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The rise and fall of the mining royalty regime in Zambia

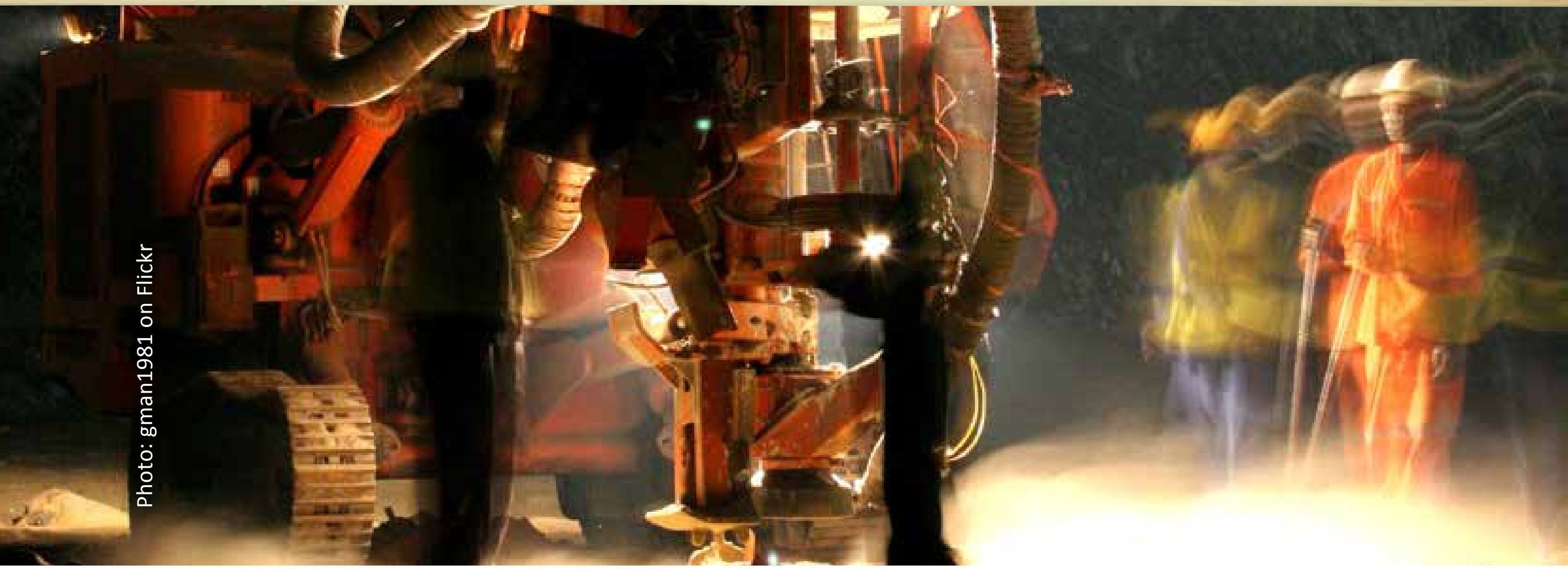

Photo: gman1981 on Flickr

Zambia has a long history of disputed changes of the mining tax regime with damaging effects on the working relations between the Government and the mining sector. A shared assumption has been that profit-related taxes such as the corporate income tax (CIT) should be a main component of the mining tax regime. In the 2014/15 Budget, the Government abolished the CIT and instead increased the royalty rates substantially. A few months later the new tax regime was reversed, the CIT was reintroduced and royalty rates reduced. In this Brief we examine these dramatic changes in mining taxation. We argue that a more constructive public-private dialogue is essential to ensure a sustainable tax framework and taxpayers' trust in the tax system.

