Mining Royalty is not Tax: Analyzing the Supreme Court Judgment

No. 423
14-January-2025
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New Delhi

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Abstract

Against the backdrop of the recent Supreme Court ruling that royalty on mining leases is not a tax, the existing mining royalty regime in India is analysed. Royalty is based on economic rent and is designed on the basis of multiple regimes, including ad valorem, tonnage-based, and profit-based across countries, and is not a tax. The buoyancy estimates of mining royalty revealed that structural reforms in the mining sector can augment revenue generation to the states. Further debates are required to analyse the rates and base of the mining royalty regime in India, given that resource-rich states in India remain income-poor.

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This paper is published by EPW in January 2025 edition.
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On July 25, 2024, the Supreme Court of India delivered a landmark judgment that "that royalty on mining leases cannot be classified as a tax". This decision, led by Chief Justice D.Y. Chandrachud addresses the fiscal federal issues related to the division of taxation powers. Under Article 246 of the Constitution, the Seventh Schedule delineates powers between the Union and State Lists. The Seventh Schedule provides a three-fold classification of legislative subjects between the Centre and the states, viz., List-I (the Union List), List-II (the State List) and List-III (the Concurrent List). The Entry 50 of the State List empowering states to levy taxes on mineral rights, but excludes mining royalties from this definition. Against the backdrop of the recent Supreme Court Judgement on the fiscal aspects of mining sector, this paper analyses the existing mining royalty regime in India.

Analyzing the State Reorganisation Acts and Fiscal Responsibility Acts, Chakraborty, et al (2016) revealed that the formation of new States rich in minerals like Jharkhand and Chhattisgarh have not created any distinct fiscal agency in the mining sector. The States – both parent and the new States – have adjusted their fiscal deficits to conform to the fiscal rules (FRBM Act) stipulated by the Centre; and these States have revenue surplus – not deficits - ex-post to the enactment of fiscal rules. The new States have insignificant share of mining proceeds in their State exchequer, around 10 per cent of the revenue receipts.

It is indeed striking why the resource-rich States in India are income poor, and requires the analysis of the fiscal policy practices in the resource-rich States. Chakraborty and Garg (2015) analysed the use of mining fiscal space against the backdrop of recent Mines and Minerals Development and Regulation (MMDR) Amendment Bill, 2015 and argued for the similar institutional mechanisms like "oil-to-cash policy" to resolve spatial inequalities in the resource rich new States. Subsequently, the District Mineral Fund constituted in India aimed at resolving the spatial inequalities by ploughing back a specific ratio of royalty back to the districts where the minerals are extracted. All these are pointing towards the imminent fiscal policy practises in the mining regime in India. However, whether mining royalties can be treated as "taxes" and can be levied by the States of India requires deliberations, which is attempted in this paper.

The paper is organised into 5 sections. Section 1 deals with the mining royalty regime. Section 2 narrates the legal framework of mining regime under the Mines and Mineral Development Regulations Act (MMDR) and the Critical Mineral Mission announced in Union Budget 2024-25. Section 3 analyses the Supreme Court decisions on mining royalty. Section 4 presents the buoyancy estimates of mining royalties across Indian States in comparison to the buoyancy of own tax revenue. Section 5 concludes.

1. The Mining Royalty Regime

Why mining sector is unique for fiscal regime? Mining sector has unique characteristics to be considered for the fiscal regime. Mining sector is a high risk, capital intensive, long lead time sector with price cyclicality and finite life. They operate in remote areas and have environmental and social impacts, unless properly regulated. Mining sector share these unique characteristics that distinguishing them from other sectors of the economy, and requires a different fiscal regime treatment as well.

The dynamics of mining royalties is a complex subject matter which requires attention with regard to how mining royalties – the payment due to the sovereign owner (government) in exchange for the right to extract the mineral substance – are fixed and paid. Globally the basic rationale for mining royalties is based on the concept of "economic rent". It is not taxation, which is a compulsory statute. The mining royalty regime can be categorized into unit-based, ad valorem and profit-based. The unit-based royalty is the gross royalty, where the royalty is determined with reference to the volume of production, or is determined with reference to gross revenues. It is also referred to as tonnage-based royalty.

