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Taxing Challenges II:

A Studied Approach to Minerals Taxation Regimes

The Challenge of Mineral Wealth:
using resource endowments to foster sustainable development

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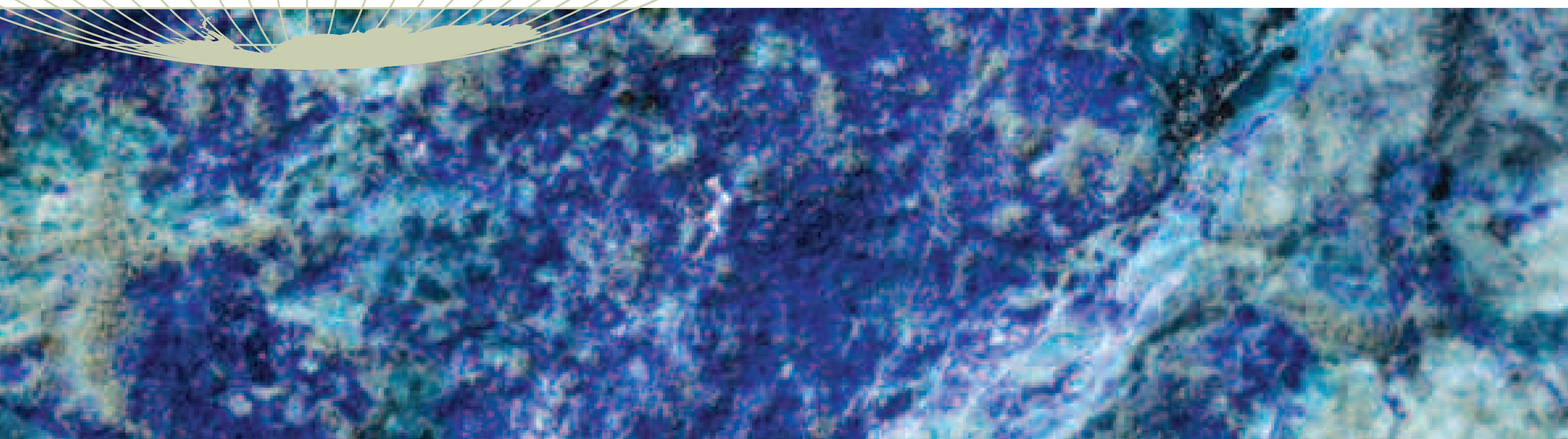

Taxing Challenges II:

A Studied Approach to Minerals Taxation Regimes

Governments and mining companies often disagree over how the former should tax the latter. An in-depth review of the design of mineral taxation regimes commissioned by ICMM highlights significant room for consensus in this area – particularly if both sides support processes for building balance into tax systems over the long-term.

Mineral taxation has become the subject of intense debate in recent years as higher commodity prices have encouraged governments to examine ways to capture a greater share of the 'resource rents' and the profits earned by mining companies.

Some argue that many developing countries in the past agreed to overly generous fiscal terms, and are now justified in increasing taxation as a source of revenue. Rising commodity prices have added to the perception that some countries have not been getting a fair deal. Both Chile and Tanzania, for example, have recently discussed or introduced higher mineral taxes. On the other hand, others caution that if the fiscal burden is set too high, it risks damaging developing countries' long-term interests by deterring mining investment and stifling growth of the industry.

Without doubt, designing a minerals taxation regime means striking a difficult balance between multiple objectives. But in many countries the public debate in this area has focused on apparent conflicts between the interests of companies and governments, and on the controversies these conflicts have sparked. More heat than light has often been generated as a result.

The forthcoming review of minerals taxation regimes[1] – whose main findings are highlighted in this Spotlight note – seeks to adopt a more nuanced, academic approach, objectively surveying the evidence as to how such regimes are, and could be, designed. Across its numerous findings, one theme is striking: that there is significant room for agreement between companies and governments, particularly if both sides support processes for building balance into tax systems over the long-term. Above all, both parties have an interest in the development of tax regimes which are widely perceived to be legitimate: governments for reasons of the public good and to demonstrate to their constituents that they are properly managing the country's resources; and companies for the reason that such regimes are more likely to be stable and predictable.

