



Tax Regimes on Mining in Latin America

Two fundamental issues underlie mining tax regimes in developing countries. One is that mining targets finite non-renewable resources and therefore taxation has the exceptional role of compensating for the de-capitalization a country endures when those resources are extracted and sold, in most cases, abroad. Additionally, large scale mining often permanently damages the environment, a fact that also requires compensation.

The second underlying issue is that the firms extracting the minerals or metals are most often foreign-owned. The difference between foreign tax payers and national tax beneficiaries – voting citizens of a mine-hosting country - elevates the risk of conflict since foreigners are inherently likely to see no direct benefit in paying taxes (except to avoid expropriation) and consequently seek to minimize them. Meanwhile, voting citizens naturally seek to get their governments to obtain the maximum amount of taxes as that translates into better services, larger public investments and income transfers to compensate for the exported non-renewable resources and the lasting environmental costs. This situation is further aggravated by the fact that in this industry the tax payers are very few in number, normally a handful of foreign firms or even just a couple, while the tax beneficiaries are much more numerous.

With these considerations in mind, the following details the two main types of tax instruments applied to the mining industry in Latin American countries: royalties and corporate income tax. It traces the current regimes from their origin in the 1980s and 1990s and discusses some of their recent updates.

Royalties

Royalties are the most common type of tribute applied to the mining industry. They are technically “rents” and not taxes, as they consist of a firm paying a government for the right to extract state-owned non-renewable natural resources. Royalties are the backbone of tax regimes on mining from the point of view of revenue generation for host-countries around the world.

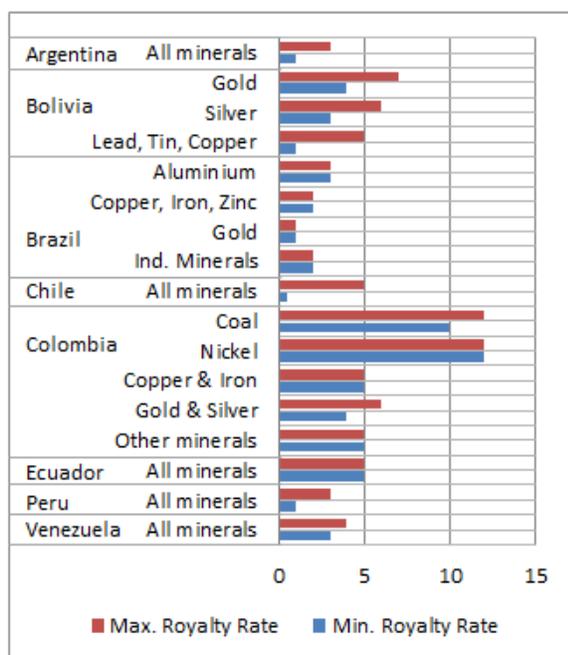
In most of Latin America, the rates at which royalties are applied to the mining industry were significantly lowered during the 1980s and 1990s with the establishment of new mining codes. In most countries, royalties went from 10-15% of revenues to 1-5% or less, sometimes being applied to profits rather than revenues.

This policy brief examines types of taxes applied to large-scale mining in Latin America, the region where Canadian firms are most active around the world, and elaborates on their positive and negative effects on host-countries, their governments and foreign investors.

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Royalty Rates in Selected Latin American Countries (2013)



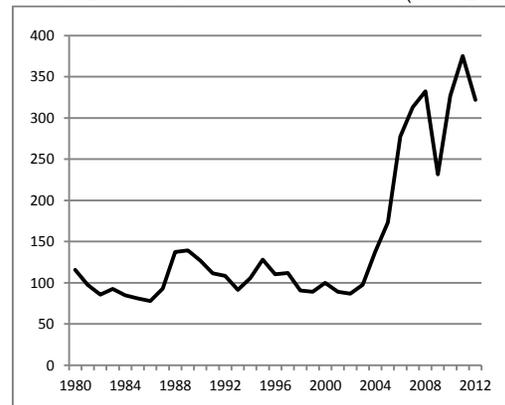
Source: Summarized by author based on national legislation.

The drastic reduction in rates was done during the peak of the Washington Consensus period, when governments held a widespread view that developing countries should reduce taxes on firms in order to attract foreign direct investment. The World Bank (WB) and the International Monetary Fund (IMF) advised lowering mining royalties often as part of structural adjustment programmes that also included the rapid sale of state mining properties and firms in Mexico, Brazil, Peru and Argentina.

When these policies were being implemented, international mining prices were depressed. Gold and silver were approximately US\$ 300 and US\$ 5 per ounce during the 1990s, compared to US\$ 1,670 and US\$ 32 in 2012. Thus, mining was not expected to be a significant source of fiscal revenues but viewed more as an instrument to diversify types of foreign investment received and to attain more geographically balanced patterns of growth.

The persistence of low international mining prices during the 1990s convinced Latin American countries that higher royalties would make many mines in operation unprofitable and likely to close. High rates in royalties can lead mining companies to only exploit the best veins, thereby shortening the potential life of mining projects. Shortened and often abrupt termination of mining projects increases instability in local economies. Thus, leading mining nations such as Chile and Peru accepted the WB-IMF recommendation to apply royalties or other taxes to profits instead of revenues.

