

An Analysis of the Recent Reform to the Peruvian Mining Sector from a Tax Perspective

by

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Abstract

Recently, Peru went through a major process to reform its mining tax system oriented to striking an appropriate balance between two conflicting goals: (1) to raise tax revenues, and (2) to attract investment to the mining sector. This thesis analyzes if this objective is being achieved.

This thesis analyses the recent enactments in the Peruvian mining tax regime by using a combination of doctrinal analysis, law and economics and public choice analysis. This thesis contains a detailed assessment of the political dynamics that give rise to the particular law reform and presents some recommendations as to what should be considered by the government when enacting additional mining tax legislation in order for the reform to be successful in achieving the goals intended.

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Chapter I

Taxation of Mining Investment: Relevant stakeholders

The purpose of the first part of this chapter is to make the reader aware of how the thesis will develop by explaining the methodology used throughout the thesis and to provide a brief description of the important points considered by the approaches used. The second part of the chapter describes which are the main aspects considered by the mining investors and the host country government at the very initial stage of a mining project. This is, the considerations, objectives, interests and concerns of each of these parties when deciding whether a particular mining project should go through or not. In line with the fact that the interests of the government and the investor are usually diametrically opposed as they both will try to obtain the highest benefit, the last part of the thesis considers the usual trade-offs arising for each party during the decision of going through with the mining project.

1. Methodology

There are several possible analytical perspectives in the evaluation of the law. The doctrinal analysis approach, on one side, implies the analysis of the law taking the actual text of the legislation as the starting point of the analysis.¹ The law and economics approach evaluates a law in order to achieve the best or most efficient allocation of resources.² The public choice analysis approach starts by assessing the political dynamics that give rise to the particular law.³ Any complete analysis relies in a combination of these analytical approaches.⁴

Throughout this thesis I have used the three different approaches, relying on a combination of the law and economics and the public choice approaches on chapter 2 and on a combination of the doctrinal analysis and the public choice approaches in chapter 3. The remaining sections of

¹ Maxwell L. Stearns & Todd Zywicki, *Public Choice Concepts and Applications in Law* (Minnesota: West, 2009) at 3

² *Ibid* at 4

³ *Ibid* at 4

⁴ *Ibid* at 6

chapter 1 rely mostly in the public choice approach to provide the reader with the general perspectives of the main actors involved in a mining tax reform.

2. Important axioms relevant to the law and economics and to the public choice approaches

The information provided in this part of the chapter, aims to introduce the reader to the theoretical assumptions of this thesis. The thesis considers the interests and concerns of each of the parties directly or indirectly involved in the mining reform process.

Public choice and the law and economics, despite analyzing the law from different perspectives, share important methodological foundations. For instance, both approaches use models that intend to capture a range of phenomena observable in reality.⁵ Law and economics scholars basically assume that individuals respond rationally to changes in incentives, whereas public choice scholars question whether individuals change their personal motivations when changing activities and accept that behaviour may change when moving from one institutional environment to the next.⁶ For public choice theorists, incentives created within institutions influence individuals behaviour.⁷ Institutions, in this context, are human constraints that condition a person's interaction with others⁸. Such constraints could be formal (such as laws), informal (such as norms of behaviour) and their enforcement characteristics.⁹ An example of how institutions motivate individuals may be seen in the figure of the presidential candidate of a country who may change his/her behaviour in order to be elected or a current president who may also be influenced by the re-election pressure.

Public choice also considers that agents are not neutral conduits that allow principals to achieve their goals as agents possess their own preferences that may agree or not with the principals'.¹⁰ In this context, a group of voters (the principal), for instance, may have slightly different

⁵ Ibid at 6

⁶ Ibid at 10

⁷ Ibid at 11

⁸ Ibid at 11

⁹ Ibid at 11

¹⁰ Ibid at 12

preferences or goals than their elected representatives (the agent). For public choice theorists, this divergence in preferences is called “agency cost”.¹¹

Public choice may not necessarily provide a direct answer to the question regarding the best measures to reduce agency costs but it does help in identifying trade-offs between accountability, independence and agency costs in order to provide a balance between these concerns.¹² In the mining tax reform context, public choice literature provide the tools to strike an adequate balance between the government (supplier of reforms), its constituents (local communities directly and indirectly affected by mining activities in a country) and mining investors considering the different goals and preferences of each of these parties in the tax reform process.

Law and economics and public choice theorists coincide on the importance of methodological individualism. Methodological individualism refers to the understanding of the incentives of the individuals comprising a group.¹³ For example, in the context of mining tax reforms, it is important to understand what are the incentives of a local community that is directly affected by a mining project (as a group) and how the individual interests of the individual members of the community may diverge from the group as a whole. This can clearly be seen for instance in the different incentives that community land owners interested in selling their lands to the mining investor may have, as opposed to those who don’t want to sell their lands. Also, in the case of a group of illegal miners, who as a group may be opposed to formalization processes to evade the payment of taxes while some individual illegal miners may have incentives to formalize and bear the cost of the tax as long as they receive legal protection from drug dealing related terrorism.

Related to individual and collective choices, free riding and forced riding problems are also considered in the economics and public choice approaches.¹⁴ Free riding refers to the cases when individuals benefit from the provision of a public good without bearing its costs.¹⁵ As an example, citizens from a mining country, who happen to live far away from the mining site (and hence don’t bear the same costs as the local communities living at or close to these sites) but who may benefit from the economic stability achieved in the country as a consequence of mining

¹¹ Ibid at 12

¹² Ibid at 13

¹³ Ibid at 13

¹⁴ Ibid at 14

¹⁵ Ibid at 14

activities. Forced riding, on the other side, refers to cases where an individual within a group is forced by the other members of the group to contribute to the provision of the good beyond his personal benefit.¹⁶

Also, related to collective choices it is important to know that politics work as an exchange model with some differences than the one we see in private markets. In political processes some persons who did not participate directly in the bargain can be directly affected or bear the costs of the decision.¹⁷ This helps to illuminate the different perspectives of citizens of a country, who cannot be considered as a unitary group when analyzing a legal reform. Each of the subgroups of citizens may bear a different cost or may have not agreed with the election of the current president neither with his government's plan or platform, but nonetheless need to abide by the government's action.

The concept of externalities is equally common to economics as well as public choice theory¹⁸. In markets where property rights are poorly defined or it is possible for individuals to transfer some of the production costs to others, social welfare is not raised as it is the case in societies with strong and well defined property rights.¹⁹ For instance, miners who illegally exploit natural resources on others land without obtaining the proper licenses or permits, generate a great deal of negative externalities, the cost of which society as a whole will need to bear by society as a whole.

The next two sections of this chapter will provide the reader with the most representative perspectives of the government and the mining investors as the two main actors in a mining tax reform. The last section of this chapter provides some insight on the elements to be considered when designing (or reforming) a fiscal system and some of the trade-offs that governments (as the representative of the citizens of a country and as the supplier of reforms) and mining investors usually face.

¹⁶ Ibid at 14

¹⁷ Ibid at 16

¹⁸ Ibid at 14

¹⁹ Ibid at 16

3. Taxation from the point of view of the State

When it comes to deciding on the feasibility of mining projects, the investing company and the host country have a common objective: to maximize their share of revenue.²⁰ Maximization of revenue is not, however, the only goal of the parties to this kind of transaction. In the case of government, for instance, the public interest should be equally or more important than revenues.²¹

In this context, it is important to keep in mind that the different participants involved in the exploitation of mineral resources have different views and may have diametrically opposed perspectives on the expectations of a mining tax regime, given that their objectives and needs are different.²² Ultimately, it is the government who holds the responsibility to design the fiscal regime that allows both parties to achieve, at least in some degree, their objectives.²³ Some details are provided in this section regarding the objectives that the government may want to achieve based on its needs.

In order to determine the needs and objectives of the government, it is useful to start by understanding the role of government in modern societies.²⁴ Among the most relevant economic purposes of modern governments are (i) to address market failures, which in some cases may require a need to subsidize some goods or services or to provide directly some goods or services such as may be the case of transportation or communication, (ii) to allocate some types goods and services, such as is the case of public health and public education, which should certainly be delivered based on need and not market demand, (iii) to redistribute economic resources on the basis of need, moderating the market natural outcome and, (iv) to apply fiscal and monetary policies in such a way as to achieve price stability, full employment and economic growth.²⁵

²⁰ Carlos Pratt, "Is it convenient to modify the fiscal tax regime to increase the earnings of the Chilean state derived from private mining activities?" (2005) 15:9 The Centre for Energy, Petroleum and Mineral Law and Policy Internet Journal online:<http://www.dundee.ac.uk/cepmlp/journal/html/Vol15/Vol15_9.pdf>

²¹ Ibid

²² Ibid

²³ Ibid

²⁴ David Duff et al, *Canadian Income Tax Law*, 3rd edition (Toronto: LexisNexis Butterworths, 2009) at 4.

²⁵ Ibid at 5.

From these roles stems the observation that governments require significant funding to finance the cost of their activities.²⁶ Taxation is one of the alternatives of government to fund its activities²⁷. Other alternatives are borrowing and printing money.²⁸

Finally, with regards to the third role of government exposed above (income redistribution), it is important to mention that redistribution as a function of taxation has been debated extensively over time. In fact some theories of distributive justice have been used to advocate for or to refuse its legitimacy.²⁹ The degree of equality that redistribution should provide is also contested in the literature. For some, a certain degree of equality needs to be provided by the government since otherwise governments face a risk of undermining their accomplishment of other social and economic objectives.³⁰ For others, some amount of inequality of income is not bad because it provides low income workers with incentives to work harder.³¹ It rests on the government to decide what constitutes an acceptable level of inequality and to moderate this amount.

In the specific context of developing countries, some additional objectives of government may be considered. In developing economies, there is a higher expectation that taxation will help government to support valuable functions, such as the provision of public goods.³² Within this function of government, taxation is expected to address mainly, three types of problems: (i) the need to address short term problems of human development such as those arising from the lack of food, housing, clothing and emergency medical treatment, (ii) the need to invest in education and preventive medicine and to improve economic potential and (iii) the creation and

²⁶ Ibid at 8.

²⁷ The extent to which taxation should be the preferred method to obtain revenue remains contested in the literature and goes beyond the scope of this thesis but it is important to note that taxation does not bring along the possibility of increased inflationary levels due to the increase in money supply, which may also lead to a potential weakening of domestic currency, as it may happen as a consequence of printing money. Another advantage of taxation with respect to money printing is that taxation is a much more fair an objective alternative for government funding. In this regard, it is important to mention that even when taxation has some potential adverse effects and has collection and compliance costs associated to it; these are generally less harmful than the effects of borrowing or printing money (David Duff et al, *Canadian Income Tax Law*, 3rd edition (Toronto: LexisNexis Butterworths, 2009) at 9).

²⁸ Supra note 24 at 9.

²⁹ Avi-Yonah, Reuven S. "The three goals of taxation." (2006-2007) 60 Tax L Rev at 3

³⁰ Jason Welker, "The role of taxes in income re-distribution – another preview of my textbook." *Incentives, Income distribution, Laffer Curve, Macroeconomics, Poverty, Supply-side economics, Taxes*, online: <<http://welkerswikinomics.com/blog/2010/05/18/the-role-of-taxes-in-income-re-distribution-another-preview-of-my-textbook/>>

³¹ James, Sebastian, "Taxation as a tool for social equality." *The Economic Times*. (December 8, 2011.), online: <http://articles.economictimes.indiatimes.com/2011-12-08/news/30490280_1_income-tax-income-tax-inequality>

³² Supra note 29 at 3.

maintenance of institutions that guarantee quality of life and further development.³³ It is important to keep in mind that these objectives may not be exclusive to developing countries.

Redistribution of income and wealth allowing for a more equal distribution than the one that results from the regular operation of a market-based economy is also relevant in the context of developing economies.³⁴ As mentioned before, the role that taxation might play in addressing the problem of income and wealth inequality in developing countries³⁵ and the way in which governments should redistribute income respecting “equality” has never been fully agreed upon by policymakers, whose opinions range from the far left Marxist/socialist ideology all the way to the *laissez faire*, free market model.³⁶

If one accepts that tax systems should redistribute wealth, then the question becomes how to design optimal tax structures to achieve fair redistribution of government revenue³⁷ in particular, in the context of mining taxation. Should the central government collect all tax revenues and then re-distribute by means of the periodical budgeting? Or should this revenues collection role be delegated to local authorities? As will be discussed in a later chapter, there is a trend towards decentralization of tax revenues collection among some developing economies, where local authorities have received increased or new taxing powers.³⁸ Some other countries are leaning towards payments (of royalties for example) being made directly to the provincial government³⁹ and finally some others have inter-governmental transfers in place. The third chapter of this thesis will present a brief discussion regarding the ideal objectives of redistribution, focusing on the intergovernmental option as this is the one adopted in the Peruvian case.