To set some context, this review forms an element of ICMM's Resource Endowment initiative, a broader initiative examining ways of enhancing the socio-economic impacts of mining (see Spotlight series 01-05 for an overview). How tax regimes are designed is clearly one of the factors influencing whether, and to what extent, mineral revenues help drive economic development and poverty reduction (a key objective for the Commonwealth Secretariat, the co-publisher of this new review).

The catalyst for this particular review within the Resource Endowment initiative was that a multi-stakeholder consultation held in Washington in June 2006 highlighted a gap in the initiative's research on the issue of tax. A preliminary Spotlight note (no. 10) entitled 'Taxing Challenges' was then published in 2007, prior to the full review, given the intensifying external interest in the topic. The basic argument of this Spotlight note was that while tax regimes are an important determinant of mining investment, development outcomes from mining are driven by a broader set of factors than tax levels alone (not least how governments choose to spend the mineral revenues they raise). The full review in turn starts from this premise – that tax regimes need to be evaluated in the context of these broader factors – but focuses on the detail of the design of such regimes.

Importantly, as with other research within the Resource Endowment initiative, the tax review was designed to ensure its rigor and balance: as well as being commissioned from respected external consultants, guidance was provided by an advisory group of leading international tax experts including from academia and international institutions. ICMM member companies also provided input into the study, giving their perspectives on the issues raised and commenting on draft versions. The findings from the review are also now being fed into other strands of the Resource Endowment initiative: in particular an addendum on tax issues has been developed for ICMM's Resource Endowment Toolkit, a practical framework designed to help evaluate the outcomes of mining investments.

Understanding regime change

The review firstly explores a number of basic themes highlighted by a survey of current and existing thinking on tax regimes and then sets out five clusters of 'observations' or policy suggestions for companies, governments and other stakeholders.

Elaborating on these basic themes, the review points to the plethora of mining taxation instruments currently used by governments. These include both income and profit related taxes such as corporate income tax, and also taxes on production inputs and services, such as import duties. Academic literature suggests that in general, taxes should be based on profits, not production or sales: although the latter form of taxation may be easier and quicker to collect, it tends to be regressive (that is, when income rises the share of government take decreases).

Some argue however that tax instruments such as royalties have a role to play in insuring that countries receive a minimum revenue flow from mining activities. In some years of mining extraction it has happened that production and value-based royalties were the only significant revenue that countries have received. But it is generally agreed that such regressive instruments should be used with care and that the overall fiscal regime should remain progressive (that is, when income rises the proportionate share of the government take also rises, but when income falls the share that companies can retain increases).

[1] The full review will be published jointly with the Commonwealth Secretariat.

Hence, the cumulative effect of the tax system - that is, of the combination of different instruments applied - needs to be assessed in this light. Again academic literature indicates that the tax system overall should be neutral with respect to its impact on investment decisions, and progressive. However, most extractive industry fiscal regimes are not progressive and many are mildly regressive. This makes them potentially inflexible to accommodate changes in global circumstances.

The flexibility of tax regimes is in fact one of the other main themes highlighted by the review. During the mid 1980s and 1990s, a time of low global commodity prices, governments were often encouraged to design their tax regimes with a strong focus on maximizing their attractiveness to international investors, sometimes at the expense of building in some form of progression. Such potentially inflexible fiscal regimes may have perversely heightened the risks faced by mining companies in some countries as they strengthened the incentive of host governments to revise significantly fiscal terms at a later stage as conditions changed. In particular as commodity prices have risen, a number of governments have opted to rewrite tax rules in order to capture more revenues from the mining firms. An unfortunate development is that some of these adjustments have in turn involved adding more regressive tax instruments, rather than increasing flexibility.

