, 2008). In terms of corporate tax revenue from the different sectors, the mining industry, though it accounts for much of the investment inflows (CUTs, 2003) and incentives, its contribution is only half of what the finance sector contributes as indicated in the figure below.

Citing studies done by Christian AID, Dymond observes that due to the current tax regimes and incentives contained in the Development Agreements, "the amount of revenue transferred to the Zambian government by the new mining companies is relatively small when compared to other resource-rich countries" such as Botswana where the diamond company Debswana remits "at least 70% of its profits to national government through revenue transfers of different sorts…"(2007:6).

Source: Based on Data from ZRA (in FIAS, 2004:10)

In view of the high copper prices and the current profit margins enjoyed by the mining companies, it is clear that "the Zambian government is unable

to derive what would normally be considered its rightful or normal rewards from the extraction of the country's key natural resources" (Dymond, 2007:7).

Both the UN and the UK government have in principle acknowledged the inadequacy of the current fiscal arrangement noting that the Zambian people are not getting what they deserve from their resources: Commenting on the newly announced mineral tax, the Parliamentary Select Committee declared its support of the move to increase effective mineral tax:

> …your committee strongly urges the government to relentlessly pursue the matter until the Zambian people get what is rightfully theirs from their natural resources... Noting that the exploitation of the country's mineral resources should primarily benefit Zambians, which has not been the case in the past, we strongly support the proposed new fiscal regime in the sector as it is in the interest of the country.... The statement that the new tax regime proposes an effective tax rate of 79 per cent is also misleading. In fact, your Committee understands and agrees with the government that the effective tax rate will be around 47 per cent" Mineral Watch Zambia, 2008).

Even if some companies have indicated that they are willing to renegotiate the contracts, there are media reports that some of the companies are intending to block any changes to the current contracts. Following the announcement of the new tax regime in this year's budget by the Minister of Finance and National Planning, there have been reports of several mining companies threatening to take legal action if the new tax system is effected. A senior staff member at one of the mining companies clearly indicated the intentions of his company if the new tax regime is implemented.
"We have development agreements in place and they still have a decade to run. We will go ahead with international arbitration if this fiscal regime goes ahead, but we trust it will not come to that." (Mineral Watch Zambia, February 2008).

Government seems to be taking a strong stance on the newly announced fiscal regime indicating that it will not compromise on this. Acting Secretary to the Treasury, James Mulungush has indicated that the government intends to bring in new legislation that can set aside the development agreements: "The new mining regulatory regime will, therefore, do away with the requirement for Development Agreements"   (Mine Watch Zambia, February, 2008)

New Tax Regime

The new mining tax regime announced in this year's budget by the Minister of Finance includes the following

- Increasing royalty tax from 0.6% to 3%,
- Increasing corporate tax from 25% to 30%,
- Blocking of "transfer pricing" practices which allowed the companies to quote prices at which they sold copper to their parent companies or buyers abroad; instead prices for calculating tax will be based on the price of copper at the LME or the Shanghai Stock Exchange,
- Introduction of a windfall tax for every 50 cent increase in the price of copper,
- Remove of carry-forward losses from financial deals such as hedging,
- Allowing only 25% deduction of expenditure on equipment instead of 100% being allowed (Magande, 2008).

It is expected that the implementation of the new tax regime will contribute an additional US$415 million to the government coffers. While the companies are challenging this decision by the government on the basis of the Development Agreements, the Zambian government has received backing from different corners including the British Government, the UN and other major donors who argue that the DAs are a scandal, corrupt ridden, born out of coercion and manipulation, and therefore morally tainted. These have added the call for the mining companies to negotiate with the government.

With regard to GRZ, there have been two different responses to the current situation. While the Minister of Finance, (and his colleagues including the Minister of Justice, the Secretary to the Treasury, Minister of Mines and NGOs) has taken a non-compromising approach defending his new taxes, the President has taken a more conciliatory approach. "We are a listening Government, [says Dr.Mwanawasa] instead of them shouting on the hill I invite them to seek audience with the Ministers of Finance and Mines and they should be prepared... We are at 31 percent, let the mining firms show that we are wrong when we say that our taxes are low. These people are coming from countries where taxes are high" (Mineral Watch Zambia, February, 2008).

Development Agreement and the Bargaining Theory

The current Development Agreements are assumed to be the product of negotiation or bargaining between the investors or TNC and the government of Zambia. Conventionally, the widely accepted framework for looking at such agreements is the bargaining approach or model. The model was first proposed by Bruno Contini in his article entitled "Time in Bargaining Negotiations", and was later appropriated by Robbert Curry and L. Wade in an article entitled "A Model for Socio-political Bargaining." Other contributions to the debate on the bargaining approach include William Zartman's book, *The Politics of Trade Negotiations Between Africa and European Economic Community* (1971), and David Smith and Louis Well's, *Negotiating Third World's Mineral Agreements* (1975).