³³ Alex Cobham. "Taxation Policy and Development." *The Oxford Council on Good Governance Economy Analysis No. 2*, October 2005: 24, at 4 online < http://www.taxjustice.net/cms/upload/pdf/OCGG_-_Alex_Cobham_-_Taxation_Policy_and_Development.pdf >

³⁴ Supra note 29 at 3.

³⁵ Bird, Richard M., and Eric M. Zolt. "Redistribution via taxation: the limited role of the personal income tax in developing countries" (2004- 2005) 52 UCLA L. Rev. 1627 at 3

³⁶ Supra note 30

³⁷ It is important to keep in mind that the question of whether redistribution by means of taxation is actually useful to achieve government objectives is highly contested in the literature.

³⁸ Supra note 30

³⁹ James Otto, "Mining Taxation in Developing countries." (Study prepared for UNCTAD , November 2000 at 12, online: <<http://r0.unctad.org/infocomm/diversification/cape/pdf/otto.pdf>>

4. Taxation from the point of view of investors

From the perspective of the investor, the mining industry is considered to be a very risky industry, which is also very capital intensive and prone to wide commodity price fluctuations.⁴⁰ This makes the mining industry different from other industries in ways that justifies policies that attend to these different factors, as explained below. In addition, the investor has to deal with the issue of credible commitment of the host government once the investment is sunk, given that the government may have little or no incentive to maintain the rules initially agreed upon⁴¹.

The various sorts of risk involved (such as the risk of not knowing what size of deposit will be found, the future changes in the price of inputs –such as capital and labour - required to exploit the mine and the risk associated with the uncertainty about the final price of the mineral at the time when it will be sold⁴²) can imply extensive investments from mining firms with the possibility of not finding anything. As a consequence of this level of uncertainty in the mining industry, when deciding among different projects to invest in, investors usually prefer the less risky alternative even when the net present value of both alternatives is the same.⁴³

Significant risks may occur in the very beginning of a mining project. The investing company may experience problems even before discovering any feasible deposits in the subsoil. This is especially problematic if we consider that the upfront sunken investments in the mining industry are always high.⁴⁴ The requirement of large amounts of capital up front, added to the fact that there usually are long time lags between investment and production, imply in most cases a large negative cash flow for a period of time.⁴⁵ Another reason why the mining business is known to be risky is because it is very capital intensive. This is due to the fact that the development of a mine implies a high cost of infrastructure and technology, which are needed to recover minerals

⁴⁰Ibid at 3

⁴¹ Tim Büthe, and Helen V. Milner. "Institutional Diversity in Trade Agreements and Foreign Direct Investment: Credibility, Commitment, and Economic Flows in the Developing World, 1971-2007." (Paper presented on the American Political Science Association 2011 Annual Meeting, September 3, 2011) at 6 online:
<http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1796506>

⁴²The World Bank, Public economics, The Taxation of Natural Resources. Principles and Policy Issue (Robin Boadway and Frank Flatters), Policy Research working papers, WPS 1210. Volume 1, (December 31, 1993), online:
<http://econ.worldbank.org/external/default/main?pagePK=64165259&theSitePK=469382&piPK=64165421&menuPK=64166093&entityID=000009265_3961005112849>

⁴³ IMF, *A primer on Mineral Taxation* (Thomas Baunsgaard), Working Paper No. 01/139, (2001)

⁴⁴ Supra note 20

⁴⁵ John Freebairn & John Quiggin. "Special Taxation on the Mining Industry." *Economic Papers*, December 2010: 384-396. Page 386

in an efficient manner.⁴⁶ Yet, an additional risk is the fact that the mineral found needs to be of a certain shape, nature and grade in order for it to be economically beneficial to the investing company to exploit it, but unfortunately this information is not available before the costs are incurred.⁴⁷

Also, as mentioned above, the mining industry is exposed to commodity price fluctuations as the prices of this type of resources fluctuate.⁴⁸ This implies an additional type of risk as the investment ought to be recovered despite the price patterns or else, massive losses can occur if the price cycle is not accurately predicted.⁴⁹

In addition to this, it is important to bear in mind that the investing company has no choice as to the location of the mining activities as opposed to an investor of almost any other sector when deciding where to establish their business.⁵⁰ The investing company has to establish where the mine and the minerals are⁵¹. In most cases, mines tend to be located in remote or undeveloped spaces⁵².

In the particular case of foreign companies, in addition to being subject to the risks that other domestic companies in the same industry may face, they bear the risk of a government that may not be accessible or known to them.⁵³ The risks faced by foreign companies can be mainly classified in three different groups: expropriation risk, contract risks, and policy risks.⁵⁴

Although direct expropriation was not a common event in the recent years (partly because direct threats to property rights are not as effective as they used to be due to the changing structure of foreign investment) some examples like Venezuela and Zimbabwe should be kept in mind.⁵⁵

⁴⁶ Supra note 20

⁴⁷ Supra note 20 and Otto, J., "Global Transition in Mining Laws and Tax Systems", in United Nation (ed.) Minerals Industries Taxation Policies for Asia and the Pacific 3, at 8 (New York: UNDP, 1992).

⁴⁸ Supra note 20

⁴⁹ Ibid

⁵⁰ Ibid

⁵¹ Ibid

⁵² Ibid

⁵³ Supra note 41 at 5

⁵⁴ Supra note 41 at 6

⁵⁵ Supra note 41 at 7

Recent cases in Argentina and Bolivia show that expropriation, even if followed by compensation is occurring more often again.⁵⁶

Indirect expropriation is also a risk and it occurs through interference of the government in the use or enjoyment of the benefits generated by a property, even if the property is not seized or the legal title affected.⁵⁷

Contract risk refers to the risk associated to the incomplete or defective fulfillment of agreements signed with either government or host country firms.⁵⁸ Some of the reasons for this include the fact that host governments may be corrupt. Even if the governments are not corrupt, their judiciaries may be weak, hence will not protect contract rights signed between the foreign company and the government, even if there is no corruption involved.⁵⁹

Policy or regulatory risk refers to the modification of policies that were in force while the investor was making a decision. The common reason for this modification is mainly the intention of the government to extract a higher amount of benefit from the investment through changes in regulation, tariffs, selective law enforcement, etc.⁶⁰ Mining projects (in the same way as infrastructure ones) are sensitive to public action as governments are likely to play an important role in regulation of entry, definition of prices and other aspects referred to the particular investor.⁶¹ Due to the very nature of mining activities, that tend to cause social and environmental disruptions, popular protests are common to this industry, including investor's facilities becoming targets for expressions of discontent from the population.⁶² This implies that investors are not ideally positioned to protect their own interests from such risks.⁶³ Even in the course of normal operations, mining projects may be subject to political opportunism aimed at

⁵⁶ Francisco Peregril, "Argentina expropia a Repsol su filial YPF" *El País* (April 17, 2012), online: <http://economia.elpais.com/economia/2012/04/16/actualidad/1334590509_507539.html>; "España denuncia ante el G20 la expropiación Argentina de la petrolera YPF" *ABC.es* (April 21, 2012), online: <<http://www.abc.es/20120421/economia/abci-espaa-denuncia-201204210122.html>>; "La decisión del presidente boliviano Evo Morales de expropiar las acciones de Red Eléctrica Española (REE) es vista con preocupación en Estados Unidos" *BBC Mundo* (May 2, 2012), online <http://www.bbc.co.uk/mundo/ultimas_noticias/2012/05/120502_ultnot_bolivia_dpto_de_estado_eeuu_jgc.shtml>.

⁵⁷ OECD Directorate for Financial and Enterprise Affairs, "'Indirect Expropriation' and the 'Right to Regulate' in International Investment Law". Working Papers on International Investment No. 2004/4 (2004), online: <<http://www.oecd.org/investment/investmentpolicy/33776546.pdf>>

⁵⁸ Supra note 41 at 7

⁵⁹ Ibid

⁶⁰ Supra note 41 at 8

⁶¹ Theodore H. Moran, "Political and Regulatory Risk in Infrastructure Investment in Developing Countries: Introduction and Overview" (1999) 5-6a CEPMLP, online: <<http://www.dundee.ac.uk/cepmlp/journal/html/vol5/article5-6a.html>>

⁶² Ibid

⁶³ Ibid

pleasing public opinion against the ongoing project.⁶⁴ The “obsolescence bargain” model, which analyses the treatment of foreign investors in developing countries, with emphasis on natural resource investors describes the interaction process: investors demand from government some compensation for the initial uncertainty to which the resources are exposed⁶⁵. Host authorities agree to these terms in the aim of attracting the investment, but once the success of the project is evident, the government refuses to continue to compensate investors as generously.⁶⁶ At this time, the government is prone to demand a revision of the terms of the investment.⁶⁷

It is reasonable to question why a government would act in a way that negatively impacts their global image and reduces their possibility of attracting further foreign investment. For some, this may be explained by the fact that sometimes the short term incentives may seem more beneficial than the long term ones.⁶⁸ An additional factor may be the political ambition of the party in office; harming its reputation at the international level may not be as bad if the move will assure the reelection of the governing party. This happens at a higher rate in developing countries with scarce resources than in industrialized countries.⁶⁹

The major risks and the special characteristics detailed above explain why the mining sector requires that host country governments put in place a tax policy specifically tailored to balance and manage the huge financial commitments of investing firms, guaranteeing them a tax treatment that is fair and considers their exposure to risk, striking a balance between incentives to attract corporations and the government’s own need to retain the largest possible share of the revenues to benefit society.

5. Usual Trade-Offs in Fiscal Systems Design

As discussed above, there is a fundamental conflict between the investing party and the government negotiating a mining contract, since both parties intend to maximize their rewards

⁶⁴ Ibid

⁶⁵ Ibid

⁶⁶ Ibid

⁶⁷ Ibid

⁶⁸ Supra note 41 at 6

⁶⁹ Ibid

and avoid as much risk as possible.⁷⁰ The taxation system becomes relevant as it is through the fiscal arrangement that parties will be able to maximize their revenues, simultaneously encouraging a stable and reliable legal environment while accomplishing efficient resource development.⁷¹ Striking a balance is not an easy task, as imposing high taxes increases the risk that investors may invest elsewhere, but on the other side, if taxes are too low government may needlessly end up forgoing valuable fiscal revenue.⁷² Governments which pre-commit to not nationalizing mines are more prone to keep that commitment when tax rates are high as this would make it less likely that nationalization would provide better net results. This, of course, does not eliminate nationalizations that are guided by political ideology rather than a careful cost-benefit analysis, but it does reduce the risk of political upheaval against private companies exploiting these resources.

Due to the opposing interests of the government and the investor, sometimes parties need to forgo some of its requirements to be able to gain some other benefit. I will discuss a few of the most common trade-offs faced during mining tax reforms next.

5.1 Government's generation of rents versus investor's incentive

The most evident trade-off is represented by the conflict between the mining company investing in the host country, who tries to maximize profits and avoid risk, and the government, who intends to maximize tax revenues while pleasing the electorate and remaining competitively attractive to investment. There are several dimensions to this trade-off, some of them are detailed next:

5.1.1 Taxing profits versus taxing production

Mining investors generally prefer profits-based taxes, since these types of taxes help reduce their financial risk. In some cases, for example, profit-based taxes allow investors to delay the disbursement of the tax payment until the moment in which up-front costs have been recovered⁷³

⁷⁰ IMF, *Mining Taxation: An Application to Mali* (Thomas, Saji) Working Paper No. 10/126, (2010) at 15, online: <<http://www.imf.org/external/pubs/ft/wp/2010/wp10126.pdf>>

⁷¹ Ibid

⁷² Supra note 39 at 2

⁷³ Oxford Policy Management, *Minerals Taxation Regimes: A review of Issues and Challenges in their Application*, (Commonwealth Secretariat - International Council of Mining and Metals, 2009) at 9

(depending on country specific tax and accounting rules⁷⁴). This will likely not be the preferred alternative to host governments, since the use of these types of taxation implies that government will receive very little to none revenues for a period of time. Both parties seem to agree on the fact that a certain amount of funds received today are more valuable to the holder than they would be if received in the future.⁷⁵

Conversely, production-based taxation not only allows governments to ensure some tax revenues, but brings with it some political advantages such as earmarking those revenues.⁷⁶ For mining investors the main disadvantage of using production-based taxation is that it may imply the payment of taxes even when the investor may be in a loss position.⁷⁷ Production-based taxes may also work as a persuasion for investors to cut back production on sites that have higher per unit costs.⁷⁸

The payment of taxes is not the only dimension to this tradeoff. The design of tax policy may also include tax incentives. Accelerated depreciation and tax holidays granted in the early years of a project are the two most common ways in which governments provide time-sensitive tax incentives.⁷⁹