The ad valorem royalty is calculated by applying a percentage rate to the gross sale value. It is also referred to as value-based royalty (Table 1). This is usually 'ex- mine' or pithead value (sale realization) less allowable expenditure (Chakraborty, 2014). Ex-mine or pit head value is mineral value once mined and brought to the surface minus treatment costs. The net smelter return (NSR) royalty is one of the most recurrent systems of ad valorem royalty, where the royalty is expressed as a percentage of the enterprise's NSR (Otto, et al, 2006). The net smelter return is generally defined to be gross revenues, minus shipping, smelting, refining, and marketing costs.

Table 1: Ad valorem Mining Royalty: Various Royalty Bases

	Ad valorem Mining Royalty : Royalty tax basis
1	Ad valorem – Net Smelter Return (NSR) times percentage
2	Ad valorem – metal contained in ore at mine mouth, valued at international price times percentage
3	Ad valorem – metal contained in concentrate at the mill, valued at international reference price times percentage.
4	Ad valorem- metal contained in smelter product, valued at international reference times percentage.
5	Ad valorem – gross sales, les transportation, handling, and freight, times percentage
6	Ad valorem – sliding scale percentages of NSR

Source: Chakraborty (2016)

The profit-based royalty is calculated as a percentage of gross/net profit. It can be calculated in two ways, as shown in Table 2. The profit-based royalty is also referred to as net profit royalty, net proceeds royalty, and so forth.

Table 2: Types of Profit-based Royalty: Various Royalty Bases

	Royalty tax basis
1	Profit-based – percentage of gross sales, less operating costs, transportation, handling and freight
2	Profit-based – percentage of gross sales, less capitalized costs, operating costs, transportation, handling and freight

Source: Chakraborty (2016)

No mining royalty regime is free from challenges. The merits and demerits of the most common types of royalty – viz., unit-based, ad valorem and profit based royalty – from government and investor perspectives are listed in Table 3.

Government and investors have conflicting objectives. While government prefers the methods of mining royalty that are stable, transparent, equitable and generates revenue in continuum, easy to administer; mining firms prefer the royalty approaches which are stable and predictable and are based on the ability to pay, respond to downturns in price cycles, do not distort production decisions such as cut-off grade or mine life and do not add significantly to operating costs (Chakraborty, 2016).

From a government perspective, unit-based and ad valorem-type royalties are preferred as it can satisfy the objective of revenue in continuum, while profit based royalties will be paid only in the years with profits for the firm. While private sector mining prefer zero royalty regime, and if imposed, having it based on profit or ad valorem (Chakraborty, 2016). Under profit based royalty regime, Brown Tax and Resource Rent Tax are the two major options of royalties (Otto, 1995). Under the Brown tax, the government collects a constant percentage of a project's net cash flow in years in which profits are earned and provides cash rebates to private investors in years of negative net cash flow. On the other hand, the Resource Rent Tax is a profit based royalty that provides governments with an approximation to the Brown tax but avoids cash rebates in years in which losses are incurred. Under a resource rent tax, the government collects a constant percentage of a project's net cash flow where losses (negative net cash flow) are accumulated at a threshold rate and offset against future profit. However, these two options of royalties (though named as taxes, these are mining royalties, which comes under "non-tax" category) are not relevant in the context of developing countries like India as no country in Asia Pacific has profit-based mining royalty regime.

2. The Mining Legal Framework in India

The legal framework for the regulation of mines and minerals (except petroleum and natural gas) was first put up in 1957 – the Mines and Minerals (Regulation and Development) Act 1957 ('MMRD'). MMRD 1957 constituted the basic laws governing the mining sector in India including the regulations related to prospecting fee, royalties, and dead rent in respect of the prospecting and mining leases for minerals other than minor minerals, payable to the state government[i]. The holder of the prospecting license is required to pay annually, in advance. The holder of the mining lease for minerals other than minor minerals is liable to pay a `Dead Rent' to the state government till any mineral is removed or consumed, from which time, the holder has to pay royalty or dead rent, whichever is higher. These provisions of MMRD can only be amended by the central government through a notification in the official gazette. The royalty and the dead rent has been revised in order to make them favourable to the private sector. The dead rent for the first year of the lease has been removed for all categories. The royalty rates and the dead rent for minor minerals are fixed by the respective state

governments. Consequently, the MMDR Act, 1957 (MMDR) was amended in January 1994 and Mineral Concession Rules 1960 (MCR) and Mineral Conservation and Development Rules 1958 (MCDR) were brought into force soon after, to incorporate these changes and simplify the procedure for grant of mineral concessions to attract large private investments. The MMDR Act was further amended in December 1999 and MCR and MCDR were amended in the following year, 2000. It brought a number of changes in procedures of prospecting license, reconnaissance permits and mining leases and shifted more powers from central government to State governments. However, government control over mining sector continued through administrative pricing regime.