This model is usually built on a number of assumptions, but three stand out, and are relevant to this discussion. The first assumption is that since the contracts are a result of negotiations, they constitute a win-win situation where both parties consider the benefit-cost ratio and try to reach a compromise in each other's favour. The second assumption is that the negotiating parties are doing so out of their own choice; that is, they are not coerced into or under pressure to engage in a bargaining process. A third assumption often made is that the negotiating teams do so in the interest of the people.

Win-Win Outcome

In outlining the bargaining approach in the African context, Curry and Rothchild (1974) indicate that key variables in the bargaining model include *flexibility*, *experience*, *power* and *skill* though they argue that "*impatience"* and "*reciprocal demand intensity*" do have serious bearing on the configuration of benefit-cost ratio that the negotiating teams settle for. Curry and Rothchild begin with the assumption that both parties know that there is both a cost and a benefit to the agreement reached. In the case of the government, the *benefit* from the investment agreement with TNCs lies in the fact that "permitting the enterprise to operate in its domain results in employment and income for

the people, as well as public revenue for the state" (1974:174). On the flip side, the government has to trade these benefits with the cost of depleting natural resources, and that foreign companies discourage the emergence of local private enterprise.

As for the TNCs they benefit from the agreement through expected profit and corporate income. A cost of "giving up productive factors" has to be borne by the foreign company (ibid). Since both parties are aware of the costs and benefits involved in a particular agreement, it is argued that both would seek to reach a "mutually acceptable exchange ratio" (Curry and Rothchild, 1974:174). As such, the outcome of this model is envisioned to be a win-win situation: the government wins through the inflow of productive capital resulting in employment, income, revenue and development while the company also wins through generated income and after-tax profit.

This is developed from the earlier work by Wade and Curry (1971) in which the bargaining parties are assumed to be "economising individuals" who assign their resources in a way that results in maximum benefit. A utility maximizing economic man at the centre of the classical economic theory is what the negotiating parties are made out to be. As the economising individuals seek to maximise their individual utility, their "offer curve" results in the Pareto-optimal ratio of benefit and costs, the model assumes. However, Curry and Rothchild do acknowledge that the ratios reached are heavily influenced by the "relative strength of each agent's impatience and demand intensity…" (1974:175). In other words, if a government is impatient or in a hurry to attract capital investment, its bargaining position is weakened. This is especially true in cases where one of the negotiating teams is aware of the desperate situation or "demand intensity" of the other party. Similarly, if the government has no alternative sources of capital, it will have to accept the benefit-cost exchange ratio that is less in its favour. As for the company, because of less restrictions on the mobility of capital, investors tend always to be in a stronger bargaining position (Robinson, 2005).

Tilted Platforms

Rather than end the analysis here as Curry and Rothchild (1974) and Wade and Curry (1971) do, there are a number of observations to be made. First, even if one accepts the assumptions of the bargaining theory, it seems evident that negotiations are rarely between two equal parties. Foreign investors, especially if it involves TNCs always have an upper hand such that they often define the terms of the contract.

This is especially true when it comes to the relationship between TNCs and low-income countries like Zambia as the Mining Development Agreements above indicate. Imbalanced relations between the company and the developing countries government are not only influenced by the visible negotiators, but there are invisible forces behind the scene which apply pressure directly (as the case of Zambia shows—pressure from the IFIs) or indirectly through powers behind the scene (Burdette, 1977). Therefore, the bargaining model can be misleading in its assumption that skills, experience, flexibility, time are the key variables. Certainly these are important, but even these are factors over which the TNCs have an enormous advantage. Given this scenario it is improbable that the situation will be a zero-sum game where both parties win. The stronger party wins more at the expense of the weaker.

A major weakness in the bargaining theory emerges from it assumptions which are too hypothetical to reflect the actual situation in which bargaining takes place. For example the assumption that "each player knows only his own utility function" (Contini, 1968) or that each party is *unaware* of the degree of initial condition of the other (Wade and Curry, 1971) does not reflect the real world in which the negotiation for investments like the mining contracts are carried out. In the Zambian case, it can be asserted with certainty that the mining companies were well aware of the dire situation or pressure to privatise with which the Zambian government was faced.

Bargaining out of Free Choice

Bargaining theory also assumes that the negotiating parties are doing so out of their own free choice to improve their condition. A genuine question can be raised as to the validity of the assumption particularly in developing countries where governments are always under pressure to offer competitive tax regimes. In instances where countries are desperate for capital investments amidst low domestic saving and low fixed capital formation, it is absurd to assume that negotiators with such countries take place in a 'free' environment. Discounting the donors and IFIs influence, situation under which the investment negotiations such as the development agreements in Zambia cannot be said to have taken place in a free atmosphere. Wade and Curry (1971) and Curry and Rothchild's (1974) bargain model postulates two individuals *A* and *B freely* engaged in an exchange activity freely embarked on with both sides in a condition of symmetrical information. The only acknowledged variant factors are impatience and demand intensity to reach a decision. It is clear that these assump-

tions do not correspond to the actual process of bargaining, in which the TNCs have an advantage when it comes to options, information, skill, experience and focus. As Contini (1968) has noted, the bargaining process is often so delicate that even the value of time (the time frame in which an agreement should be reached to avoid costs) can shift the ratios of benefits and cost between the two negotiating partners. In that sense, time acts as a constraint on the *free agency* of the team under pressure.