5.1.2 Tax discrimination

Tax discrimination is another aspect of the trade-off. It is a common practice throughout the world. The three most common tax discrimination practices are based on the type of mineral being mined, the scale of the operation, and the "nationality" of the miner.⁸⁰ Discrimination by type of mineral may be achieved, for instance, by the use of higher royalty rates for a specific type of mineral or class of minerals, for minerals that compete in a global market, and/or for minerals that generate higher profits than others.⁸¹ Discrimination by size of operation usually takes into account the profit-potential of the investment and provides exemptions from certain

⁷⁴ Ibid at 36

⁷⁵ Supra note 39 at 17

⁷⁶ Supra note 73 at 9

⁷⁷ Ibid

⁷⁸ Supra note 73 at 36

⁷⁹ Supra note 39 at 17

⁸⁰ Ibid

⁸¹ Ibid

taxes for a period of time.⁸² Finally, discrimination by nationality of the miner is common in developing countries and it is usually achieved by means of providing special tax terms to foreign investment through specially negotiated agreements.⁸³

The subject of tax discrimination is highly contested in the literature with regards to the way in which these types of provisions should be interpreted.⁸⁴ The fact that a local versus foreign party or a large versus small company implies different uses of government services may justify differences in their tax treatment.⁸⁵ In this sense, arriving to the conclusion that a tax is discriminatory requires an understanding of the values being promoted by the non-discrimination principles.⁸⁶ The analysis of these principles is beyond the scope of this thesis, but nonetheless, it is important to keep in mind the perspectives and usual trade-off that tax discrimination may imply for governments and foreign investors.⁸⁷

In this sense, we should keep in mind that from the government's perspective, tax discrimination allows for an increase in tax revenues but may reduce competitiveness as compared to other jurisdictions. Conversely, from the investor's point of view, (depending on the specific situation such as the size of the operation for instance), risk compensation, volatility of mineral prices in the global market and lack of neutrality are situations that may need to be addressed by government. The challenge is to determine how much tax can be extracted from the investment while providing mining companies with reassurances that the investment is worthwhile.⁸⁸

5.2 Government's sovereignty versus credible commitment

This section will discuss the trade-off between a government's sovereignty versus credibility. In a country where political risk is perceived as high, companies are usually attracted by the incentives provided by host government, such a reduced tax burden, what allows companies to

⁸² Ibid

⁸³ Ibid

⁸⁴ Ruth Mason & Michael S. Knoll, "What is Tax Discrimination?" (2012) 21 Yale Law Journal

⁸⁵ Ibid

⁸⁶ Ibid

⁸⁷ Ibid

⁸⁸ James Otto, et al., *Mining Royalties A Global Study of Their Impact on Investors, Government and Civil Society*, (Washington D.C.: The International Bank for Reconstruction and Development/The World Bank, 2006), online: <<http://siteresources.worldbank.org/INTOGMC/Resources/336099-1156955107170/miningroyaltiespublication.pdf>>

potentially increase the rate of return on the investment.⁸⁹ The government, on the other side, is enticed by the projected revenues, the jobs created for local population and the investment in new technology associated with foreign investments.⁹⁰ However, in cases where the mining investment is expected to contribute immediately to the economic development of the country, mining companies should be aware that the fact that the host government needs to wait longer to receive the tax revenue increases the political risk.⁹¹ The balance tilts towards the host government once the investment is sunk since, at this point, the government has little incentive to maintain the rules that favor the investor, placing the investor in a very vulnerable position with regards to the change to the fiscal terms once the production stage has started.⁹² Changes in political leadership may also cause a change in the tax regime.⁹³

With the intention of, among others, protecting the foreign investment against political risk, most investors rely on International Investment Agreement (IIA).⁹⁴ More generally, IIA are treaties signed between two or more countries in order to address cross-border investment issues⁹⁵. IIA usually contain stabilization clauses, which aim to committing the host government not to change the legal framework that applies to a project without the consent of the investor.⁹⁶ The intention is to reduce the non-commercial (i.e. fiscal, regulatory or political) risk associated with the investment.⁹⁷

However, in cases where the fiscal regime is not set in statute but negotiated between the parties, uncertainty tends to be greater.⁹⁸ As a consequence, investors are more likely to require stability clauses in such cases.⁹⁹ A stability clause is an agreement signed between the host government and the investor, in which the government guarantees the investor that the regulatory framework

⁸⁹ Supra note 73 at 66

⁹⁰ Ibid

⁹¹ Ibid

⁹² Ibid

⁹³ Supra note 41 at 5

⁹⁴ Howard Mann, *International Investment Agreements, Business and Human Rights: Key Issues and Opportunities* (Winnipeg, International Institute for Sustainable Development, 2008), online: <http://www.iisd.org/pdf/2008/iaa_business_human_rights.pdf>

⁹⁵ Ibid

⁹⁶ Lorenzo Cotula, *Foreign investment contracts* (London: International Institute for Environment and Development, 2007) at 2, online: <<http://pubs.iied.org/pdfs/17015IIED.pdf>>

⁹⁷ Ibid

⁹⁸ Supra note 73 at 56

⁹⁹ Ibid

of a particular regime will not be altered throughout the investment term¹⁰⁰. Alterations to the fiscal regimes are not restricted to increases in tax rates; pressure for mining investors to make “voluntary” contributions towards what would be normally considered as public expenditures is an example seen recently in Tanzania and Peru.¹⁰¹

6. Conclusion

Based on the information provided above, the main point of this chapter is that the interests of the main negotiating parties to a mining investment agreement (the government and the investor) are diametrically opposed given that both parties will always try to maximize their revenues and minimize their level of risk in order to meet their different needs. Government, on one side needs to balance the reception of tax revenues to fund its activities, while keeping the the public interest as a priority. On the other side, investors require a tax policy specifically tailored to balance and manage the huge financial commitments of investing firms

¹⁰⁰ Supra note 96 at 2

¹⁰¹ Supra note 73 at 66

Chapter II

The Mining Sector in Peru: Relevant Stakeholders

This second chapter is focused on the Peruvian case and is mainly divided in two parts. The first one contains details on the relevance of the mining sector to the Peruvian economy, the size of the mining tax contribution to the economy and the way in which the redistribution process formally works. The information contained in the first part of this chapter will allow the reader to appreciate the importance of the conflicts of interests and frictions generated by the evaluation or approval of a mining project in Peru. The second part, relying heavily on the public choice approach, provides a detailed description of the conflicting interests of the main parties involved when a mining project is being decided. This second part of the chapter contains descriptions of the concerns of each of the parties and how should these parties would like to see their concerns addressed and, if applicable, the action that the government has already taken in this regard. Finally, this second chapter contains a detailed description of the Prior Consultation Law, its impact and some development points.

1. The relevance of Mining in Peru

During the past few years, the Peruvian economy has proved to be very stable despite the world financial crisis. One of the reasons for this stability is the fast pace at which mining investments in Peru have increased, to the point of becoming one of the main contributors to the Peruvian national economy. This increase in mining activities put the inadequacy of Peruvian mining legislation in the spotlight, in particular the tax legislation that regulates the government's participation in mineral exploitation, the legislation that regulates local communities' participation in the process (and also benefit from the revenues) and the rules regarding illegal mining activities. Some examples of the inadequacy of the legislation are: on the one hand, Peru's excessive tax burden imposed to mining investors, which is higher than other countries (and the fact that Peruvian law taxes the operating revenues instead of the profits, generating a

disincentive to mining companies)¹⁰² and on the other hand the distress and opposition of the population, particularly the communities located close to mining sites. In response, these communities found a way to put pressure on government and to show their disagreement with the government's mining decisions through street demonstrations, which in most cases are accompanied by violent protests.

Several local communities have expressed their opposition to mining projects close to or in the place where they live. The local distress, paired with the general lack of trust in the government, has generated a variety of social conflicts, most of which become violent. Social conflict in turn threatens, among other things, the mining revenues expected by the government and the country's image, since it sends signs of a volatile political environment (a stable political environment being particularly important to attract investment and generate revenues). The national economy also suffers the impact of the protests driven by local communities directly affected by the mining project, as the violence that arises from these conflicts affects local commerce and in most cases protestors block main highways disturbing the regular development of economic activities. Threats to personal safety are also a concern, as the violent manifestations of discomfort by local communities have already taken several lives away.

This chapter is divided in three parts. The first one intends to provide the reader with a clear image of the relevance of mining revenues, and particularly mining tax revenues, for the Peruvian economy. Even during a time of world economic crisis, mining revenues accounted for one of the main sources of income to the government. This section is important to highlight what is at stake when mining investors decide to avoid or to disinvest in Peru due to violent protests of locals who disagree with the mining project for reasons that could range from environmental concerns to insecurity regarding the alienation of their only source of income (their land).

The second part of the chapter discusses the concerns and expectations of the main actors during the negotiation of mining agreements. The government, for example, faces conflicting interests between capturing higher revenues that could be used to finance public services (or embezzled) and political expediency if mining agreements are subscribed, versus protecting the conservation of natural resources from plundering and the environment and protecting the local communities

¹⁰² Instituto Peruano de Economía, *La Tributación Minera en el Perú* (Lima, Sociedad Nacional de Minería y Petróleo, 2011), online: <<http://www.snmpe.org.pe/pdfs/Tributacion-Minera-en-el-Peru/Libro-La-tributacion-Minera-en-el-Peru.pdf>>

that may be affected by the mining activities. In addition to the government as a supplier of reforms, we have (i) the mining companies, (ii) local communities living close to actual or potential mining sites and (iii) the rest of the country population demanding several actions from the government. Each of these actors have their own interest, which may be diametrically opposed to the interests of the other groups. The mining companies are interested in high profits but demand certain conditions to bring their capital to Peru, such as a stable tax and legal regime, political stability, government presence to defuse social conflict within mining communities in a timely manner. The disagreement of mining communities with the mining project generates friction with government and also with mining companies. The rest of the country's population, although not directly affected, will experience the effects of the forgone mining revenues or the violent protest of the local communities as these citizens see their business activities interrupted due to highways blockage and other forms of protest.

The third part of this chapter includes some background information to the Prior Consultation Law, (a law that allows indigenous and native population to be consulted before the government makes a decision that may affect them in any manner whatsoever), a description of the current legislation and some proposals for improvement.

1.1 The importance of Peruvian Mining with relation to the economy

Mining exports (metal) accounted for 60.9% of Peru's national exports in the year 2009.¹⁰³ This was despite the fact that, according to a report issued by the Ministry of Energy and Mines — MINEM, the mining sector exports had declined by 12.31% (from US\$18.6 to US\$16.3 billion) between 2008 and 2009 largely due to the international financial crisis.¹⁰⁴

Table 1 shows Peruvian mining exports alongside other sectors' exports.

¹⁰³ Instituto de Ingenieros de Minas del Perú, *Minería Peruana: Contribución al Desarrollo Económico y Social* (Lima, Ministerio de Energía y Minas, 2011), online: < <http://www.minem.gob.pe/publicacion.php?idSector=1&idPublicacion=366>>

¹⁰⁴ Ibid

Peru Total exports per productive sector 2009
In US\$ millions

| Products | Productive Sector | 2008 | 2009 | Variation (%) | Exports value (%) |
|------------------------|---------------------------------|---------------|---------------|---------------|-------------------|
| Tradicional | Fishing | 1,791 | 1,683 | -6.05 | 6.26 |
| | Agricultural | 685 | 633 | -7.53 | 2.35 |
| | Mining | 18,657 | 16,361 | -12.31 | 60.86 |
| | Oil and derivatives | 2,663 | 1,894 | -28.9 | 7.04 |
| | Subtotal | 23,796 | 20,571 | -13.56 | 76.51 |
| Non-tradicional | Agricultural | 1,912 | 1,823 | -4.68 | 6.78 |
| | Fishing | 622 | 517 | -16.83 | 1.92 |
| | Textiles | 2,018 | 1,492 | -26.04 | 5.55 |
| | Timber, paper and manufacturing | 425 | 335 | -21.32 | 1.25 |
| | Chemical | 1,041 | 837 | -19.62 | 3.11 |
| | Non-metalic minerals | 176 | 148 | -15.83 | 0.55 |
| | Iron and Steel | 908 | 560 | -38.36 | 2.08 |
| | Metal-Mecanic | 324 | 357 | -10.15 | 1.33 |
| | Others | 118 | 93 | -20.94 | 0.35 |
| | Subtotal | 7,543 | 6,160 | -18.33 | 22.91 |
| Otros | | 190 | 154 | -19.25 | 0.57 |
| Total Exports | | 31,529 | 26,885 | -14.73 | 100 |

Source: Instituto de Ingenieros de Minas del Perú. *Minería Peruana: Contribución al Desarrollo Económico y Social* (Lima. Ministerio de Energía y Minas. 2011)

Even with such reductions, when compared to other countries with strong mining sectors, the relative importance of mining to the national economy is higher in Peru than in any other country, as Table 2 shows.