Recently, the Mines and Minerals (Development and Regulation) Amendment Act, 2023, which has come into force from 17th August, 2023, had listed 24 critical and strategic minerals in Part D of the First Schedule of the MMDR Act[ii]. The amendment provided that mining lease and composite licence of these 24 minerals shall be auctioned by the Central Government[iii].

The Critical Mineral mission was announced in the Union Budget 2024-25. The Finance Minister announced in the budget that the Critical Mineral Mission includes the auction of offshore mineral blocks and elimination of custom duty on 25 critical minerals**.** Subsequently, the Union Cabinet chaired by Prime Minister approved the amendment of Second Schedule to the Mines and Minerals (Development and Regulation) Act, 1957 ('MMDR Act') for rationalisation of royalty rates for all 24 critical and strategic minerals. The Union Cabinet's approval on 29th February 2024 for specification of rate of royalty enables the Central Government to auction blocks for these 12 minerals for the first time in the country.

In India, the mining royalty rate and determination of auction bid parameters are prepared under the Ministry of Mines. The royalty rate on minerals is an important financial parameter for the bidders in auction of blocks. The Second Schedule of the MMDR Act provides royalty rates for various minerals. Item No. 55 of the Second Schedule of the MMDR Act provides that royalty rate for the minerals whose royalty rate is not specifically provided therein shall be 12% of the Average Sale Price (ASP)[iv]. Thus, the default mining royalty rate would be 12% of ASP (if the royalty rate for these is not specifically provided), which is considerably high as compared to other critical and strategic minerals. Also, this royalty rate of 12% is not comparable with other mineral producing countries, as the mining royalty regime differs across countries.

The royalty, dead rent, applicable amount quoted in the auction and any other statutory payment in relation to the mining lease or composite licence auctioned by the Central Government shall accrue to the State Government or

concerned authorities, as the case may be, as if the auction has been conducted by the State Government[v].

3. The Supreme Court Judgement

In the Supreme Court judgement, it is made clear that the "royalty is not a tax. Royalty is a contractual consideration paid by the mining lessee to the lessor for enjoyment of mineral rights. The liability to pay royalty arises out of the contractual conditions of the mining lease. The payments made to the Government cannot be deemed to be a tax merely because the statute provides for their recovery as arrears".

The recent judgement clarifies that while states can impose local taxes (Seventh Schedule, Article 246 of Indian Constitution), royalty fees for mineral extraction are not considered a "tax" under constitutional provisions. On July 25, 2024 Supreme Court gave a landmark ruling that royalty on mining leases cannot be considered as a tax. The Court noted that the MMDR Act was enacted by Parliament in exercise of its legislative power derived from Article 246 read with Entry 54 of List I. The Act seeks to provide for the regulation of mines and development of minerals under the control of the Union.

The MMDR Act has enabled the Central Government to examine the rates of royalty in respect of all minerals and modulate them periodically after taking into consideration various factors, including the uniformity of mineral prices. A Study Group of Royalty, constituted by the Ministry of Mines (Government of India), every three years, has been engaged in revising the royalty rates in consultation with Indian Bureau of Mines, industrial houses and mining companies. The royalty rates for coal is determined separately by the Ministry of Coal.

The Supreme Court clarified that the primary reason for empowering the Central Government to fix the rate of royalty could be traced to the *Industrial Policy Resolution*. The mining sector in India remained completely under the state ownership till nineties, with restriction on private investment. The policy determination was against the backdrop of the Industrial Policy Resolution, 1956 (IPR). IPR assigned major minerals such as coal, lignite, mineral oils, iron ore, copper, zinc, atomic minerals, in Schedule A, which was reserved exclusively for the public sector, and minor minerals in Schedule B, in which the private sector was allowed some participation in mining activities along with the public sector. With the advent of the liberalisation policy in early 1990s in India, a National Mineral Policy was announced in 1993. Until early 1990s, Foreign Direct Investment (FDI) was not allowed in the mining sector. Mineral concessions were restricted to firms with less than 40 per cent foreign holding, as in other sectors.