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The volatility of the Zambian mining tax regime

Since the 2006 elections, mining taxation has become a central part of a polarised political debate in Zambia. There is a strong perception among many Zambians, media and civil society organisations that international mining companies deprive them of their wealth and that the Government´s distribution of wealth is unjust. These sentiments create political mobilisation and election campaigns that depict the government elites as compromised by the mining industry for personal gain. During the period 1991-2011, the Movement for Multiparty Democracy (MMD) was the ruling party. It became increasingly unpopular in the mineral-rich Cobberbelt. The main opposition party Patriotic Front (PF) capitalised on this and lost the 2006 elections to MMD with only a narrow margin. PF's campaign, that in addition to its pro-poor rhetoric's, focused on reducing personal taxes and increasing mining taxes, won the support of urban workers who considered the MMD to have sold out the country to multinational companies. After the election, MMD changed the mining tax regime in the 2008 budget. Corporate income tax was increased from 25% to 30%, mining royalty increased from 0.6% to 3% of gross sales value, and a windfall tax was to be triggered at different price levels for different base metals. In 2012, the royalty rate was further increased to 6%.

Abolishing corporate income tax

In November 2012, the Deputy Minister of Finance stated that 'Zambia loses between USD 1.5-2 billion every year due to tax evasion and avoidance, mainly in the mining sector'. The mining industry disputed this claiming that Zambia received a reasonable level of tax revenue from the sector. These positions reflect a deep-rooted distrust between the Government and the mining companies, also echoed in key informant interviews that the authors of this brief carried out with government officials, mining companies, tax practitioners and academics in 2015 (see also Conrad 2012; Fraser and Lamer 2011). The lack of trust creates an unsustainable situation as the country´s mineral resources are being depleted, and must be seen in relation to the poorly implemented privatisation of the Zambian mines.

Extractive industries are a key part of Zambia's economy and government revenue (2012/13):

- Zambia is the 8th largest producer of copper in the world
- 9th largest producer of cobalt
- The mining sector contributes 9% of GDP
- Indirectly, the mining sector may contribute as much as 50% of GDP
- 67% of export earnings
- 33% of total government revenue (direct and indirect taxes, royalties etc)

Source: https://eiti.org/Zambia

The state-owned mining company, Zambia Consolidated Copper Mines (ZCCM), was privatised in the late 1990s. The 1995 Privatization Act permitted the government to enter into Development Agreements (DAs) with specific companies. Instead of a uniform tax regime, the DAs were unique with each company. The individual agreements allowed companies to carry forward losses for 15-20 years. The government agreed not to amend any of the individual tax agreements negotiated for a period up to 20 years. The individualised, secretive nature of the DAs meant that there were no meaningful consultations, open public discussions or disclosures of the terms (Conrad 2012). The inability of the government to earn revenues from the mines prompted national and transnational civil society organisations and opposition parties to pressure the government to renegotiate the agreements.

Profit-related taxes such as the CIT are supposed to deliver a significant share of the total government revenue from the resource production and export. However, as reflected in the figure below, royalty contributed with 21% of the total revenues from the mining sector in 2013, compared to only 16% for corporate income tax, which is less than the personal income taxes paid by the employees of the mining companies in the form of PAYE (17%). The largest revenue stream from extractives was from VAT on imports (27%). However, as exporters, much of the VAT paid will be refunded to the mining companies.

According to the Mineral Value Chain Monitoring Project Baseline Report (January 2015), only two mines, Kansanshi and Chibuluma, out of nine major cobber mines have consistently paid CIT in recent years. The others have reported losses or marginal profits. This illustrates, in the words of the Africa Progress Panel (2013: 65) that: "Resource-rich countries in Africa are highly vulnerable to aggressive tax planning and tax evasion facilitated by the extensive use of offshore companies, the high levels of intra-company trade and the commercial secrecy surrounding foreign investment activity. African governments lack the human, financial and technical resources needed to secure tax compliance, and the commercial market intelligence needed to assess company tax liabilities. As a result, they are losing significant revenue streams."

The administrative challenges of taxing profits in extractive industries and the relatively low revenue yield from CIT, led the Government to make the unprecedented step in 2014 to abolish CIT and increase the royalty rates substantially.