Total and Mining Exports 2009
In US\$ millions

| | Peru | Chile | Mexico | Colombia | Brazil | Southafrica | Canada | Australia |
|---------------------------------------|--------------|--------------|-------------|--------------|--------------|--------------|--------------|--------------|
| Mining exports | 16,361 | 30,461 | 1,448 | 13,786 | 16,191 | 26,268 | 57,499 | 60,625 |
| Total exports | 26,885 | 53,735 | 229,783 | 32,853 | 152,980 | 86,120 | 319,882 | 194,224 |
| Mining exports as a % of total | 60.9% | 56.7% | 0.6% | 42.0% | 10.6% | 30.5% | 18.0% | 31.2% |

Source: Instituto de Ingenieros de Minas del Perú. *Minería Peruana: Contribución al Desarrollo Económico y Social* (Lima. Ministerio de Energía y Minas. 2011)

The “Metals Economics Group” issued a report in March 2010 regarding global trends in mineral exploration. Peru was considered the third largest recipient of global capital for mining exploration based on estimated budgets for 1,846 exploration companies around the globe.¹⁰⁵

According to the United States Geological Survey (USGS), in the year 2011, Peru occupied the second place in the world in mining production on copper, the third place in zinc, silver and tin,

¹⁰⁵ Ibid

the fourth in lead and molybdenum, the sixth in gold and the tenth in cadmium.¹⁰⁶ In Latin America, Peru leads on the production on major metals, ranking first in gold, zinc, lead and tin, and second in copper, silver, cadmium and molybdenum.¹⁰⁷ The tax rate on the income generated in the mining sector can reach up to 48 percent (27% on income tax, 8% on employee's profit sharing, 6% on mining royalties¹⁰⁸, 3% on dividend withholding, 2% on voluntary payments¹⁰⁹, and some others that add up to about 2%).¹¹⁰

In 2011, mining investments represented 20.8% of total private investment in the country, which is equivalent to US\$7,202 million.¹¹¹ According to a well-known Peruvian macroeconomic consulting firm, mining is the main source of financing in mining provinces, it created employment opportunities for 800,000 persons (652,000 direct employment and 176,000 indirectly) and the poverty levels in provinces with mining resources was lower than in places where no natural resources are found.¹¹² In relation to poverty levels, it was indicated that child malnutrition is 4.4% lower in mining provinces (41.2 % malnutrition in mining provinces and 45.6 in non-mining provinces).¹¹³

In 2012 Peru is expecting around US\$ 53,391 million of mining investments.¹¹⁴ This data shows the relevance of mining revenues and other contributions to the national economy, indicating the large economic benefits the government can accrue if it allows such projects to take place. However, as I will discuss in section two, there is a trade-off, as these projects affect citizens located in remote mining communities, who have been very vocal about their dissatisfaction with such projects, organizing protests that can seriously damage the government's political image.

¹⁰⁶ Ibid

¹⁰⁷ Ibid

¹⁰⁸ Mining royalties is only applicable to mining companies in the general regime (the regime to which a company pertains in determined by its size).

¹⁰⁹ Only 39 mining companies subscribed the voluntary contribution agreement.

¹¹⁰ It is important to keep in mind that these percentages do not refer to the actual tax rate of each of this taxes or contributions, but to the overall load that these taxes and contributions represent to the investor. Supra note 103.

¹¹¹ "Minería representó el 20,8% de las inversiones privadas en 2011", *El Comercio Peru* (May 14, 2012) online: <<http://elcomercio.pe/economia/1414639/noticia-mineria-represento-208-inversiones-privadas-2011>>

¹¹² Ibid

¹¹³ Ibid

¹¹⁴ Ministerio de Energía y Minas, "Cartera estimada de Proyectos de Inversión" (2012) at 1, online: <<http://www.minem.gob.pe/minem/archivos/file/Mineria/INVERSION/2012/2012-CARTERAESTIMADA-ABRIL.pdf>>

1.2 Mining tax contribution to the Peruvian economy and redistribution

In addition to been important to the national economy in general, mining revenues are also very relevant for the public budget through taxation. Mining tax revenues are not only important to enable the federal government to fund important public services, but they may also serve as tools to redistribute wealth through decentralization, thus providing funding for the communities located in or close to mining sites (in most cases remote communities where public services or investments are hardly seen). For the latter, redistribution can be used to train such communities in activities other than mining as a way of preparing members of the community for future times when mineral resources have been exhausted.

The first part of the subsection shows some statistics that demonstrate the importance of mining tax revenues as a percentage of total revenues from all other economic sectors. In addition, this subsection elaborates on the redistribution aspects of these funds and how these may be used or invested. In this sense, the second portion of this subsection details how the government apportions the total tax revenues to the corresponding provincial and local governments and briefly summarizes some of the restrictions for the use of these funds.

In this regard, it is important to consider that, according to the Peruvian Constitution, the government is the sovereign owner of the natural resources and is able to grant mining concessions to private persons, setting in which conditions these resources should be exploited. The federal/central government receives all the mineral revenues and distributes some to regional and local governments.¹¹⁵

In addition to the Income Tax on mining revenues, VAT, excise tax, import tariffs, a temporary tax on fixed assets, and taxes on financial transactions, the mining sector also contributes with payments applicable to the granting and penalty of mining concessions and mining royalties.¹¹⁶

¹¹⁵ Supra note 103 at 46

¹¹⁶ Supra note 103 at 47

1.2.1 Mining tax revenues as a percentage of total tax revenues

During 2009 the government collected S/. 3,018 million of Income Tax, a decrease of 16% as compared to the 2008 amount of S/. 3,666 million and the 2007 peak of S/. 5,157 billion (US\$2,000 billion).¹¹⁷ In this regard, it is important to bear in mind that even though the collection of Income Taxes for 2009 decreased considerably as compared to the 2008 year, the mining sector is the largest contributor to the government revenues as compared to other economic sectors.¹¹⁸

Corporate Income Tax collected by economic sector

| Sectors | 2008 (in millions) | 2009 (in millions) | Relative Variation | 2009% |
|---------------|-----------------------|-----------------------|-----------------------|---------------|
| Mining | 6,743 | 3,018 | -55,24 | 23,39 |
| Commerce | 2,235 | 2,099 | -6,06 | 16,27 |
| Manufactures | 2,235 | 2,004 | -10,35 | 15,52 |
| Hydrocarbons | 996 | 543 | -45,46 | 4,21 |
| Construction | 395 | 548 | 38,85 | 4,24 |
| Fishing | 59 | 54 | -8,39 | 0,42 |
| Agricultural | 54 | 38 | -29,97 | 0,29 |
| Others(1) | 4,454 | 4,604 | 3,36 | 35,67 |
| Totals | 17,169 | 12 907 | -24,82 | 100,00 |

(1) Includes telecommunication services, financial services, health related services, social services, tourism and others

Source: Instituto de Ingenieros de Minas del Perú, *Minería Peruana: Contribución al Desarrollo Económico y Social* (Lima, Ministerio de Energía y Minas, 2011)

Mining royalties were also contracted by 33,56% as compared to the 2008 year.¹¹⁹ The decrease of both income tax revenues and mining royalties is mainly attributable to the world financial crisis given that the aforementioned payments are driven by the mining companies' profits and their production value.¹²⁰

1.2.2 Redistribution of taxes in Peru

This subsection explains how the mining tax revenues are distributed to the different provinces. This section is divided in two parts: the first part contains the details on the distribution of Mining Canon (as percentage of income tax revenues) and mining royalties. Both parts provide

¹¹⁷ Supra note 103 at 48

¹¹⁸ Supra note 103 at 50

¹¹⁹ Ibid

¹²⁰ Supra note 103 at 48

some detail on estimated amounts distributed by the central government for these concepts and the restrictions in the use of these funds.

In this regard, it is important to bear in mind that from all the taxes collected by the government (such as VAT, excise tax, import tariffs, a temporary tax on fixed assets, and taxes on financial transactions) only mining Canon and Mining Royalties are directly re-distributed to provincial and local governments. The revenues from other taxes are used by the central government directly. The provincial and local governments also receive a share of the revenues collected by other extractive sectors and additional revenues such as a percentage of the fees applicable to the granting and penalty of mining concessions.

1.2.2.1 Mining Canon

Canon is defined by the Law as the participation of Provincial and local governments in the total revenues and rents obtained by the government in the exploitation of natural resources (aside from payments for mining concession granting and penalties).¹²¹ The participation percentage is 50% of the corporate income tax received by the central government from mining companies.¹²² These amounts are transferred to regional and local governments (including local universities) as “mining Canon”.

The resources received by the provincial or local governments are to be used exclusively for the financing or co-financing of infrastructure projects within their jurisdictions.¹²³ Regional governments have to provide universities in their jurisdictions with 20% of whatever amount they receive.¹²⁴ Universities are bound to use the revenues only on technological and scientific research projects that help that region’s development.¹²⁵ The distribution is made according to the chart below, where the numbers indicate the percentage received by each sphere of local government:

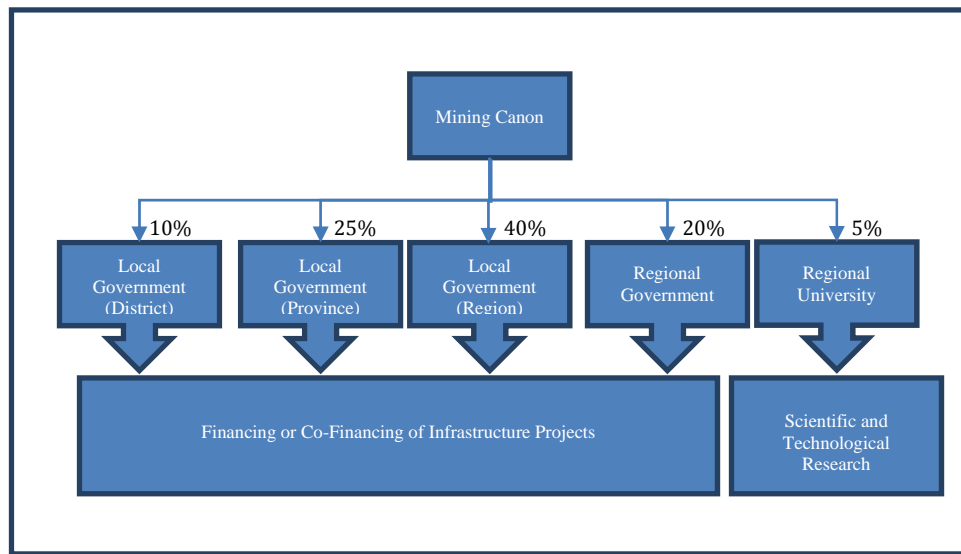
¹²¹ *Law N° 27506 Ley de Canon*, Peru, July 9, 2001

¹²² *Supra* note 103 at 54

¹²³ *Ibid*

¹²⁴ *Ibid*

¹²⁵ *Supra* note 103 at 55



Source: Instituto de Ingenieros de Minas del Perú, *Minería Peruana: Contribución al Desarrollo Económico y Social* (Lima, Ministerio de Energía y Minas, 2011)

According to the data provided by the Peruvian Ministry of Finance, regional governments along the country received S/ 937.5 million (US\$360 million) of Mining Canon during 2009 (12.62% less than what was received in 2008).¹²⁶ The decrease in relation to the 2008 amount is due to the lower amount of revenues received by the mining companies, which in turn is due to the global financial crisis.¹²⁷

1.2.2.2 Mining Royalties

Mining royalties are the financial contribution that the mining companies make to the government in exchange for the exploitation of the mining resources. Mining royalties are calculated as a percentage (ranging between 1% and 3%) of the value of the mineral resource or its production value.¹²⁸

Mining holders with annual production of up to US\$60 million are liable for a 1% mining royalty.¹²⁹ Holders that produce over US\$60 million and US\$120 million are liable for 2% mining royalty and holders who produce over US\$120 million are liable for a 3% mining

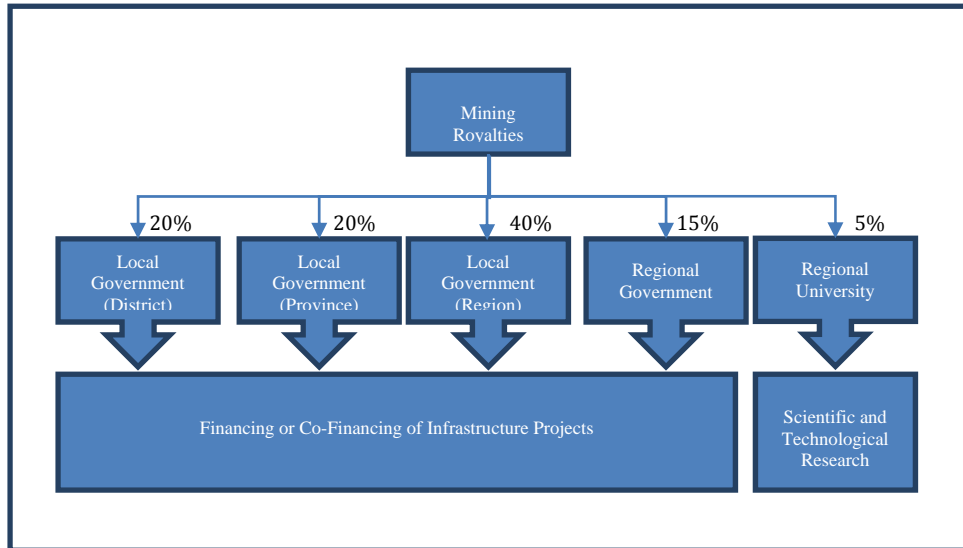
¹²⁶ Supra note 103 at 54

¹²⁷ Supra note 103 at 48

¹²⁸ Supra note 103 at 58

¹²⁹ Ibid

royalty.¹³⁰ Mining royalties are distributed to local and provincial governments in the percentages indicated in the chart below. The actual distribution is identical to the one determined by the law¹³¹.