The potential for unintended consequences is also noted in the review's examination of different types of fiscal regime. A distinction is drawn between tax legislation which covers the mining sector as a whole (a common approach in developed countries) and project-specific agreements negotiated between the state and private companies (which are found in many developing countries). The latter approach may have provided governments with the flexibility to take into account specific contexts at the time of negotiation. But the review argues that this approach may have weakened the development of institutional checks and balances in the host countries.

For example, where agreements are negotiated in private, governments often make it clear that they do not want the terms of the contracts made public in order to maintain negotiating power with other companies. But this can create opportunities for (what might be politely described as) discretionary use of revenue, and also preclude both parties from engaging in transparency initiatives. The administrative complexity associated with negotiated agreements can pose an additional challenge for already capacity-constrained governments.

Moreover, the frequent inclusion of clauses in such agreements to lock in fiscal conditions to safeguard companies from future legislative changes, particularly in countries where such political risks are perceived to be high, has not always worked as intended. New governments have sometimes justified their demand for renegotiation of fiscal terms precisely by questioning the legitimacy of the terms granted by their predecessors. In this way, stability agreements do not always guarantee fiscal stability and sometimes may backfire.

The issue of how best to collect and allocate taxes across different tiers of government within a country – another theme highlighted by the review – is equally fraught with complexity. Many developing countries have been undergoing decentralization processes. The review highlights two distinct potential features of a minerals tax regime in this respect: fiscal decentralization, in which regional or local governments are given greater powers to levy taxes from companies; and revenue sharing, in which the central government directs a proportion of federally-raised revenues back to such sub-national governments in mining regions.

Countries have adopted a variety of different models in this area, but the review emphasizes that no approach works in all circumstances, and none is without risk. For example, revenue sharing often only generates significant welfare benefits for mining regions if additional revenue flows are matched by improved governance and administrative capacity on the part of regional governments (this parallels findings of other research in the Resource Endowment initiative). Likewise, fiscal decentralization may usefully help empower regional governments, but it carries with it the risk of exposing such governments to excessive volatility from mineral revenues (central governments will likely have more diverse sources of tax income).

Importantly, interviews with tax representatives of ICMM member companies undertaken as part of the review indicate that major mining companies are increasingly aware of the complexities and the need for a balanced approach across all these themes. Companies attach importance not only to tax rates and tax bases, the review finds, but increasingly to other aspects of tax regimes, including fiscal stability and political risks, the simplicity and consistency of a regime, tax administration, transparency, the capacity of government to spend mineral tax revenues effectively, and accounting conventions.

In fact, companies highlight the stability and predictability of a tax regime as its most important feature. It is often now well understood that, as noted previously, governments that provide generous tax incentives to attract investment, or negotiate special terms bilaterally, often feel that they have to revisit fiscal terms at a later stage. Many companies say they would prefer to operate in a country where the fiscal regime is broadly considered 'balanced', and therefore more likely to be stable, rather than in one where tax rates are minimal.

Companies (as well as local communities and non-governmental organizations) are also attaching growing importance to the capacity of government to use revenues effectively, as well as to revenue transparency. There is enlightened self interest at work here: both of these factors affect the way in which companies are perceived by the citizens of host countries and regions in which they operate and they influence whether the revenues raised from their investments lead to broad based economic development and poverty reduction or not. Although creating an appropriate fiscal regime is essential, it must also be underpinned by effective governance arrangements, including for revenue collection and allocation and for budget and policy implementation.

This document is one of a series of publications produced by ICMM under its Resource Endowment initiative, which aims to better understand how large scale mining activity in low and middle income countries impacts the socio-economic development of host countries. This action-research project is being done together with UNCTAD and the World Bank Group, with broad stakeholder engagement. This Spotlight, together with the forthcoming report on minerals taxation regimes, is being published in collaboration with the Commonwealth Secretariat. For the latest information on the Resource Endowment initiative, including details of publications, activities and partners, visit www.icmm.com/resource-endowment

The International Council on Mining and Metals (ICMM) is the industry's peak CEO-led organization. It comprises the leading international mining and metals companies as well as regional, national and commodity associations. ICMM's vision is a respected mining and metals industry that is widely recognized as essential for society and as a key contributor to sustainable development.

