



POLICY BRIEF: NEGOTIATION OF STABILITY AGREEMENTS IN MINING

19 April 2004



Issue Background

Based on a request from the Ministry of Finance and Economics (MOFE) and discussions held between the GoM and USAID/EPRC, it was agreed that EPRC would provide assistance to the GoM on:

- Best practices and lessons learned from other countries in the negotiation and administration of stability agreements as a policy instrument in the mining sector
- The development of an economic and financial model that would estimate the impact over time of diverse stability agreement scenarios on fiscal revenues, employment, income, current account, capital account, and regional effects
- Long-term international market analysis and forecast (demand, prices, etc.) for the most important Mongolian mining products, competing countries and their tax policies and their effect on foreign investors' decisions to invest in Mongolia
- Development of alternative scenarios to inform policy options of the GoM in the mining sector.

Main recommendations of the assessment included:

Recommendations

1. The engagement of international legal counsel and mining experts to advise the government on terms of negotiation for complex stability agreements
2. Consideration needs to be given to the full range of financial incentives for businesses and in particular foreign businesses engaged in natural resource development with the objective of ensuring that the state gets a reasonable share of revenues in the short as well as long term and that natural resource development contributes to the economy as a whole and is not subsidized in any way. Current arrangements eliminate profit taxes for the first 8-10 years of a project and attract reduced rates for 3-5 years thereafter. In the case of mining projects that means that state income is predominantly from royalties for a very long period (or about half the life of a typical mine). Royalty rates need to be reconsidered in the context of a review of overall tax rates and investment incentives
3. The handling of VAT needs to be reconsidered in relation to large capital intensive projects. Current practice, which effectively removes VAT considerations from such projects, concurrently removes an important driver towards secondary value-adding industries such as smelting and refining
4. The establishment of appropriate financial instruments, such as a fund to finance emergent mining service companies needs to be considered. Major mining companies considering investment in Mongolia have indicated that long-term contracts could be offered to local companies and these could be used as collateral for loans or leasing arrangements if such instruments were available
5. To ensure that the state income from mining and other natural resource developments helps achieve the policy objectives of poverty reduction and economic growth, it should be used to lower taxes on low-income individuals and on businesses
6. Key issues of infrastructure development need to be addressed when the need for such infrastructure is triggered by a major capital intensive project. A major mining project will need roads, railways, water supply, power and social infrastructure. It will impact the environment for 30-40 years both physically and visually. How infrastructure needs and environmental impact mitigation measures are planned, handled (in the context of incentives) and financed are key policy considerations. The main concern is to ensure that incentives aimed at attracting productive foreign investment do not have the undesirable side effect of reducing state income from taxes for an indefinite period
7. The government should consider revising the process and decision-making structure on large scale capital intensive projects having long-term impacts to insure that issues of infrastructure, water resources, environment, minerals development, energy, foreign investment, state income, and trade are properly addressed. Current law requires that stability agreements be approved by the Minister of Finance and Economy (MoFE); approval by a committee of ministers or Cabinet would minimize future fiscal risks to investors, improve technical coordination of relevant line ministries and appropriate economic, financial, and legal analysis of proposed stability agreements by the GoM
8. Although Mongolia's legal framework for the mining sector is among the best of its kind, the assessment provides recommendations on clarifications needed, license terms, minimum investment requirements for qualifying a project for a stability agreement, revision of rates payable for exploration and mining license fees, and increasing the period of tax-loss carry-forward to five years, among others.

Sources

See EPRC's Technical Report: "Mongolian mining sector competitiveness and the use of stability agreements." EPRC: Ulaanbaatar, Mongolia. April 2004.