Mineral Taxation in India

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Organization of talk

- Motivation
- Some reflections on mineral taxation in general
- A review of India’s mineral sector and its taxation
- Current reforms and way forward
Motivation
Motivation

- **Current Issue:** States feel that they are not being adequately compensated
  - Rising mineral prices do not get reflected in their receipts
    - Assuming 7.5% ad valorem for all iron ore, royalties would have been 6-8 times their realized levels (Hoda committee report)
  - States not in a position to remedy the situation
  - Most mineral rich states are among the poorest

- **Emerging issue I:** Shortfall in mining investment is hurting infrastructure; Greater private investment required
  - Geology and tax regime are important factors in investment decisions
  - High tax burdens will make mineral products globally uncompetitive

- **Emerging issue II:** Growing public concern with environmental degradation due to mineral extraction
  - Use of environmental resources can be with or without spillover effects
  - Mineral taxation impacts rates of extraction and depletion dates
Implicit Price Index for Minerals has Risen Sharply in Recent Years

(1960-61 = 100)
Comparison between Implicit Mineral Price Index & General Price Index

(1994-95 = 100)

- Mineral Price Index
- General Price Index
Investment in Mining at 1999-2000 prices; (Rs Crore)

Years

Series 1
Share of Private Sector in Mining is Lower than in Overall
Rising Need for Power Investment Mean That Coal Production and Investment Must Accelerate

- Coal production has increased @ 3% over the last 10 years
- @ 5.3% in the last 3 years
- Expected to increase @ 9.6% during Eleventh Plan.
Percent of Surveyed Mining Companies That Consider Mining Taxation Regime a Deterrent

Source: Fraser Institute Survey 2005/06
Some reflections on mineral taxation in general
A separate fiscal regime is justified because scarce exhaustible resource (like minerals) generate economic rent when extracted
  - resource taxation to capture rent

Some Key questions

- How much to tax: Maximize immediate revenue or long-term revenue?
- What instruments: What instruments adjust for price cycles?
- Fiscal diversity or uniformity within the mining sector?
- Who should tax: Central Government or States?
Evaluating a tax system

- In analyzing mining taxes, it is essential to look at the complete system of all taxes.

- To assess overall tax impact, the following questions need to be kept in mind:
  - Is there adequate return to investors?
  - Is there adequate revenue for the Government?
  - Is the tax system globally competitive?
A Review of India’s Mineral Sector and its Taxation
## What is the sector worth?

### Value of Domestic Production from Mining and Quarrying

<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td><strong>Value of Output</strong></td>
<td>53,016</td>
<td>76,269</td>
<td>134,638</td>
</tr>
<tr>
<td><strong>Major Minerals</strong></td>
<td>49,151</td>
<td>64,546</td>
<td>119,487</td>
</tr>
<tr>
<td><strong>Fuel Minerals</strong></td>
<td>43,306</td>
<td>54,935</td>
<td>100,598</td>
</tr>
<tr>
<td><strong>Coal</strong></td>
<td>24,485</td>
<td>34,098</td>
<td>44,147</td>
</tr>
<tr>
<td><strong>Metallic Minerals</strong></td>
<td>3,691</td>
<td>6,683</td>
<td>15,229</td>
</tr>
<tr>
<td><strong>Iron Ore</strong></td>
<td>1,924</td>
<td>3,851</td>
<td>11,646</td>
</tr>
<tr>
<td><strong>Non-metallic Minerals</strong></td>
<td>2,155</td>
<td>2,928</td>
<td>3,660</td>
</tr>
<tr>
<td><strong>Minor Minerals</strong></td>
<td>3,864</td>
<td>11,723</td>
<td>15,151</td>
</tr>
<tr>
<td><strong>less: Inputs</strong></td>
<td>11,172</td>
<td>17,316</td>
<td>32,117</td>
</tr>
<tr>
<td><strong>less: FISIM</strong></td>
<td>250</td>
<td>659</td>
<td>705</td>
</tr>
<tr>
<td><strong>GDP from Mining</strong></td>
<td>41,594</td>
<td>58,294</td>
<td>101,816</td>
</tr>
<tr>
<td><strong>Total GDP</strong></td>
<td>1,952,035</td>
<td>3,117,371</td>
<td>4,145,810</td>
</tr>
<tr>
<td><strong>Share of Mining in GDP</strong></td>
<td>2.13 %</td>
<td>1.87 %</td>
<td>2.45 %</td>
</tr>
</tbody>
</table>