With the formulation of the National Mineral Policy in 1993, there was a minor easing up and FDI was allowed up to 50 per cent, with no limit on captive mines. Additional FDI could also be allowed on a case-by-case basis. All FDI proposals required clearance by the Foreign Investment Promotion Board (FIPB). In 1997, FDI up to 50 per cent was taken out of the purview of the FIPB and put on automatic approval route. For exploration and mining of diamonds and precious stones, 74 per cent of FDI was permitted under auto an automatic route in February, 2000. In February 2006, the mining sector was opened up to 100 per cent FDI. As of today, FDI upto 100 per cent is permitted in non-fuel and non-atomic minerals.

The Supreme Court highlighted that mining regime is not about a Centre-State division of taxation powers. The mining royalty is conceptually different from tax, as it is "in respect of mining leases" paid out of a contractual obligation between an owner and the lessee. The Court also emphasised on ensuring a certain level of uniformity in mineral prices, and therefore the royalty rates are fixed by the Central Government and the revenue is collected by the States under non-tax category. In contrast, tax is a compulsory payment statutorily due to be paid to the government.

The judgement explained three fundamental differences between royalty and tax, as follows.

(i) Royalty is charged by a proprietor; tax "is an imposition of a sovereign"

(ii) Royalty is a consideration; tax is levied in a "taxable event" determined by law

(iii) Royalty arises from a lease deed; tax is imposed by an authority of law

The Court noted that the State Governments were not empowered to determine royalty to maintain a uniform regime of royalty across India. This was intended to promote international competitiveness of commodity prices in the international market.

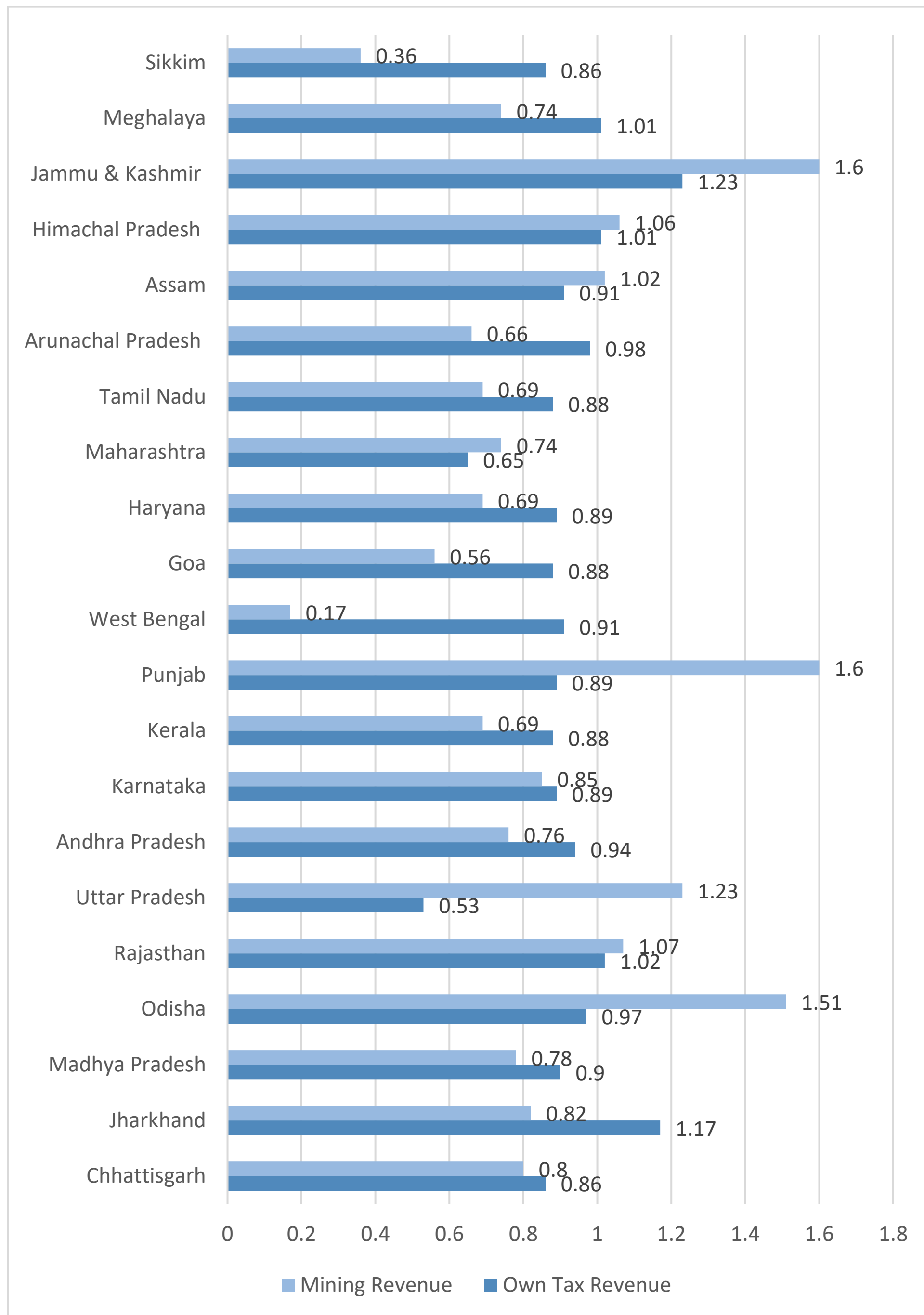
The Supreme Court highlighted that there are differences between royalty and a tax: the proprietor charges royalty as a consideration for parting with the right to win minerals, while a tax is an imposition of a sovereign; royalty is paid in consideration of doing a particular action, that is, extracting minerals from the soil, while tax is generally levied with respect to a taxable event determined by law; and royalty generally flows from the lease deed as compared to tax which is imposed by authority of law.