Source: Instituto de Ingenieros de Minas del Perú, *Minería Peruana: Contribución al Desarrollo Económico y Social* (Lima, Ministerio de Energía y Minas, 2011)

In 2009, regional Governments received a total amount of S/.49.9 million (US\$19 million), which represents 31.5% less than what was received in 2008.¹³² This reduction is said to be due to the lower metal prices on international markets, which forced some companies to keep their production at minimum levels or close their mines.¹³³

The main objective of this first section was to situate the reader within the framework of how much the tax mining revenues contribute to the economy at every level of government (central, provincial and local) to allow the reader to better understand the rationale and background behind the interests and concerns of each of the parties that usually get involved in the negotiation of a mining project.

¹³⁰ Ibid

¹³¹ Refer to the numerous indexes of mining canon distribution approved by the Ministry of Energy and Mines, online: <<http://www.minem.gob.pe/legislacionSector.php?idSector=1>>

¹³² Supra note 103 at 58

¹³³ Ibid

2. Conflicting interests

As mentioned in chapter 1, each party to the mining project has a preference of how the conditions to a mining project would be best tailored for their specific needs. The government, for instance, is likely to prefer more fiscal resources rather than less, as this is likely to generate electoral benefits. Thus, it would almost always prefer to have the mining project approved and have the mining investor generating the highest possible revenues and maximizing production in order to benefit from maximized income tax revenues and other rents, which in turn implies more funding for public works, which leads to a better government image. However, the government is not interested in accepting conditions that will undermine or threaten the living conditions of mining communities living close to or inside the mining site, neither conditions that will negatively affect the rest of the country. This is especially true if the damage to local communities is likely to affect electoral results. Therefore, electoral considerations may affect the government's decision on how to balance these conflicting interests, especially when this balance comes through explicit provisions in the legislation applicable to mining. There could be incentives, therefore, for parties to request the government to supply legislation and reforms to manage such conflicts of interest.

On the other side, the mining investor and mining communities also participate in the negotiation process when deciding the conditions for a mining project to be approved. These parties, despite not being able to decide on how the legislation is to be enacted, usually demand the government including certain specific provisions in the legislation. Even when no formal legislation or formal procedures exist for this negotiation (as legislating is an exclusive power of government), the pressure from these interested parties may make the government decide one way or the other when enacting or reforming legislation.

The mining investor acts as a party directly involved in the negotiation of conditions with the government. Since the mining investor is the one who in the end gets to decide whether to carry on with the investment in Peru, it has an advantage in terms of being able to negotiate better conditions with the government. Clearly, for the mining investor one of the most attractive conditions will be the possibility to repatriate as much profit to its home country as possible, free of tax. Thus, the tax burden imposed is a big portion of the negotiation. Some other conditions,

such a stabilized legal regime, a stable economy in general, government accountability, etc. are also part of the negotiation process.

In addition, with a large list of requests and demands, local communities also are part of the negotiation process. These communities feel affected by the imposition of a mining project on or close to the place where they live or carry on their daily activities (such as cultivating lands). As a reaction to this, communities lobby (or actually demand –in most cases with violent actions–) the government to take their requirements into account.

Finally, the citizens of the country -- who are not directly affected by the mining activity but who feel an indirect impact of the government's decision regarding mining projects (mainly due to negative externalities such as environmental concerns) -- are also a relevant part in the negotiation. In the end, this is the group of people who will decide who gets to govern the country in the next election.

In this order of ideas, this portion of the chapter intends to present the reader with a cost-benefit analysis of the concerns and interest of each of the parties involved in the mining negotiation process in order to determine how should the government (or if it should at all) introduce legal reforms, focusing particularly in the legal reforms referring to tax matters. This analysis implies analyzing both the supply side of reforms (the government) and the demand side of regulations in mining activities (such as are (1) the communities directly affected by the companies, (2) the citizens of the country in general and (3) the companies planning or considering the possibility of investment in Peru). In addition, this portion of the chapter includes an attempt to describe how each of these parties would like to see their concerns being resolved by government.

As exposed above, each of these parties has its own interests and concerns and will try to pull the negotiation towards addressing its own goals. When parties concerns are not addressed, there is a risk that the level of tension will escalate and turn into a crisis.¹³⁴ With regards to how these conflicts evolve between government and local communities, an Ombudsman report identifies up to five stages: early stage (when the parties become aware of their differences and identify their opponents), escalation (when the intensity of direct physical violence increases), crisis (when violence escalates to the point where it affects fundamental rights of others), de-escalation (when

¹³⁴ Defensoría del Pueblo, *Quiénes Somos?*, online <<http://www.defensoria.gob.pe/defensoria.php>>

tension decreases and parties become more open to the idea of dialogue) and dialogue (when a communication process –direct or mediated- is achieved with the intention of reaching a common solution to the problem).¹³⁵ The reason why a conflict can escalate (or de-escalate) from one stage to another varies in each case, but the most common reasons are the lack of response to the concern posed, the lack of willingness to dialog openly, instrumentalization of the conflict with other aims, the idea that violence is a legitimate resource.¹³⁶

This friction could be identified either before the enactment of a reform (as it would be the case of local mining communities demanding that government approves a particular piece of legislation that allows them to participate of the mining revenues generated by the project) or after a reform has been enacted (as it would be the case of illegal miners protesting for the criminal typology of illegal mining and requesting the derogation of the law).

In the particular case of Peru, cases of friction escalating into crisis due to concerns related to mining projects have, unfortunately, become common. In fact, according to the latest Ombudsman report, in 2011 Peru registered 220 social conflicts throughout the country, half of which are related to concerns against mining activities.¹³⁷ 153 of these conflicts remained active by February 2012.¹³⁸ It is also important to keep in mind that over the past five years, the Ombudsman reported that the frequency of social conflicts increased over 300%.¹³⁹ The cause for social conflict varies in each case, but among the immediate causes of conflict that have been identified by the Ombudsman report are: the lack of willingness of government to construct a road or highway, the fear of contamination of natural sources such as water, air or soil, suspected corruption in the management of public monies and lack of interest from government in a particular situation.¹⁴⁰

¹³⁵ Defensoría del Pueblo, *Violencia en los Conflictos Sociales*, Informe Defensoria No. 156 (Lima, Defensoría del Pueblo, March 2012) at 31, online: <<http://www.defensoria.gob.pe/informes-publicaciones.php>>

¹³⁶ Ibid

¹³⁷ “Conflictos sociales marcaron el ritmo de las inversiones en las regiones”, *El Comercio Peru*, (January 9, 2012), online: <http://elcomercio.pe/peru/1358577/noticia-conflictos-sociales-marcaron-ritmo-inversiones-regiones_1>

¹³⁸ “Defensoría del Pueblo reporta la existencia de 228 conflictos sociales”, *El Comercio Peru* (February 10, 2012), online: <<http://elcomercio.pe/politica/1372619/noticia-defensoria-pueblo-reporta-existencia-228-conflictos-sociales>>

¹³⁹ Ibid

¹⁴⁰ Supra 135 at 37

2.1 Demand side

The demand side of mining reforms relates to the parties requesting that their concerns be addressed by the government. The cost-benefit analysis of these parties consists on determining how much they are willing to give up or pay for what they would receive (or how would they benefit) from the development of a mining project. Each of the parties included in the demand side has its own interests and concerns and, as a group, there are certain conditions they may not be willing to give up at any cost. This portion of the chapter intends to capture the costs and benefits of each of the parties, providing not only theoretical literature, but also examples of how these concerns are actually manifested by these communities. It also attempts to provide an idea of the ways in which these parties would like their concerns to be addressed, attending to the costs and benefits they individually face.

2.1.1 Communities involved: expectations according to literature and real life in Peru

2.1.1.1 What are their interests and concerns

Throughout the year 2011, different places in Peru seemed to show a repetitive cycle over and over again: citizens showed their disagreement with something (a mining concession for the most part) by blocking highways, taking over public places, organizing massive gatherings of people, etc. Then local and regional government authorities try to dialogue with them, citizens reject any government proposal and get even more radical. Often, the conflict was not attended at an earlier stage. Instead the authorities waited until the situation has become critical to intervene. As mentioned above, among the elements contributing for a conflict to escalate from one level to another are the lack of response from the corresponding authority and the idea that violence is a legitimate recourse to manifest disagreement.¹⁴¹ After violent confrontations with police and armed forces in general, the government (or the mining investor) steps back and let the citizens get their way.¹⁴² The reason why government seems to often side with the protesters is due to

¹⁴¹ Ibid

¹⁴² “El 2011 fue un año en el que las protestas antimineras primaron en el país”, *El Comercio Peru* (December 28, 2011)., online: <<http://elcomercio.pe/peru/1353815/noticia-2011-fue-ano-que-protestas-antimineras-primaron-pais>>

the fact that this opposition to the mining projects provides opportunities to political leaders to obtain political support.¹⁴³

The aforementioned explains and exemplifies that in Peru, the relationship between the communities that inhabit the area where mining activities take place and the mining companies is generally driven by mutual distrust and lack of credibility. The same applies to their relationship with the government. Communication problems and cultural differences can be highlighted as some of the reasons behind this distrust and lack of credibility.¹⁴⁴

Local communities have reported that they feel left aside by the government because the elected members of government rarely even consider their needs, interests or concerns and very occasionally consult with them.¹⁴⁵ In cases where communication has been attempted, the level of understanding is poor due to the complexity and technicality of mining issues.¹⁴⁶ According to a study conducted by USAID, the main reason why these communities are not able to get access to government officials stems from long-term structural and cultural problems such as poverty and illiteracy as well as underlying forms of discrimination.¹⁴⁷

As a consequence, communities feel their expectations are not fulfilled, in addition to the environmental concerns and land tenure concerns that come with mining activities. This in turn helps fuel the perception that new mining operations will duplicate the problems that other mining communities have already faced and remain unsolved, as they feel these issues are not being addressed by the government.¹⁴⁸

The lack of communication with the government is paired with the fact that many leaders and social organizations still agree with the idea that violence is an effective means of achieving their

¹⁴³ Aldo Ponce and Cinthia McClintock, "The Explosive Combination of Inefficient Local Bureaucracies and Mining Production: Evidence from Localized Societal Protests in Peru", online:

<<http://business.gwu.edu/CIBER/studentactivities/files/Mining&SocietalProtet.pdf>>..