*Source: CSO*
Revenue from Mining Sector

- **Producing States’ revenue**
  - Royalty (State as owner of minerals; constitutes bulk)
  - Dead rent (area-based; to discourage operators to keep properties idle)
  - Initial application fee, annual fee payable, surface rent, sales tax, VAT, local area tax (Panchayat Tax) and stamp duty (meagre amount)
  - Orissa and WB have imposed cess and surcharge on minerals in the belief that they have taxation powers under entries 49 and 50 of List II of 7th Schedule

- **Pooled taxes (Center plus states, including non-producing states)**
  - Corporate tax on mineral companies
  - Excise duties
  - Customs duties
## Significance of Royalty in State Finances (2004-05)

<table>
<thead>
<tr>
<th>State</th>
<th>Royalty (all mining) as % of</th>
<th>Royalty (coal mining) as % of</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total revenue</td>
<td>Own revenue</td>
</tr>
<tr>
<td>Chhatisgarh</td>
<td>9.6</td>
<td>15.5</td>
</tr>
<tr>
<td>Jharkhand</td>
<td>12.5</td>
<td>25.2</td>
</tr>
<tr>
<td>Orissa</td>
<td>5.6</td>
<td>12.0</td>
</tr>
<tr>
<td>Madhya Pradesh</td>
<td>3.7</td>
<td>6.0</td>
</tr>
<tr>
<td>Rajasthan</td>
<td>3.3</td>
<td>5.6</td>
</tr>
<tr>
<td>Karnataka</td>
<td>0.8</td>
<td>1.0</td>
</tr>
</tbody>
</table>
Current Royalty Regime in India

- Major minerals: GoI fixes, but are collected and retained by states
  - Tax system is uniform across states
  - Changes in rates allowed once in 3 years (stability)
  - Regime moving progressively towards ad valorem
    - Still, 22 out of 51 attract specific rates, incl important ones like coal; grade-wise rates for 6 (removes distortion)
    - Ad valorem incidence of specific rates vary from 1-2% for iron ore to 25-35% in case of limestone
    - Balance 39 items, rates vary from 1% (mg concentrate to 20% (gypsum)
    - Base & precious metals: fixed % of metal content value based on LME price

- Minor minerals: States have powers to fix and collect
## Coal royalty over the years

(Rs. per tonne)  
(w.e.f.)

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<tbody>
<tr>
<td>Group-I Coking Coal SG-I,II WG-I</td>
<td>7.00</td>
<td>150.00</td>
<td>195.00</td>
<td>250.00</td>
<td>=180+(0.05)P</td>
</tr>
<tr>
<td>Group-II Coking Coal WG-II,III Non-coking A,B</td>
<td>6.50</td>
<td>120.00</td>
<td>135.00</td>
<td>165.00</td>
<td>=130+(0.05)P</td>
</tr>
<tr>
<td>Group-III Coking Coal WG-IV, Non-coking-C</td>
<td>5.50</td>
<td>75.00</td>
<td>95.00</td>
<td>115.00</td>
<td>=90+(0.05)P</td>
</tr>
<tr>
<td>Group IV Non-coking D,E</td>
<td>4.50</td>
<td>45.00</td>
<td>70.00</td>
<td>85.00</td>
<td>=70+(0.05)P</td>
</tr>
<tr>
<td>Group-V Non-coking F,G</td>
<td>2.50</td>
<td>25.00</td>
<td>50.00</td>
<td>65.00</td>
<td>=55+(0.05)P</td>
</tr>
</tbody>
</table>

Note: Where P is mean basic pithead price of run-of-mine coal and lignite as reflected in the invoice, excluding taxes, levies etc.
An Illustration of States’ Grievance: Royalty on coal (as % of price) declines after every revision

Source: Dr. Hemlata Rao
Current reforms and way forward
Moving from one royalty structure to another

Royalty Systems

Quantity-based (rate per ton)
- **Advantage**
  - Easy to administer
- **Problem**
  - Is not price neutral
  - Tilts time path
  - Raises cut-off grade

Value-based (% of revenue)
- **Advantage**
  - Revenue buoyancy
  - Price neutrality
- **Problem**
  - No benchmark in case of some
  - Encourages under-reporting
  - Transfer pricing (captive)

Profit-based (% of net profit)
- **Advantage**
  - Less distortionary
  - More equitable
- **Problem**
  - Uncertainty in yield
  - Problems in administration