Non-Colluding Parties

The other key assumption made in the bargaining model is that the bargaining parties are non-colluding; that is negotiating teams are believed to be honest members of society who seek to conduct their business in an open and selfless manner. Curry and Rothchild explain this assumption: "We first assume that there are two non-colluding agents participating in the process—an African government and a multinational firm" (1974: 174). Implicitly the negotiating teams are seen to be a homogeneous group, consisting of individuals with the same goals and interests. While homogeneity may be secured for the multinational corporations, governments often represent various interests, which influence the outcome of the bargaining process. The assumption in the bargaining model is that "government are acting on behalf of the welfare of the population, rather than for a smaller group" (Burdette, 1977:473). But cases of reported corruption in the process of negotiating investment deals are far from validating the assumption that government's interest coincides with the interest of the public.

As Burdette (1977) has observed, government negotiators may settle for a particular cost benefit ratio in the agreement for reasons, which may have nothing to do with the interest of the public. Government may decide to settle for a particular position on the "offer curve" not because that is what serves public interest or welfare, but because certain individuals in government may want to "enjoy the profits themselves" or to use the deals to gain political capital. High secrecy and reported corruption in the development agreements in Zambia confirm the incongruency between the state and the public interest. Alleged cases of malpractices in the awarding of mining contracts to bidders and the fraudulent handling of proceeds from the sale of the government assets in ZCCM highlight the divergence of interest between the government and the public. This scenario supports the Public Choice Theory which denies the existence of a "benevolent state", and instead argues that the individual decision makers in the state act no differently from individual decision makers in the market (Buchanan and Tullock, 1962).

Conclusion

Zambia has negotiated several investment agreements with TNCs especially in the mining industry. These negotiations have always involved making concession in the form of tax on the part of the government to ensure adequate investment in the sector. Despite government making these generous concessions, the impact of the tax incentives are not clear. The assumption that making such concessions would attract FDI has not been conclusively proven. Flows of FDI have been inadequate and erratic even at the period when the most generous incentives were offered (CUTs, 2003). Even in the mining industry, where most of these concessions have been applied, investments have been unpredictable and below expected levels (FIAS, 2004).

Increased investments in the mining sector seem to respond to the price or projected price of copper on the world market. For instance, investments in the mining industry in Zambia only showed significant improvement after the 2004 rise in copper prices. The unprecedented soaring of copper prices on the world market in 2006 made the mining sector the most lucrative industry in Zambia. Although the high prices of copper have meant more profit for the mining companies, the people of Zambia have little or no benefit from these increased revenues. Concessions offered by the government to the mining companies in the development agreements make it difficult for the government to receive a reasonable share from the mineral resources. It is in this context that the government seeks to renegotiate the current development agreements and introduce a tax regime that would ensure that government gets its rightful share from the mining sector.

Since the development agreements are still binding, revision of these contracts requires the two parties to enter into bargaining. What the government would get out of the re-bargaining process depends on the number of factors including its long-term vision and plan for development, the ability to ensure that the negotiations are

done in the interest of the general public and not for the benefit of a few individuals. While there is currently a lot of support for government to review these contracts, it remains to be seen if government has the capacity, experience, skill and power to renegotiate these agreements so that the resources from the minerals can be used for national development. Renegotiation of the development agreements does not necessarily mean that the outcome will be in the interest of the public as often assumed. Much depends on the government's commitment to the general welfare of the people.

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Endnotes

1 Figures from the July Monthly issued by the *Central Statistics Office* suggest that copper contributed 75.8% of total export earnings (2007, 6)

2 Copper production declined from over 700 000 tonnes per year in 1970s to just over 300 000 tonnes per year in 1995 (Ministry of Mines and Mineral Development, 1998:5).

3 Mining contracts became accessible to the Zambian public through an independent website: (www.minewatchzambia.com). Even at this website, not all the contracts are published.

4 The stability period has been defined in the contracts as the period in which the contracts are binding on the parties involved.

5 These were a series of reforms that saw the government acquiring 51% or the controlling interest in the major industrial and mining enterprises. The reforms were announced by the president during his Matero speech in 1969 (See "Towards Complete Independence" by Kenneth Kaunda, 1969).

6 The standard royalty tax for resources such as mineral, according to the IMF Report is between 5-10% (in Dymond, 2007). And the average corporate tax for SADC is about 45% (Robinson, 2005; Mwanawasa, "State of the Nation Speech," 2008)

7 METR stands for Marginal Effective Tax Rate which is the composite quantitative measure of the net effect of all taxes and incentives on an investment in a particular sector face if at that particular time.

8 By 1997, Zambia's external debt had reached over US$ 7 billion (twice the country's GDP).

9 See Cali and te Velde (2007) for a detail analysis of the impact of the copper price boom on non-traditional exports.