NEWSLETTER

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Reforming the regulation of the mining sector in Georgia

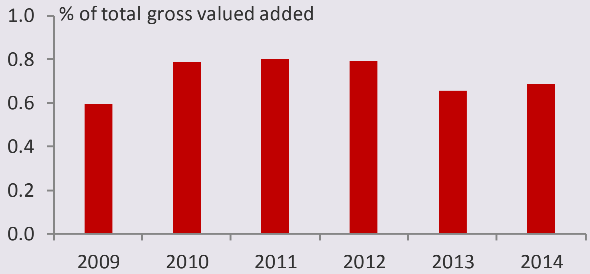
Mining is a relatively small sector in Georgia, but mining products are crucial inputs for around 25% of Georgia's merchandise exports. The regulation for this sector is, however, outdated and equally applies to large-scale mining of precious metals and small scale quarries for construction materials. As a result, no significant new investments into the mining sector have been made in the past years. Fiscal revenues from the mining sector are also limited although natural resource extraction involves high resource rents that should be taxed by the state.

Multiple obstacles to investment currently exist: The tax burden of companies has been designed to provide an early and steady income to the government, but it takes inadequate account of the income situation of companies. At the same time, the total tax burden is relatively low and the Georgian public does not receive a fair share of the resource rents. Information about resource deposits is dispersed and hard to gather, thus increasing investor uncertainty about the attractiveness of potential sites. A reform of the regulation for new investment projects should strive to remove obstacles to investment and, at the same time, to increase the share of the resource rent retained by the government.

The mining industry in Georgia

Mining is a relatively small sector of the Georgian economy, accounting for around 0.8% of gross value added. Nevertheless, the country has some notable deposits of manganese, copper and gold. Products of the mining sector are crucial inputs of around 25% of Georgia's merchandise exports.

Gross value added in mining and quarrying



Source: Geostat

The share of mining in total production has stagnated in the past years. Indeed, no major new investments have taken place, and there is a widespread perception that, due to inadequate regulation, Georgia fails to attract investment in the mining sector.

A potential source of growth and public revenue

Attracting investment into the mining sector has the potential to spur economic growth through demand for construction and services, but also through the possibility of locating further value added stages of the resource in the country. In the case of manganese, ores are extracted in the Chiatura mine and then processed into ferro-alloys in a plant in Zestafoni, making up almost 10% of the total value of Georgian merchandise exports in 2012-2014. However, this production dates back to the Soviet era and many resource producing countries have aimed, but failed, at extending the value chain of their resources domestically. Leveraging resources for developing the manufacturing sector is hence a valid, but difficult policy objective.

However, there is a clear case for resource extraction as a source of fiscal revenues. Finite natural resources generally yield resource rents – excess profits due to the market price permanently exceeding production costs – and capturing a fair share of these resource rents for the public should be the objective of a carefully designed system of fees and taxes. At the same time, taxing the mining sector is a complex task for governments as mining companies are often large multinational companies with good abilities at minimising tax burdens, for example through internal transfer pricing strategies that can reduce accounting profits in the source country of the resources.

Inadequate current regulation

The current regulatory framework in Georgia is marked by several inadequacies. It does not differentiate between different types of mining, although large-scale mining operations for metals usually conducted by international companies will require a different treatment than small-scale operations such as the extraction of construction materials for domestic use. The regulation should differentiate between these different parts of the sector in future.

Another feature of the current system is a mandatory auction with a minimum price for the sale of mining licenses. As usually only one investor is interested in a specific license, the auction system is ineffective and in practice only the minimum price of the auction is paid to purchase a license. That payment however constitutes a relatively high financial burden in the initial stage of a mining project, when an investor's liquidity is already strained due to the investment costs.

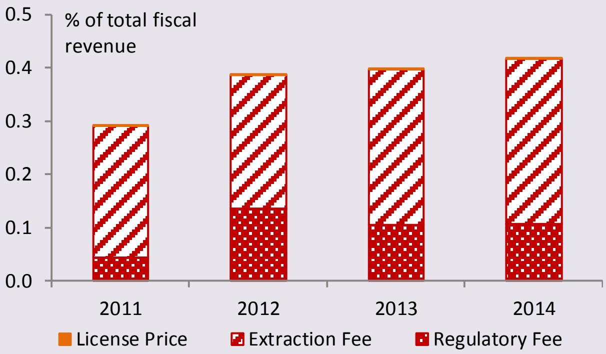
A third feature of the current framework is that royalty payments –a per-unit tax on extracted resources – are tied to pre-planned rather than actual extraction volumes. This feature is intended for ease of administration (and may indeed be appropriate for small mining operations) and to ensure that licensees are actually extracting the resource rather than keeping the license for speculative purposes. However, it has the clear downside of making the tax burden unresponsive to the revenue situation of the taxed companies and thus increasing the risk of market price decreases faced by potential investors.

In the current system, mining companies are supposed to provide a predictable and frontloaded stream of income to the government rather than being taxed according to their revenues and profits. However, these are real sector firms, not banks.

Limited fiscal revenue from mining at present

As a result, the revenue earned from the mining sector is relatively low. Revenues from license sales and royalties only add up to around GEL 30 m (ca. USD 12.5 m) per year or 0.4% of fiscal revenues. This is both due to the small size of the mining sector, as obstacles to investment reduce the sector's growth, and due to the fact that the current *levels of* royalties are quite small in international comparison.

Direct revenues from mining activities



Source: National Environmental Agency, Geostat

Developing a national strategy for mining

In order to incentivise more investment in the export-oriented part of the mining sector and to increase fiscal revenues, a comprehensive set of reforms aimed at new investments should be carried out, centred on a national strategy for mining. This strategy should involve a consolidation and public availability of the presently dispersed geological information as well as a targeted attraction of potential investors for individual sites through the combined efforts of the National Environmental Agency, Invest in Georgia, the Ministry of Environment and Natural Resources and the Ministry of Economy and Sustainable Development. Auctions should be held when multiple investors are interested in a site but should have no minimum price.

Reconciling fiscal revenue with economic growth

The royalty system should be reformed to be sensitive to international market prices by including a flexible element that responds to variations in internationally measured commodity prices. Headline royalty rates should be updated in pre-specified intervals to ensure a royalty level comparable to that of other relevant countries. Also, the institutions responsible for royalty and corporate tax collection should be sufficiently equipped to ensure a high degree of tax compliance by mining companies.

The suggested reforms should apply only to new, not yet existing mining projects. It should improve access to information and reduce riskiness and frontloading of tax obligations for companies in order to create more investment. A revision and increase of royalty levels – if combined with the other reforms – will not impede the growth of the sector, but further contribute to increased total fiscal revenues.

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Note: A more comprehensive analysis of the topic is provided in the Policy Paper PP/05/2015 "Removing obstacles to investment in Georgia's mining regulation" available at www.get-georgia.de

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