• A alternate system worth exploring is profit sharing with operators as attempted in the Petroleum Sector
Recommendations of Hoda Committee

- **Mode:** Move decisively to *ad valorem* rates

- **Rates:** Use Western Australian level as benchmark
  - Raise rates to Western Australian levels
  - Leave rate unchanged, if they are higher than Western Australian level
    - Unless the existing rates are inhibiting mining operations—in such cases lower the rates
  - Keep royalties on base metals, noble metals and precious stones low to encourage exploration

- **Base:** Transaction value; should include profit element over unit cost of production
  - Sale price rather than pit mouth value
  - Sale price to be adjusted for transaction costs etc
  - Beware of transfer pricing by captive mines

- **Illegal mining:** Non-bailable, cognisable criminal offence; special courts
Problems with proposed system

- Overestimates economic rent
  - Ignores capital costs in resource exploitation
  - Desirable investment may be discouraged, especially at high tax rates

- Double taxation of capital income when royalty coexists with corp. tax
  - Corp taxes are levies on capital income
  - Non-deductibility of capital costs means royalty is based on (economic rents plus capital income)

- Government has no clue on how much it can tax without dissuading investment
Way forward: Production Sharing Contract (as in petroleum)—Efficiency through Competitive Bidding

- **Prior to 1999**
  - Majority of block allocation on nomination basis to ONGC and OIL.
  - No competition, no incentive => Sluggish investment; poor exploration

- **Post 1999**
  - Allocation on competitive bidding basis with transparent bid evaluation criterion
  - Private participation allowed; 100 percent FDI
  - Govt gives license without making any financial commitment for itself
  - Basis for bid evaluation: (I) financial standing and technical capability, (II) work commitment and (III) fiscal package meaning what % of profit petroleum to be shared with Govt.
  - Model production sharing contract provides fiscal stability to the investors
  - Quality of exploration has improved
  - 162 blocks allocated; already invested $3 billion; commitment: $8 billion
### An illustration of tax sharing

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Revenue</td>
<td>100</td>
<td>Freedom to sell crude at international price, but only in domestic market)</td>
</tr>
<tr>
<td>Less: First Charge: Royalty</td>
<td>10</td>
<td>=&gt; Central or state government</td>
</tr>
<tr>
<td>Net Revenue</td>
<td>90</td>
<td>=&gt; Includes exploration cost and production cost and royalty; 100% recovery</td>
</tr>
<tr>
<td>Less: Cost petroleum</td>
<td>40</td>
<td></td>
</tr>
<tr>
<td>Profit petroleum</td>
<td>50</td>
<td>=&gt; Cash or kind; Split 50:50 between center and relevant states</td>
</tr>
<tr>
<td>Less: Govt’s share (@60%)</td>
<td>30</td>
<td></td>
</tr>
<tr>
<td>Operator’s pre-tax profit</td>
<td>20</td>
<td></td>
</tr>
<tr>
<td>Less: Corp. Tax (@34%)</td>
<td>6</td>
<td>=&gt; Pooled (Center plus states)</td>
</tr>
<tr>
<td>Post-tax profit</td>
<td>14</td>
<td></td>
</tr>
</tbody>
</table>

Note: no custom duty on imports for exploration; Tax holiday for seven years
NELP: Concept of Pre Tax Investment Multiple (PTIM)

Revenue

Cost Petroleum (includes Royalty, OPEX and allowed cost recovery of CAPEX)

Profit Petroleum (both of contractor & Government)

Contractor’s take = Cost petroleum + Contractor’s share of Profit petroleum

Contractor’s net cash flow = Contractor’s take – (Production cost (OPEX) + Royalty)

Contractor’s Cumulative net cash flow

PTIM = Cumulative exploration & development cost
Profit share bidding (example):

<table>
<thead>
<tr>
<th>PTIM Tranches</th>
<th>Profit Share to Government</th>
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<tbody>
<tr>
<td>Upto 1.5</td>
<td>30%</td>
</tr>
<tr>
<td>3.5 and above</td>
<td>80% (to be bid higher than earlier tranche)</td>
</tr>
</tbody>
</table>

Diagram:
- Up to 1.5
- 3.5 & above
Conclusion

- Extend production sharing from crude and natural gas to all other minerals
  - Start with some important minerals such as coal, iron, bauxite

- No sharing of profits in respect of older blocks

- Ad valorem royalty to continue, albeit at lower rates

- Compensation scheme in case of a state incurring loss