¹⁴⁴ Martín Tanaka et al., "Minería y Conflicto Social" (2007), 65 *Revista Economía y Sociedad* 7-17, online: <<http://cies.org.pe/files/ES/bol65/01-REVESZ.pdf>>

¹⁴⁵ "Democracy and Governance in Peru: An Assessment" (Washington DC, U.S. Agency for International Development, 2000), online: <<http://www.gci275.com/archive/governance.pdf>>

¹⁴⁶ *Wealth and Sustainability: The Environmental and Social Dimensions of the Mining Sector in Peru* by The World Bank, online:

<http://siteresources.worldbank.org/INTPERU/SPANISH/Resources/FINAL_EXECUTIVE_SUMMARY_Mining.pdf>

¹⁴⁷ Supra note 145

¹⁴⁸ Supra note 146

objectives.¹⁴⁹ This combination usually makes the concerns of local communities to escalate to the level of violent protests. Unfortunately, in 58% of the cases, the dialogue process between the government and local communities about the reason of their disagreement and the possible ways to find a solution starts only after the conflict has become violent.¹⁵⁰

As mentioned before, the mistrust of mining communities is not only in their relationship with government but also with mining investors, and according to the USAID research this may be due to a lack of knowledge about each other.¹⁵¹ Mining companies have done little to understand the social and cultural aspects of these communities and the government seems unfazed of the situation.¹⁵² This has led local mining communities -- with the support of a number of social and environmental NGOs -- to adopt a confrontational attitude towards the industry and the central government.¹⁵³ This lack of communication and the accumulation of mutual negative feelings from communities to government and the mining industry certainly contributes to the creation or aggravation of conflicts during the various stages of the mining cycle.¹⁵⁴ Even if mining companies decided to attend local concerns directly in their best interest, this may not assure that protests would end since the roots of the problem are still unresolved. Local governments remain ineffective in managing their budgets in a way to make local communities feel a share of the benefits generated by the mining revenues received from mining companies and government fails to mediate between local communities and mining companies.¹⁵⁵

In addition to the mistrust and communication issues, the fact that mining activities are usually developed in extremely poor and rural areas, where economic stagnation, lack of employment opportunities, and weak, underdeveloped social capital are not uncommon, contributes to aggravate the feeling of communities toward mining activities and to make them resist mining operations.¹⁵⁶ As expected, local communities see mining activity as one that produces several negative effects on them as a community.¹⁵⁷

¹⁴⁹ Supra note 135 at 39

¹⁵⁰ Supra note 135 at 38

¹⁵¹ Supra note 146

¹⁵² Ibid

¹⁵³ Ibid

¹⁵⁴ Ibid

¹⁵⁵ Supra note 143

¹⁵⁶ Supra note 146

¹⁵⁷ Ibid

Land acquisition is also complex and a particularly conflictive aspect of mining communities concern.¹⁵⁸ The opposition of local population with respect to mining activities is usually driven by the fact that the land they use to cultivate (and where now the mining activities are expected to take place) is generally their only property and cultivating it may very well be the only activity they have been trained to do throughout their life.¹⁵⁹ Accordingly, the proposal of a mining company to buy their land may not be entirely attractive to them. In this regard, it is important to bear in mind that upon granting a concession, the government requires that an agreement is reached between the investor and the land owners in order for the investor to be able to start the exploration process.¹⁶⁰ Local population are, however, usually confronted with the dilemma that if they decide not to sell the property to the mining company, the government could simply expropriate their land for the sake of a “public benefit”.¹⁶¹ This concern would seem to be a dead end in the mining negotiation process as no mining project may prosper without the “approval” of local communities or so called social license. However, this type of conflicts have been solved several times in different mining agreements that had been approved in the past and communities were satisfied with the deal. The negotiation with mining communities may be difficult but it is possible and the key is to understand that not all communities have the same needs or fears, which implies that the negotiation conditions may vary in every deal.

In addition to this, water and other natural resources constitute the support of these communities’ life. Due to their remoteness, these communities usually survive using their land and the natural resources available to cultivate products. This is what allows them to get their daily food and sell some to bear the cost of their basic needs. The pace with which Peruvian investments are developing has aroused feelings of protectionism of natural resources (such as water and land) by communities located in areas where these investments occur.¹⁶² As a matter of fact, the majority of the social conflicts are attributable to socio-environmental concerns of the population.¹⁶³ A

¹⁵⁸ Supra note 146

¹⁵⁹ “¿Hacen bien las mineras en comprar la tierra de las comunidades donde operan?”, *El Comercio Peru*, (December 19, 2011), online: < <http://elcomercio.pe/economia/1350112/noticia-hacen-bien-mineras-comprar-tierra-comunidades-donde-operan>>

¹⁶⁰ Miguel Santillana, “Negociacion Inevitable para las Industrias Extractivas”, *Los Blogs de Semana Economica* (October 27, 2011), online: <<http://blogs.semanaeconomica.com/blogs/oso-decirlo/posts/negociacion-inevitable-para-las-industrias-extractivas#ixzz23g2y4kwA>>

¹⁶¹ Supra note 159

¹⁶² Supra note 135 at 35

¹⁶³ Supra note 135 at 3

socio-environmental conflict according to the typology used by the Ombudsman's office refers to the control, use and/or access to the environment and its resources.¹⁶⁴

An example of how local mining communities show their disagreement with a mining project could be found for instance in the blockage of the main road leading to the Cerro Quilish gold deposit to be exploited by Yanacocha Mining Company in 2004.¹⁶⁵ Protesters argued that the Cerro Quilish deposit would pollute water supplies, something Yanacocha denied.¹⁶⁶ The way in which these protests are conducted and the regularity with which they happen demonstrate how local communities try to call the attention of the government to express their concerns, in this particular case, with water contamination. As a consequence of this protest, the government revoked Yanacocha's exploration permit due to Yanacocha's public request.¹⁶⁷ The reason given by Yanacocha for the request of the permit removal was that the opposition to the project was too strong and that the dimension of opposition was originally underestimated by them.¹⁶⁸ The group of protestors was led by local farmers and near-by residents.¹⁶⁹

Also due to environmental complaints, a few days before the latest presidential elections (2011), three people died during a violent riot in Islay (Arequipa) where protestors were fighting the Tia Maria mining Project.¹⁷⁰ The rejection of the project by local communities was based on several environmental concerns raised by the United Nations Office for Project Services (UNOPS).¹⁷¹ As a consequence of the riots, the executive branch of government rejected the mining concession granted to Southern to extract copper, suspending an expected investment of US\$950 million.¹⁷²

In Puno, citizens encouraged by a local leader started a series of protests showing their disagreement with the on-site mining activities.¹⁷³ The initial protests included setting several

¹⁶⁴ Supra note 135 at 37

¹⁶⁵ Robert Koza, "Peru Social Demands, Conflicts Put Mining Industry On Edge", *Mines and Communities*, (June 16, 2005), online: <<http://www.minesandcommunities.org/article.php?a=595&l=1>>

¹⁶⁶ Ibid

¹⁶⁷ Ibid

¹⁶⁸ Ibid

¹⁶⁹ Ibid

¹⁷⁰ Supra note 142

¹⁷¹ Supra note 142

¹⁷² Supra note 142

¹⁷³ Supra note 137

public businesses on fire and more than 6,000 people taking over the local airport runway.¹⁷⁴ They requested the decontamination of the Ramis River and the declaration of the area as not suitable for mining activities.¹⁷⁵ Collisions with local police left 5 people dead.¹⁷⁶ The government, once again pleased the protestors by signing all the necessary documents to satisfy their demands.¹⁷⁷

The latest protest related to mining concerns of local communities was the one related to the Conga mining project, which is valued in US\$4.800 million.¹⁷⁸ The issue with this mining project is that four natural lagoons will dry up due to the mining project.¹⁷⁹ The government has financed an environmental impact study by an independent professional.¹⁸⁰ The protesters leaders (the regional president among them) refused to sign the agreement to put an end to the conflict if the environmental study showed that the mining project would cause no harm to the environment.¹⁸¹

In the particular case of Conga, there are different reasons for their disagreement with the mining project. In general terms, the community as a whole is concerned with the possibility of the lagoons drying-out as a consequence of the mining activities. There is in addition a small group of protestors who are not willing to accept the mining project regardless that the project proofs to be environmentally conscious.¹⁸² This last group includes the president of the Cajamarca region, Gregorio Santos, the leader of the environmental defense front, Wilfredo Saavedra (identified as a militant of a Peruvian terrorist movement associated with Marxists ideologies¹⁸³), and the leader of the “Land and Liberty” social movement, Marco Arana.¹⁸⁴ These last three individuals are, coincidentally, the same persons who have been organizing the protests against the mining project and promoting the local communities residents to join the protests.¹⁸⁵

¹⁷⁴ Ibid

¹⁷⁵ Ibid

¹⁷⁶ Ibid

¹⁷⁷ Ibid

¹⁷⁸ Supra note 142

¹⁷⁹ Supra note 142

¹⁸⁰ Supra note 142

¹⁸¹ Supra note 142

¹⁸² “Frente anti Conga se divide por intereses políticos de sus dirigentes”, El Comercio Peru (April 19, 2012), online: <<http://elcomercio.pe/politica/1403661/noticia-frente-anti-conga-se-divide-intereses-politicos-sus-dirigentes>>

¹⁸³ Ibid

¹⁸⁴ Ibid

¹⁸⁵ Ibid

Some argue that the protests in the Conga mine disguise political aims by the environmental group led by Gregorio Santos. Recently a political party was formally established by this group to participate in the regional and local election in 2014 and on the 2016 presidential elections.¹⁸⁶ Santos in fact is apparently not willing to wait until 2016 as a few weeks ago he offered a rally which urged local communities to "give a coup" against the office of the current Peruvian president.¹⁸⁷ Concerns about the mining protests being driven by non-explicit political aspirations of some community leaders in this case have been raised by several people including the Prime Minister and two Congressmen representing Cajamarca (the province where the Conga mine would be located).¹⁸⁸

Community can manifest their concerns either before or after the concession and permits are granted to the mining investor. Conga is an example where the protests were raised before the mining investor was able to get all the approvals. In fact, the pressure from the local population was so strong that the government decided to fund an independent environmental study to show the population that the mining project was "safe" for the environment.¹⁸⁹ In other cases, the protests happen after all concession and permissions are granted. The reason for this latter scenario may be the frustrated expectation of the population, who initially believe that a millionaire investment in their town or province would help reduce poverty, and yet see no substantial improvement in their life quality after the mining project is implemented.

Community concerns are not only limited to environmental issues or land tenure, but also refer to job security and income concerns. In this regard, it is important to keep in mind that local citizens are giving up their land (usually their only source of income) to the mining investor for the mining project to be carried on. This certainly generates concerns with regard to the means that they will need to support their families. Due to the fact that these local citizens living in remote mining communities feel they have no access to government, they voice their requests by means of riots or public protests. Some others resort to informal or illegal mining activities.

¹⁸⁶ "Wilfredo Saavedra criticó aspiración política de Gregorio Santos", *El Comercio Peru*, (May 22, 2012), online: <<http://elcomercio.pe/peru/1418340/noticia-wilfredo-saavedra-critico-aspiracion-politica-gregorio-santos>>

¹⁸⁷ "Gregorio Santos insto a "sacar" al presidente Ollanta Humala", *El Comercio Peru* (June 5, 2012), online: <<http://elcomercio.pe/politica/1424231/noticia-gregorio-santos-istosacar-al-presidente-ollanta-humala>>

¹⁸⁸ "Oscar Valdes: Las Leyes Peruanas dicen que Conga si va", *Peru 21* (June 4, 2012), Online: <<http://peru21.pe/2012/06/04/actualidad/oscar-valdes-leyes-peruanas-dicen-que-conga-si-va-2027202>>

¹⁸⁹ "Peritaje a Conga es transparente, independiente y sera public, anuncian" *Andina Agencia Peruana de Noticias* (April 9, 2012), online: <<http://www.andina.com.pe/Espanol/noticia-peritaje-a-conga-es-transparente-independiente-y-sera-publico-anuncian-407435.aspx>>

Illegal mining is becoming a significant problem for the Peruvian economy and although the illegal miners are a group conformed by citizens living inside or adjacent to mining sites, the literature indicates that illegal miners tend to relocate quickly depending on where the most profitable mines can be found. As a consequence, a discussion about illegal miners, their concerns and interests will be presented later in this chapter.

One example of communities protesting mining activities happened recently when a group of Doe Run mining company workers' and local residents of La Oroya blocked a central highway with the intention to call the Government's attention about their disagreement with the metallurgic complex closure.¹⁹⁰ The blockage provoked not only traffic problems but also disruption of commercial activities, as some travelers were not able to reach work destinations, containers were not delivered on time, etc.¹⁹¹ The aim of the protesters was the immediate reactivation of the metallurgic complex in La Oroya.¹⁹² The complex was closed until Doe Run finished their financial restructuring process and executed some environmental measures requested by the Government.¹⁹³ The protesters met with the Mining and Energy Minister to find a solution to their complaints, and the workers expressed their fears about losing their jobs.¹⁹⁴

In yet another example, mine workers in two different mines in Cerro de Pasco have declared themselves into an indefinite strike until they received the payment of accrued profit sharing and the reintegration of laid-off workers.¹⁹⁵

Recently, the National Federation of Metal Miners and Steelworkers of Peru announced the cancellation of a strike after the publication of legal rules creating the supplementary retirement fund for the sector, which accumulates contributions of 0.5% of mining workers gross monthly wages plus 0.5% of the mining companies annual net income.¹⁹⁶ With the intention to call the

¹⁹⁰ "Paro en La Oroya: obreros de Doe Run bloquean la Carretera Central", *El Comercio Peru* (April 4, 2012), online: <<http://elcomercio.pe/peru/1397018/noticia-paro-oroya-obreros-doe-run-bloquean-carretera-central>>

¹⁹¹ *Ibid*

¹⁹² *Ibid*

¹⁹³ *Ibid*

¹⁹⁴ *Ibid*

¹⁹⁵ "Trabajadores de dos minas en Cerro de Pasco en huelga indefinida", *El Comercio Peru* (May 24, 2012), online: <<http://elcomercio.pe/peru/1418868/noticia-trabajadores-dos-minas-cerro-pasco-huelga-indefinida>>

¹⁹⁶ "Federación minera canceló huelga anunciada para el lunes", *El Comercio Peru* (May 12, 2012), online: <<http://elcomercio.pe/peru/1414084/noticia-federacion-minera-cancelo-huelga-anunciada-proximo-lunes>>

attention of Labour authorities, some mining workers handcuffed themselves to the Ministry of Labour's front fence to require the regulation of superannuation.¹⁹⁷