From a profit based tax system to a revenue based tax system

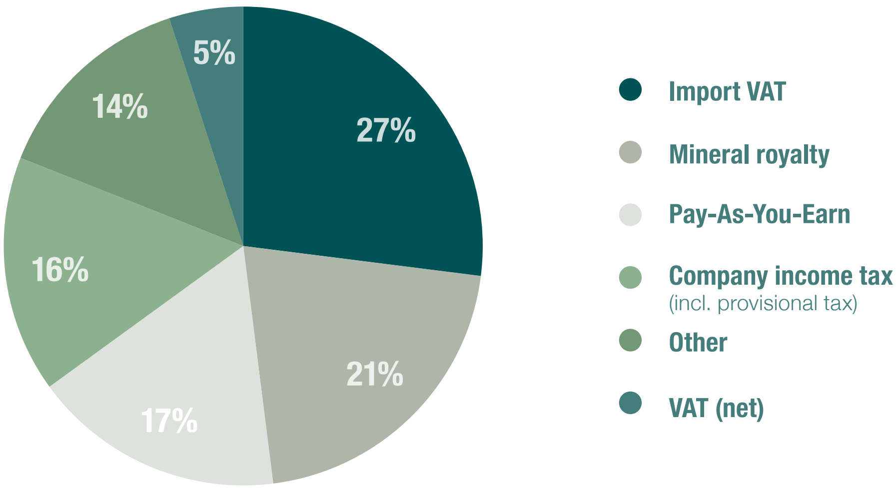
Royalties are, in principle, payments made to the government to compensate for the right to extract a non-renewable natural resource. Royalty, which is a well-established component in the mining tax regime in Zambia, was considered to have key administrative advantages relative to other taxes. In principle, the tax base is easier to observe, often based on a percentage of the value of the output (ad valorem), easier to administrate and, thus, less subject to tax avoidance pressures. Based on these rather simplistic assumptions, royalty was expected to imply more revenue stability and less volatility compared to taxes on profit.

In the October 2014 Budget Speech, the Minister of Finance announced that mineral royalties on the norm value of base metals produced, would increase from 6% to 20% on open cast mining and to 8% on underground mining. Ad valorem royalty rates for copper vary between countries, generally ranging between 0% and 8%. The new rate in Zambia for open mines was way above this range. The corporate income tax rate applicable on the mining operations with an exception of mineral processing, was revised from 30% to 0%. Variable profits tax of up to 15% when the taxable income exceeded 8% of gross sales, was abolished. These changes, effective from 1 January 2015, changed the mining tax regime from a profit based tax system to a revenue based tax system. The royalty regime aimed to close the loopholes companies had used to evade corporate income tax.

The fall of the royalty regime

Major tax reforms benefit from transparent and thorough consultations between the Government and taxpayers.

REVENUE STREAMS FROM MINING 2013



Experiences show that such consultations may help identify undesirable implications of drafted proposals and contribute to the legitimacy of the new tax regime. Consensus among key stakeholders is a prerequisite for a sustainable tax framework.

Interviews conducted by the research team with a large number of stakeholders in the private and public sectors in Lusaka during 2015, found that 'consultations' of any substance between the Government and the industry on the new mining tax legislation were largely missing or dysfunctional. Most were taken by surprise by the new royalty rates and only made aware of them when the Budget was announced by the Minister of Finance in October 2014. However, the Medium Term Expenditure Framework and Policies for the 2015 Budget (Ministry of Finance) from August 2014, provided some indications that a major mining tax reform was being prepared. In the budget projections for 2015-17 (Table, p. 36), revenues from CIT are zeroed, while a dramatic increase in royalties is projected. This information led the industry to start lobbying against the expected reform. But it was not until the budget was announced and the specific changes made public, that the mining sector mobilised against the new tax legislation. The new royalty regime coincided with a significant drop in the copper prices. When the new mining act was passed in Parliament in December 2014, the Canadian owned Barrick Gold Corporation, owner of the Lumwana open pit mine in Northwestern Province, issued a statement that the company would suspend its operations.