The Supreme Court said that under the MMDR Act, the Central Government fixes the rates of royalty, but it is still paid to the proprietor by virtue of a mining lease. In case the minerals vest in the Government, the mining lease is signed between the State Government (as lessor) and the lessee in pursuance of Article 299 of the Constitution. Through the mining lease, the Government parts with its exclusive privilege over mineral rights. A consideration paid under a contract to the State Government for acquiring exclusive privileges cannot be termed as an impost. Since royalty is a consideration paid by the lessee to the lessor under a mining lease, it cannot be termed as an impost.

4. Buoyancy of Tax and Mining Royalty In India across States

Tax buoyancy measures the responsiveness of tax revenue to a change in national income and the tax policy. Technically, it is defined as the ratio of percentage change in tax revenue to a percentage change in GDP. Similarly, the buoyancy of mining royalties can also be calculated. Chakraborty and Thomas, (2024) estimated the buoyancy of mining royalties across States and compared it with the State's own tax buoyancy (Figure 1).

Figure 1: Buoyancies of Own Tax Revenue and Mining Royalty across Indian States 1991-92 to 2022-23



Source: Chakraborty and Thomas (2024)

The estimates revealed that mineral rich States like Chhattisgarh (0.8) and Jharkhand (0.82) have buoyancy nearing unity, however Odisha (1.51) has the buoyancy above unity. The structural reforms in the mining sector related to the "rates" and "base" are required for increased revenue augmentation. Therefore the real debate is about the way the "base" is calculated in the mining royalty. It is hightime to consider incorporating the "value chain" in the mining royalty

calculations of non-atomic non-ferrous minerals. As it is ad valorem rates, the mining royalty is market linked. The demand from the industry is that the royalty rate revision every three years by the Royalty Group has been affecting the competitiveness of the sector. Against the backdrop of energy transition towards non-fossil fuel towards net-zero carbon commitments, there will be an inevitable fiscal transition in the mining royalty regime as well.

5. Conclusions

Against the backdrop of Supreme Court Judgement on royalty on minerals, the paper has analysed the legal and fiscal fiats of mining regime in India. The existing system in India is that the Central government decides the rates of mining royalties and the revenue is collected by the State governments. The Supreme Court judgement of the case related to the argument that mining royalty is a tax and can be levied by the State governments is examined whether mining royalty is "tax". The royalty is based on "economic rent" and is designed on the basis of multiple regime including ad valorem, tonnage-based and profit-based across countries, and not a tax. The buoyancy estimates of mining royalty revealed that structural reforms in the mining sector can augment revenue generation to the States, and further debates are required to analyse the "rates" and "base" of the mining royalty regime in India, as resource rich States in India are income poor.

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