Another example of mining workers fight for what they call unfair benefits was seen a few weeks ago when workers of Argentum Mining Company had a violent encounter with local police where four workers were injured.¹⁹⁸ Up to about 760 employees (95% of the total employees) demanded the fair payment of profits by trying to take-over the Central Highway.¹⁹⁹

2.1.1.2 How would the communities like the government to address these interests and concerns

Some local communities expressed their concerns about the negative impact of mining activities during a riot in Puno. The protesting communities, represented by their local authorities, intended to negotiate a solution to the violent protests and were able to reach an agreement with the executive branch of government.²⁰⁰ The communities agreed to stop the violent protests as long as the government suspended the current mining projects during the negotiation process and allowed the land owners to decide whether they wanted to sell their lands to the mining company or not, without any pressure from government.²⁰¹ They wanted to have a say in the decision of the mining activity approval and they want to feel that their opinion is respected. During the negotiation, a local leader followed by a group of citizens stated to the press that the violent protests will continue because the government did not comply with the communities requirement to suspend all the mining concessions south of Puno during the negotiation period.²⁰²

Puno was not the only case in which communities voiced their concerns with respect to ownership rights. In La Libertad, more than 2 thousand farmers took control of a lagoon to show their disagreement with the mining activities carried out in the area.²⁰³ The protesters indicated that they planned on planting more than 3000 trees to reaffirm the ownership of their lands

¹⁹⁷ Ibid

¹⁹⁸ "Mineros de Morococha se enfrentaron a policías: hay cuatro heridos", *El Comercio Peru* (April 10, 2012), online: <<http://elcomercio.pe/peru/1399757/noticia-mineros-morococha-se-enfrentaron-policias-hay-cuatro-heridos>>

¹⁹⁹ Ibid

²⁰⁰ "Puno en vilo por el reinicio de la protesta minera", *El Comercio Peru* (May 29, 2011), online: <<http://elcomercio.pe/peru/765171/noticia-puno-vilo-reinicio-protesta-antiminera>>

²⁰¹ Ibid

²⁰² Ibid

²⁰³ "Pobladores de Santiago de Chuco tomaron laguna en protesta contra minera", *El Comercio Peru* (December 10, 2011), online: <<http://elcomercio.pe/peru/1346076/noticia-pobladores-santiago-chuco-tomaron-laguna-protesta-contra-minera>>

(which are arguably a part of a mining concession).²⁰⁴ The complaints by protestors and residents of the area is based on the argument that the mine pollutes the water and is harmful to the health of the population living close to the area.²⁰⁵

Sometimes, due to the lack of governmental actions to protect their ownership rights over lands, the population has been able to directly negotiate with mining companies to reach a solution to their problems in a peaceful way. In the mining project known as Trapiche (Apurímac), the mining company was able to negotiate and reach an agreement with the owners of the land, granting them a monthly payment during the whole life cycle of the mine.²⁰⁶ In addition, if the price of the mineral went up, the monthly payment was to go up as well.²⁰⁷ On top of that, the land owners negotiated profit sharing payments.²⁰⁸ Some analysts contest the increase on the monthly fees as the price of the mineral goes up under the argument that land owners are not owners of the subsoil minerals and that the increase in mineral price should only benefit the government (tangentially benefiting the citizens outside the community) through the royalty payments.²⁰⁹ A decrease in the monthly payment when mineral prices go down was also raised as a point of argument to deny the fairness of the fluctuating rental agreement.²¹⁰

Decontamination of water sources is also a common request from local communities. During a meeting held by more than 60 local community leaders, they requested the government to declare springs, lakes and glaciers as intangible areas in order to protect them from being contaminated by extracting activities.²¹¹ In the case of the protests in Conga, local residents are also requesting the respect of their ecologic zoning process and the defense of the natural water sources.²¹²

In addition, during the aforementioned meeting held by local community leaders, the government was asked to implement, with a direct participation of the local communities, protection of

²⁰⁴ Ibid

²⁰⁵ Ibid

²⁰⁶ Supra note 159

²⁰⁷ Ibid

²⁰⁸ Ibid

²⁰⁹ Ibid

²¹⁰ Ibid

²¹¹ “Campesinos piden a gobierno que declare intangibles lagunas, ríos y glaciares”, *El Comercio Peru* (December 7, 2011), online: <<http://elcomercio.pe/peru/1344667/noticia-campesinos-piden-gobierno-que-declare-intangibles-lagunas-rios-glaciares>>

²¹² “Presidente Humala está contaminado por las mineras”, afirmó Marco Arana”, *El Comercio Peru* (March 26, 2012), online: <<http://elcomercio.pe/politica/1392896/noticia-presidente-humala-esta-contaminado-mineras-afirmo-marco-arana>>

ecological areas, and the launching of a program to decontaminating all the areas polluted by mining activities.²¹³ They also required the government to fine the mining companies that contaminate the natural resources.²¹⁴

Local leaders also emphasize the need for creating a law that allows the local communities to participate on the decision of government to approve or disapprove a mining investment.²¹⁵ Communities want to be formally consulted regarding the mining investment including an explanation in lay terms of what the mining activity will imply. The respect to the property rights of the local communities was a specific point of request.²¹⁶

In addition, the Ministry of Energy and Mines assured that according to his discussions with some mining communities, it was clear for him that the majority of them want their communities to achieve a certain level of development that allows them to leave the extreme poverty status that they actually face.²¹⁷

2.1.1.3 Mining companies and government reply to communities' concerns

As mentioned above, most of the mining activity in Peru is performed in remote areas where governmental presence is almost inexistent and local communities feel largely ignored by the government and without access to official channels to voice their concerns. Normally, these communities express their concerns to governmental authorities by going out to the streets and blocking a highway or concurred road. Often this results in violent outcomes, when police forces are sent to restore the order. These protests affect not only the local businesses or the rest of the population due to the interruption of normal activities but also the mining company's activities as well. Mining investors have mentioned that the capacity of local communities to exert pressure should never be underestimated. In this sense, and for the sake of the safeguard of the economic and business interests, the mining companies usually try to please mining communities in order to be able to maintain a safe and manageable working environment.

²¹³ Supra note 211

²¹⁴ Ibid

²¹⁵ Ibid

²¹⁶ Ibid

²¹⁷ "Ministro Merino: "Mayoría de comunidades quiere el desarrollo y salir de la pobreza"", *Info Region Agencia de Prensa Ambiental* (May 31, 2012), online: <<http://www.inforegion.pe/portada/135728/ministro-merino-mayoria-de-comunidades-quiere-el-desarrollo-y-salir-de-la-pobreza/>>

An example of this was seen in Las Bambas mining project, where a social fund was created with an initial funding amount of USD 45,5 million (3% of the committed investment)²¹⁸ granted by Xstrata Copper, the concession holder.²¹⁹ To date, a total of US\$63 million have been contributed to the fund. With these resources, the mining company carries out sustainable development projects to benefit the populations of Cotabambas and Grau (the provinces where the mining activities take place) in the areas of water and sanitation, agriculture, health, education, electricity and transportation.²²⁰ The projects are said to have benefited 43,190 people in the area.²²¹ The fund board is conformed by the Provincial Mayors of Grau and Cotabamba and the local mayors of the districts where the mining activities take place and two Xstrata representatives.²²²

In addition, there are employment concerns due to the fact that a mining company simply cannot employ the whole population. These concerns have been addressed with the creation of small companies owned by the community to provide services to the mining company. Non-competition agreements are signed as part of the initial negotiation with the mining company as part of the retribution for the sale of lands.²²³

On the side of government, some bills have been presented to the Congress with regards to the creation of legislation to nationally regulate the protection of water. The purpose of this is to promote agricultural activities to protect the communities that are now benefiting from mining from a future lack of resources due to the end of their main source of income.²²⁴

Also, as requested by local leaders, a proposal was submitted to the Congress to evaluate and approve a law that allows affected or impacted communities to be formally consulted regarding their concerns with any mining project that would be carried on in or close their homes. A further discussion of this legislation is developed later in this chapter.

²¹⁸ Supra note 159

²¹⁹ Xstrata Copper- Division Operaciones Sudamerica Peru, Fondo social Las Bambas, online: <<http://www.xstratacopperperu.pe/ES/Operaciones/LasBambas/Paginas/FondoSocialLasBambas.aspx>>

²²⁰ Ibid

²²¹ Ibid

²²² Ibid

²²³ "Alejandro Toledo: "Me preocupa mucho la militarización del Estado", *El Comercio Peru* (December 11, 2011), online: <<http://elcomercio.pe/politica/1346417/noticia-alejandro-toledo-me-preocupa-mucho-militarizacion-estado>>

²²⁴ Ibid

2.1.2 Illegal Miners

Illegal mining has been described as mineral extraction performed without legal authorization to do so²²⁵ Illegal mining is generally associated with small scale mining.²²⁶ In this regard, it is important to keep in mind that small scale mining can be conducted at three different levels: artisanal mining, traditional mining and licensed mining. Artisanal mining, also known as micro scale mining, uses simple tools and due to the simplicity of the operations performed and the lack of significant investment, mobility of illegal miners is very common as the activity can be started or discontinued wherever a new discovery of precious metals has been reported.²²⁷ Traditional mining is usually characterized by a simple management structure. It also features hired labour.²²⁸ Licensed mining is characterized by its formal management structure.²²⁹ Illegal mining is most commonly found in the first two groups.²³⁰

Illegal miners most commonly look for high value minerals such as gold or gems in order to maximize the returns from the sale.²³¹ In Peru, illegal mining happens only in the context of gold mining.²³² The low transportation infrastructure costs (due to the small scale amount mined) added to the fact that these minerals require minimal processing technology (such as mercury amalgamation processes for gold, for instance), helps maximize the returns from illegal mining and makes it attractive in places lacking basic infrastructure.²³³

Illegal mining is a significant problem in Peru. The number of illegal miners is expanding and the estimate amounts of illegal mining revenues are increasing every year to the point where the amount of illegal mining revenues have surpassed those attributed to drug trafficking.²³⁴ As indicated by Macroconsult, a well reputed Peruvian macroeconomic research firm, the estimated

²²⁵*The Socio-Economic impacts of Artisanal and Small-Scale Mining in Developing Countries*, ed. by Galvin M. Hilson (The Netherlands, Sweets & Zeitlinger B.V., Lisse, 2005) , at 40, online:

<http://books.google.ca/books?hl=en&lr=&id=7QNRVmxq5RsC&oi=fnd&pg=PP1&dq=illegal+mining+Peru&ots=wwJWN77V_r&sig=poHlaBkR_Njl0sD7zytqMY_XUDg#v=onepage&q=illegal%20mining%20Peru&f=false>

²²⁶Supra note 225 at 41

²²⁷Ibid

²²⁸Ibid

²²⁹Ibid

²³⁰Ibid

²³¹Supra note 225 at 40

²³² Juana R. Kuramoto, “Artisanal and Informal Mining in Peru” (Lima: Mining Minerals and Sustainable Development, 2001), online: <<http://pubs.iied.org/pdfs/G00730.pdf>>

²³³Ibid

²³⁴ “El 22% de de las exportaciones de oro peruano proceden de la minería ilegal”, *El Comercio Peru* (May 12, 2012), online: <<http://elcomercio.pe/economia/1415563/noticia-22-exportaciones-oro-peruano-proceden-mineria-ilegal>>

gold illegal exports account for (at least) US\$1,800 million dollars (22% of national gold exports), the amount of profits generated by illegal mining are quantified in about US\$1,000 million, which implies to approximately US\$305 million in forgone taxes.²³⁵ Illegal mining directly employs an average of 100 thousand workers.²³⁶

Among the reasons for illegal mining, the lack of knowledge of existing legislation can be highlighted.²³⁷ In addition, the majority of artisanal mining operations are illegal due to the lack of organization in this type of activity.²³⁸ Artisanal mining, in turn proliferates as a consequence of survival needs.