UNCTAD Mineral and Metals Price Index (1980-2013)



Source: UNCTAD Statistics (<http://unctadstat.unctad.org/>)
Price Year 2000 = 100

When, after 2003, mineral prices rose by over 300%, large-scale mines became extremely profitable and foreign direct investment in Latin American mining grew exponentially. For example, there were two Canadian-owned mines in the mid-1990s and by 2012, there were 86. Revenues grew from less than US\$ 100 million to US\$ 19 billion annually.

By contrast, tax revenues for the host countries have remained at much lower levels. The asymmetry between the gains for mining companies and those of governments is a persistent source of conflict between local groups, national governments and multinational corporations.

A partial solution could be variable royalty rates, which are already employed to some extent in Peru and Chile. However, to date, rate variation has not been able to guarantee an increase in state revenues proportional to the increased profitability of mines when prices climb.

Regardless of their incomplete application, royalty rates also have other significant influences on natural resources-based development. If rates are fixed at a high level, there may be fewer mines in a given country or region, and aggregate environmental impacts would be reduced. As such, conservation circles support the application of higher royalty rates for nations where mining competes with other economic activities for land and water, or where it has particularly high environmental costs.

In terms of firm structure in the mining industry, royalties are a “regressive” tax in that large-scale, highly efficient (most often, foreign) firms can better afford to pay it than small-scale (local or national) miners. The higher the royalty rate, the more efficient and capital intensive a mine will have to be in order to be economical. Evidence of this is found already in Brazil, Colombia, Mexico and Peru, where mining production has become increasingly concentrated in the largest foreign firms. Since 2008, the policy response to this phenomenon has been to apply different rates according to the scale of production.

An important fiscal consideration is that, compared to other revenues, royalties are much easier to collect, requiring on-the-ground or border inspections rather than sophisticated financial audits. Therefore, collection of royalties has frequently been decentralized to the smaller, less capable bureaucracies of the subnational or provincial

governments, who have the added advantage of direct territorial control of mining sites.

Royalty revenues are also easier to forecast because fewer factors are involved in their calculation compared to corporate income tax, for example. On these grounds, the WB and IMF often recommend that revenues from royalties be earmarked for long term projects such as education or physical infrastructure.

Corporate Income Tax

In Latin America, mining is subject to corporate income tax (CIT), where profits are considered to be corporate income. International development advisers have long suggested that CIT become the main mechanism to collect revenues from natural resources since, unlike royalties, it does not selectively apply to extractives over other industries. CIT is also progressive in the sense that larger, more profitable firms pay more than smaller firms. In most countries in Latin America, CIT is applied at rates that vary from 18.5% in the case of Chile, to over 30% in Argentina, Brazil and most other countries.

In comparison with royalties, CIT has the fiscal advantage that as the profits of a mining company increase, so do the government's revenues. However, the CIT is also very procyclical, as profits often depend in the short-term on international mining commodity prices. This is a significant problem since government expenditures are needed more in times of economic downturns than when going through economic booms. For the same reason, CIT revenue is not suitable for long-term developmental goals.

Developing countries that are fiscally dependent on the mining industry need to have mechanisms to save revenues to offset that cyclical nature of CIT. These countries, without adequate institutions to save income

from boom periods to be used in crises times, can reduce their vulnerability to international price changes by assessing higher royalties on revenues and thus, depending less on CIT.

Another well-known weakness of CIT is that, compared to royalties or most other types of taxes (such as property or personal income) it is much harder for developing countries to collect. Large multinational firms can afford sophisticated legal and accounting services that reduce their tax burden by exaggerating costs and artificially reducing taxable profits, and through the use of transfer pricing, off-shore subsidiaries and fake licencing.

Tax regimes for mining in Latin America also include a series of credits that can be used to reduce what is to be paid for CIT. These are depreciation credits to account for the value of the reserves extracted, and the machinery and buildings used in the process of extraction and refining.

The amount of credit offered for depreciation varies from country to country, with most of them allowing for systematic reductions in taxable profits for 4 to 10 years, and permitting reductions of taxes from 30-100%. Additionally, the import duty paid on machinery and production inputs is deductible. Considering that modern large-scale mining is a capital intensive industry with substantial investments in imported machinery and spare parts, this deduction can be large.

The aggregate fiscal effect is that while the nominal rate for CIT for a 20-year mining project is usually between 18.5% and 35% of profits, the effective paid rate is often only 10-15%. These credit clauses were envisioned in the 1990s as a way to create incentives to install expensive cutting-edge technology as a way to modernize the industry. Their application, however, in a context of high international prices in the 2000s, has meant

that companies get most of these tax discounts for mining expensive minerals and metals and much less so for the technology they brought with their investment.

Increasing the Developmental Impact of Mining

To improve tax regimes in countries with significant mining industries, principles such as flexibility and progressiveness to maximize long term tax revenues and reduce concentration in the mining sector should be observed.

In other countries where mining is a less significant part of the economy or where there are higher levels of controversy and detrimental environmental impacts, taxation should focus on maximizing the short-term tax income and not the expansion of the mining industry there. This approach will also reduce new mines to a more manageable number.

In both types of host nations, the complexity of tax systems should be minimized for countries or sub-national governments with less administrative capacity to guard against tax evasion. Lastly, transparency is paramount to guarantee for citizens, corporations, and government officials the possibility of having informed discussions.

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