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Summary observations

While the review is not intended to set out a recommended tax regime, let alone an ideal rate, five clusters of 'observations' flow naturally from the themes above.

First, the review suggests that governments design tax regimes whose overall effect is neutral and progressive, and which maximize revenues from mining over the long-term (this means creating incentives for sustained investment in the sector and potentially adopting a thirty to fifty year timescale). Recognizing that such objectives may not always be easy to achieve in practice, the review suggests mechanisms be established for periodic and collaborative re-assessment. The idea here is to build flexibility into the system so that popular and political support for tax regimes remains in place over time.

Second, the review suggests that the complexity of mineral tax regimes in lower-income countries should be minimized. Simplicity would make it easier for governments to calculate and audit tax payments. The governments of many low-income countries lack administrative capacity, so reducing the burden they face in this respect is important. Nonetheless, the review suggests a preference should be maintained for income or profit-based taxes so that countries' overall tax system is progressive but also neutral with respect to investment decisions.

Third, on the theme of different types of fiscal regime, the review inclines against project-specific agreements or other such special arrangements. As well as creating potential administrative overload in countries lacking such capacity, such agreements as noted can pose risks to the stability of tax regimes if the government or other stakeholders eventually become dissatisfied with the revenue and development outcome.

Fourth, on the issue of the collection and allocation of taxes across different tiers of government, the review cautions against the search for simple solutions in this area. This issue has recently attracted increased attention in many countries, but as mentioned previously, the evidence that either fiscal decentralization or revenue sharing with sub-national governments in and of themselves enhance the development impacts of mining is inconclusive. A variety of other factors need to be taken into account if sensible policy decisions are to be made in this area.

Fifth, and finally, the review makes a strong case for greater transparency concerning the taxation of mining, the spending of mining revenue, and also the underlying fiscal terms of mining agreements. Transparency is widely acknowledged to be a necessary pre-condition for sound fiscal management and socio-economic development. From the perspective of the companies interviewed, it is also vital to ensuring that citizens are made aware of mining's tax contribution and the benefits derived from it, and also supportive of agreements struck with governments. Transparency alone may not be sufficient of course – it cannot by itself, for example, foster consensus on the how revenues are allocated nor ensure these are spent effectively. But the paper suggests that companies and governments support core transparency efforts such as the Extractive Industries Transparency Initiative (EITI) as an important step towards these longer term goals.

Across all five observations, importantly, the review highlights numerous points on which governments and companies would be likely to agree, at least in principle. Also comments on the review by the advisory group of international taxation experts – while setting out some differences of view – were broadly positive, variously describing the paper as 'thoughtful' and 'sophisticated'.

In particular, on the central issue of the need for tax regimes to be designed so that they are considered balanced and thereby are protected from instability and unpredictability, there is surely considerable room for cooperative dialogue between companies and governments – particularly if both sides support the development of processes which will help ensure or restore this balance over the long-term. In this way, the review may just help generate some light amid the heat of the political debates currently raging on mineral taxation in many countries.

About the co-publishers of this Spotlight

The Special Advisory Services Division (SASD) is part of the Commonwealth Secretariat, which was established in 1965 as the main intergovernmental agency of the Commonwealth of Nations. Through its Economic & Legal Section, SASD provides technical assistance that focuses on reform of regulatory environments in Commonwealth countries to encourage increased investment and private sector development. In the area of natural resources, the services delivered focus on the diagnosis of barriers to investment and in identifying and developing suitable legislative, institutional and fiscal frameworks based on international best practices.

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The responsibility for the contents of this Spotlight note lies with the main authors.