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THE CASE FOR WINDFALL PROFIT TAXES IN GHANA'S MINING CODE

Summary

This Legislative Alert examines the fiscal provisions of Ghana's mining code. It briefly examines the changes that have been made in Ghana since the first code was enacted in 1986. Noting the recent change in royalty rates, as well as the imposition of ad-hoc levies, the Legislative Alert argues that in the context of the Government's current commitment to review the fiscal regime, serious consideration should be given to the introduction, indeed reintroduction, of a windfall profits tax. Such taxes, if effectively implemented and administered, could ensure that Ghana would benefit from times of high commodity (particularly gold) prices, whilst at the same time providing a stable and sustainable fiscal policy environment to promote investment.

IEA Ghana

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In August of this year, the price of gold continued its seemingly inexhaustible climb upwards, rising above $1700USD per ounce - a 230 per cent increase since the start of 2006. For many Ghanaians, the ultimate owners of the metal, this startling increase inevitably raises the question of whether they, and Ghana as a whole, are sufficiently benefitting from the extraction of the precious metal that once gave the country its name.

The global commodity boom has caused many resource rich countries around the world to examine this question. The response has been clear with many countries, most recently Guinea, seeking to adjust their mining codes to ensure a greater return for citizens. Clearly the Ghanaian Government agrees that this question is worth asking. In both the 2010 and 2011 Budget Statements the Government committed to engage the mining companies to review "the whole mining sector fiscal regime".

There is a clear justification for countries wanting to derive value (above and beyond ordinary business taxes) from the extraction of their natural resources. Not only are the resources legally owned by the country and its people, their finite nature means that those who exploit them are often able to earn additional profits (economic rents) – that is profits derived not from the value-adding activities of business but from the simple fact that the world needs natural resources to feed its development.

Since the enactment of Ghana's original mining code in 1986, Ghana has focused on royalties as the primary means of extracting value from its mining industry. Under the 1986 Code, mining operators were required to pay a percentage of the total revenue derived from the mining operation. Though such instruments are commonly employed elsewhere, a unique feature of the Ghanaian model was that the royalty rate varied between 3 and 12 percent based on "the profitability of the mining operations". Another aspect of the original regime was an additional profits tax. Effectively, this sought to apply an additional 25 percent tax on profits over a certain level (more generally known as a windfall profit).

A review of the 1986 Mining Code resulted in the enactment of a new Code in 2006 which included a variable royalty of between 3 and 6 per cent and ceased to have any additional profits tax.

The fiscal terms of the 2006 Code can perhaps be understood in the context of the time. The royalty had rarely, if ever, been adjusted above 3 per cent and the additional profits tax had rarely, if ever, been applied. This in turn is perhaps a reflection of the lower mineral prices, high capital allowances available to the mining companies or the challenges for the tax authorities in effectively applying these instruments (or a combination of all three).

Yet the sharp increase in gold prices following 2006 quickly revealed the new Code's shortcomings. This has been acknowledged by the Government which subsequently sought to increase its revenue from mining activities. Notably, at the same time as announcing the review, the Government also announced that the royalty rate would be changed to a fixed 6 per cent. Following negotiations with mining companies this was eventually enacted as a 5

per cent rate. In addition, in 2009 Ghana introduced a National Fiscal Stabilization Levy - an additional 5 percent levy on profits on companies in certain industries, including mining. Originally introduced for 18-months, it was extended for an additional year 'in lieu of bringing in an Additional Profit Tax'.

Sadly for Ghana, the reliance on a set royalty rate and ad-hoc taxes provides neither the sustainability nor flexibility to ensure that the country can maximise its benefits from its mining industry at the same time as promoting investment. This would be best achieved through a return to an, albeit better designed, profit-based system.

From a tax theory perspective the argument for profit-based taxes is clear - as they are matched to a company's profitability, they are less distortionary than simple volume/value based royalties, which are paid irrespective of whether or not a company is profitable in a particular year. If effectively implemented, they can also ensure that a country obtains a benefit from any windfall profits received by the company, for instance, as a consequence of higher commodity prices.

Profit-based taxes are not without their challenges. Reliance on such an instrument by itself may result in revenues decreasing dramatically as commodity prices fall. This may cause problems for resource-rich developing countries whose budgets and long term development plans rely on some level of predictability. Furthermore, as mining companies have the information which will determine the rate of tax that will be applied, enforcement requires an effective and technically proficient tax revenue authority – a challenge in many developing countries. A final challenge will be the interaction of any legislative changes with so called 'stability agreements' that some mining companies have with the Government. These agreements effectively 'lock in' the fiscal settings for a particular period of time, ensuring that the company is not impacted by future changes in the fiscal regime.

Yet these challenges are not prohibitive. Development economist Paul Collier argues that whilst sole reliance on a profit-based tax may not be preferable for many developing countries, its combination with a royalty could be very effective. The royalty would ensure that the country receives a minimum return each year, with the profits tax allowing the country to share in any windfall gains.

Moreover, the political and administrative impediments in Ghana are by no means insurmountable as is evidenced by the oil & gas sector. The Ghana Model Petroleum Agreement, whilst centred on the payment of a royalty, also includes an instrument that ensures Ghana will share in any gains from above-normal returns resulting, for instance, from an increase in oil prices. There is also a great wealth of expertise for Ghana to draw upon across the globe in putting appropriate systems in place. For instance, Australia has committed to implementing a profit-based regime for its mining sector and the new Peruvian Government is currently considering the same.

The presence of stability agreements is somewhat more challenging and an issue that should be considered in its own right. What is clear, however, is that mining companies also have an interest in making sure that the

country in which they operate has a sustainable fiscal regime.

Currently, the attention of Government, donors and civil society is focussed on the emerging oil and gas industry. Whilst this focus is justified, it should not be forgotten that the mining industry has been and will continue to be an integral part of Ghana's economy. How Ghana benefits from the industry, through its fiscal system and otherwise, is and will remain an important issue. It is therefore disappointing that the draft National Mining Policy of Ghana (October 2010), whilst laudably acknowledging that the "Government seeks a fair balance between generating revenues and attracting sustainable investment in the mining sector", continues to focus on an inflexible royalty-based regime. There currently exists a need and an opportunity for Ghana to implement a sustainable fiscal system for its mining industry, one that does not rely on ad-hoc royalty changes and ad-hoc taxes and which has the potential to deliver Ghanaians a fair share of windfall gains. After all, Ghana's minerals and precious metals can only be dug up once.