Media reports following President Michael Sata's death in late October 2014 indicate that the mining companies had already started to renegotiate the new tax regime. As expected, shortly after the elections, in April 2015, the Government announced it would revert to the previous corporate income tax structure and reduce the mineral royalty rate from 20% to 9% for open cast mines, and from 8% to 6% for underground mines. This change was enacted on 1 July 2015. Unsurprisingly, it was generally well received by both the industry and tax practitioners. Barrick-Gold's Lumwana mine resumed its operations. The 2016-17 Budget maintains the current enacted tax regime, which might reflect that no immediate further changes of the mining tax regime are being prepared.

The rise and fall of the royalty regime, follows a pattern in Zambia that once a new government is in place, one can almost be certain that mining interests come to the fore. Underlining the individualised negotiations and international business influence over State House, it was the President himself who announced the revocation of the mining act in 2015.

Recommendations for a more sustainable mining tax regime in Zambia

The choice of tax bases in extractive sectors varies between countries. For Zambia, it is important to secure stability, predictability and transparency in the mining tax regime. Experiences with the rise and fall of the mining tax regime provide some lessons for policymakers.

1. The tax regime should be predictable for investors. The erratic and frequent changes in the mining tax regime, especially since 2009, have damaged the credibility of the mining tax regime in Zambia, and have had negative impacts on trust relations between the Government and the industry. Stability does not imply that changes cannot be made, but these should be well prepared and based on consultations with key stakeholders.

2. Consensus among key stakeholders is a prerequisite for a sustainable tax regime. The absence of real and substantive consultations on major tax reforms have contributed to undermine trust between the industry and the Government.

3. There is a need to establish clear, unambiguous rules with few exemptions and equal treatment of companies. The original Mining Developing Agreements in Zambia were damaging in this respect, establishing different tax regimes for individual mining companies.

4. The tax system should be simple to understand and implement for both tax administrators and taxpayers. The royalty regime proved to be difficult to administrate since it implied different royalty rates between open and underground mines. The royalty rates did not take

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into consideration that some deep shafts produce high-grade minerals, which can be extracted at relatively low costs, while some open pits produce low-grade minerals, which are relatively costly to extract. For some mines, it was also difficult to assess what share of the extracted minerals came from open and deep shafts, respectively.

5. Zambia should revamp its mineral revenue model and move towards a national modelling team anchoring transfer pricing, costs and pricing monitoring, and audits into this. This may help develop better mechanisms for information and data sharing between key public finance management agencies, and, thus, contribute to develop more reliable data for revenue projections and tax policy design.

The 'best' way to tax natural resources

Revenues from extractive resources are volatile. This is something Zambia has experienced many times. As a series of short lived and varied attempts at changing the mining tax system since the privatisation in the late 1990s have shown, diversifying public finances by broadening the tax base is important for budget stability. In this perspective, a broad-based tax system that includes the majority of enterprises and citizens is essential for accountable state-citizen relations. A 'good' natural resource tax regime is one that does not undermine - or strangle - the development of the ordinary tax system. The tax debate in Zambia is mainly about mining. There is a need for a broader approach to tax reform. One needs to think holistic about the tax system, since the different segments of it interfere with each other; the way extractive sectors are taxed, including exemptions, tax holidays, abusive tax avoidance, impacts on other taxpayers' behaviour, etc. If the most resourceful taxpayers do not contribute with tax revenue through exemptions and other measures, this will affect the tax behaviour of other taxpayers, including domestic companies. Building a robust tax regime in Zambia is not only about administrative capacity. It is largely about politics and building accountable state-citizen relations. To achieve this, will require strong and sustained citizen engagement around taxation.

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