2.1.2.1 What are the illegal minners' concerns and interests

Illegal miners, driven mostly by their poverty levels, want to be able to continue mining and selling in order to receive income to support their families. Among the total illegal miners, a group of about 60% is willing to become formal miners.²³⁹ The reason why they would like to be legal because they believe that their operating costs are much higher when operating in an illegal setting, partly because there are mafias who take advantage of their illegal condition by increasing the price of the supplies more than three times as compared to prices for legal miners.²⁴⁰ Costs are also higher because most of the cost cannot be recovered through the tax system.²⁴¹

In this regard, formalizing their activities brings some additional concerns as illegal miners are usually moving around after the new mineral discoveries, and in most cases they bring their whole family along.²⁴² As an example, the discovery of gold in the Madre de Dios' area riverbeds caused a massive immigration from the poorest areas of the country. Also, in areas located in the mid-south of the country where terrorism was very active (and where mining

²³⁵ Ibid

²³⁶ Ibid

²³⁷ Supra 232

²³⁸ Ibid

²³⁹ Macroconsult, *Impacto Económico de la Minería en el Perú* (Lima: Sociedad Nacional de Minería, Petróleo y Energía, 2012)

²⁴⁰ Ibid

²⁴¹ "La Minería Ilegal debe ser evaluada a fondo, opina experto-Perú" *Integrarse – Consultora en Relaciones Comunitarias y Responsabilidad Social Empresarial* (no date), online: <http://www.integrarse.pe/index.php?option=com_content&view=article&id=163:la-mineria-ilegal-debe-ser-evaluada-a-fondo-opina-experto-peru&catid=35:america&Itemid=199>

²⁴² Ibid

companies were afraid to invest due to the added risk), illegal mining has become one of the main activities in the area.²⁴³ In this context, formalizing their activities implies attending not only the legal and economic aspects, but also finding a way of relocating the miner's families.²⁴⁴

Illegal miners also want to be heard by government, to present their arguments in an informal setting and to be able to negotiate for a possible solution. Leaders of the Mining Federation of Madre de Dios abandoned negotiations with the government when they were forced to select only two representatives for the whole group and they thought that they required the head of each of the different groups to be represented in order to expose their different viewpoints²⁴⁵

A group of miners is not willing to negotiate at all and they demand that government repeals the law that established that illegal mining is a crime. They showed their disagreement with the government by going out to the streets and blocking a main highway for four days. This caused losses quantified in about 5 million soles (US\$1.2 million) only in the transportation and production sectors, in addition to the bad image caused to the more than 200 tourists who were not able to visit the province.²⁴⁶

Illegal mining generates a series of conflicts not only with government but with the rest of the citizens in the country and in some cases with residents of local communities. On one side, illegal mining provokes a series of environmental damages due to the inappropriate use of mercury that generates water contamination, which in turn affects the life of the miners and their families.²⁴⁷

In addition, illegal mining is usually associated with disorderly production and inefficient working of the deposit, because they abandon the work in order to exploit a richer deposit.²⁴⁸ This lack of planning affects other miners (small scale miners or even foreign) as the deposit cannot be worked again due to structures being too weak.²⁴⁹ Also, illegal mining causes

²⁴³ Supra note 232

²⁴⁴ Supra note 241

²⁴⁵ "Comision del Ejecutivo y Mineros Dialogan en Puerto Maldonado", *El Comercio Peru* (March 12, 2012), online: <<http://elcomercio.pe/peru/1386351/noticia-comision-ejecutivo-mineros-dialogan-puerto-maldonado>>

²⁴⁶ "Arequipa perdió más de S/. 20 mlls. por paro de mineros informales", *El Comercio Peru* (May 12, 2012), online: <<http://elcomercio.pe/peru/1413695/noticia-arequipa-perdio-mas-20-mlls-paro-mineros-informales>>

²⁴⁷ Supra note 232

²⁴⁸ Ibid

²⁴⁹ Ibid

economic losses to legal titleholders, who are either deprived of the natural resource they paid to exploit or have to invest additional funds in security to protect their rights.²⁵⁰

The government is also affected since it forgoes all the revenues associated to illegal mining activities, such as taxes and concession rights.²⁵¹

Since artisanal mining is heavily associated with extreme poverty and survival needs, it seems clear that illegal miners would expect the government to provide an alternative to illegal mining activities for them to be able to meet their basic needs and support their families. It may then be expected that, provided the government proposes appropriate alternatives, a large percentage (around 60% as mentioned above) of illegal miners would be willing to formalize.

2.1.2.2 Government's reply to illegal miners

The Peruvian government attempted to find a solution to the illegal mining problem by enacting several pieces of legislation to penalize illegal miners who continue with the activity, but the reaction of the illegal miners provided a clear message. For over a week, miners from various regions blocked several highways, burnt cars, destroyed private property, had violent confrontations with local police using Molotov cocktails, tried to take over an airport and a market and forced several businesses in Madre de Dios city to close with a daily loss of 1.5 million soles (US\$0.6 million), as calculated by the Peruvian Chamber of Commerce.²⁵² Their only request was the derogation of the recent laws enacted by means of which illegal mining is considered a crime.²⁵³

The government's reaction followed the same vicious cycle reported in previous cases of conflicts. First, the government announced its decision to fight illegal mining, considering it one of the main environmental predators in Peru. One protest later, the government signed an agreement with illegal miners, by means of which the government provides a "reasonable" two year term for illegal miners to formalize their activity without penalties and the ability to keep

²⁵⁰ Ibid

²⁵¹ Ibid

²⁵² "La autoridad ja, ja", Editorial, *El Comercio Peru* (March 21, 2012), online: < <http://elcomercio.pe/opinion/1390445/noticia-editorial-autoridad-ja-ja>>

²⁵³ Ibid

working illegally in the meantime.²⁵⁴ In addition, the government has assured the sale of their total production as the government has disposed that a government-owned company (which is expected to realize huge losses) will buy all of their production.²⁵⁵ However, the law that authorizes the acquisition of illegal mining production does not mention the price at which the minerals will be bought.²⁵⁶

In addition, upon the rescue of nine illegal miners who got trapped inside a mine in Ica, the miners received funds from government with the intention to support them while they do the required paperwork to formalize their activities.²⁵⁷ They were also provided with pieces of land to build their houses and access to credit in the financial system.²⁵⁸ The government's decision in this case is unfortunate as this kind of acting seems to send the message that the consequence of engaging in illegal activities is receiving benefits from the authorities.

To provide another example of how the vicious cycle of the government ends up siding with the communities is seen when the government requested the armed forces to eliminate the Dragas²⁵⁹ that operated in the Madre de Dios rivers, informal miners took over the entire city and blocked the main highway that allows entry and exit to the city and after a few days of violent confrontations where 2 miners died, the government ordered the armed forces to stop the operation.²⁶⁰

2.1.3 Expectations of Citizens outside the mining communities

This subsection intends to illustrate how the population (other than within local communities) is concerned with the action happening as a consequence of the mining negotiations. This section also presents a brief summary of these citizen's main interests and concerns with regards to

²⁵⁴ "Y ahora, ¿quién podrá defendernos?", Editorial, *El Comercio Peru* (May 28, 2012), online: <<http://elcomercio.pe/opinion/1420601/noticia-editorial-y-ahora-quien-podra-defendernos>>

²⁵⁵ Ibid

²⁵⁶ Ibid

²⁵⁷ "Jara repondio criticas "No le dimos dinero a mineros informales sino a sus familias", *El Comercio Peru* (April 27, 2012), online: <<http://elcomercio.pe/politica/1407292/noticia-jara-respondio-criticas-no-le-dimos-dinero-mineros-informales-sino-sus-familias>>

²⁵⁸ Ibid

mining activities happening in the country. The importance of highlighting these interests and concerns is given by the fact, in the end, this is the group of citizens who has the power to elect a new government. Election candidates are usually interested in getting to know what the opinion of the majority is in order to determine their success depending on their governmental plans.

2.1.3.1 What are the citizens' interests and concerns

Even though they are not directly affected by the mining activity or do not have the same economic and social concerns as the citizens living inside or neighbouring the mining site, the general citizen also have concerns and face trade-offs when it comes to mining activities. The main trade-off faced by the majority of citizens is the “economic wellness” of the country (which could be obtained with the government’s approval of as many mining projects as possible) versus the violence that this governmental decision may generate.

The revenues from an approved mining project (under the assumption that the government is not corrupt) allow all citizens to benefit from the potential increase in social services performed by the government and also leads to a more stable economy, which in turn allows for better life standards and better living conditions in general. In this regard, it is important to note that the expectations that revenues from mining activities will allow the country to switch from being a developing to becoming a developed country may only be a vain hope. The idea of development as a consequence of extractive activities is highly contested in the literature. In fact, the main claim of the resource curse debate is that mining is associated with low levels of economic growth.²⁶¹

The resource curse refers to the claim that the dependency of an economy on natural resources may cause negative economic and political effects in developing countries leading to poor economic growth as compared to resource-deprived countries.²⁶² The analysis of the several economic theories that explain the poor economic growth as a consequence of resource

²⁶¹ Anthony Bebbington et al., *Contention and Ambiguity: Mining and the Possibilities of Development* (The University of Manchester – Brooks World Poverty Institute, 2008) at 6, online < <http://www.bwpi.manchester.ac.uk/resources/Working-Papers/bwpi-wp-5708.pdf>>

²⁶² Richard M. Auty, *Sustaining Development in Mineral Economies - The Resource Curse Thesis* (New York: Routledge, 1993), online: <http://books.google.ca/books?id=usJ36Px_2LAC&printsec=frontcover&source=gbs_ge_summary_r&cad=0#v=onepage&q&f=false>

dependency is beyond the scope of this chapter. Nonetheless, it is important to consider that among the explanation for such lower growth rates is the “Dutch Disease”, which refers to the negative effects of natural resource exploitation in the sense that it causes a contraction of other economic sectors. (usually agriculture and manufacturing)²⁶³ This contraction is mainly associated with (i) the appreciation of the local currency making other exports less attractive in international markets and (ii) the shift of capital and labor force from other economic sectors to the resource sector.²⁶⁴ The overall effects of the contraction of the economic sectors (other than the resource sector) is felt when resource prices decrease, forcing the country’s budget to shrink.²⁶⁵

Weakening of democratic institutions and increased number of civil conflicts are also associated with resource dependency but remain controversial in the literature. The most authoritative research with regards to the weakening of democratic institutions is the one conducted by Michael Ross.²⁶⁶ Ross found that countries which rely on oil or mineral exports are usually less democratic than those who do not rely in mineral exports.²⁶⁷ Subsequent studies have confirmed Ross’s findings.²⁶⁸ Contradicting Ross’ claims, however, Haber and Menaldo question the correlation between resource dependency and regime type (authoritarianism or democracy) arguing that due to methodological errors the evidence on which these claims were based is tainted²⁶⁹. With regards to the increase in the number of civil wars, Collier and Hoeffler claim that natural resource dependency is an important determinant of civil war.²⁷⁰ Reynal-Querol claims that natural resource dependency increases the frequency of non-ethnic civil wars.²⁷¹ On the other side, Ross indicates that there is little support for this correlation.²⁷²

²⁶³ Warner Max Corden, “Booming sector and Dutch disease economics, a survey” Australian National University Working Paper 78 (1982).

²⁶⁴ Ibid

²⁶⁵ Ibid

²⁶⁶ Michael L Ross, “Does oil Hinder Democracy?” (2001) 53:3 World Politics 325.

²⁶⁷ Ibid

²⁶⁸ David L Epstein et al, “Democratic Transitions” (2006) 50:3 American Journal of Political Science 551; Jamy Uldefer, “Natural Resource Wealth and the Survival of Autocracies” (2007) 40:8 Comparative Political Studies 995.

²⁶⁹ Stephen Haber & Victor Menaldo, “Do Natural Resources Fuel Authoritarianism? A Reappraisal of the Resource Curse” (2011) 105:1 American Political Science Review 1, online: SSRN <<http://ssrn.com/abstract=1545103>>.

²⁷⁰ Paul Collier & Anke Hoeffler, “On the Economic Consequences of Civil War” (1999) 51:1 Oxford Economic Papers 168

²⁷¹ Martha Reynal-Querol, “Ethnicity, Political Systems, and Civil Wars” (2002) 46:1 Journal of Conflict Resolution 29.

²⁷² Michael Ross, “What Do We Know about Natural Resources and Civil War?” (2004) 41:3 Journal of Peace Research; Paul Collier, *War, Guns and Votes: Democracy in Dangerous Places* (London: Bodley Head, 2009).

Moreover, if we accept the possibility that government may be corrupted, then the possibilities of development for the country (and hence the possibilities of citizens to see any of the benefits mentioned above) are even lower. The literature supports the claim that in the cases of corrupt governments the state is more concerned about attending the needs and demands of mining companies rather than citizens.²⁷³

Another benefit that is said to come with mining investment is the higher rates of funding for education. The citizens living in the same province where the mining activities are taking place, even if they live far from the mining site per se and thus don't have the concerns identified in the previous section, may be able to benefit from the canon funding that is intended to benefit the whole province as opposed to benefiting only the small group of citizens living in the place where mining activities take place. The canon funding allows for better infrastructure in schools, hospitals, etc. and some citizens may as well benefit from funding for research purposes.

Since the year 2004 several public educational institutions located in the provinces where mining revenues are generated have indeed received 5% of this revenue on a cumulative basis. These funds are to be used “exclusively in scientific and technological investigation that enhances the development of the region where these institutions are located”.²⁷⁴ This includes the use of funds to allow educational institutions lacking the suitable premises (such as specialized labs) the technology and capacity to be able to produce the type of knowledge required from the different provinces.²⁷⁵ The objective of this funding was to promote academic research aimed to provide competitiveness and added value that can be applied by means of a partnership with local and regional governments, private corporations and society in general, mainly in public health, prevention of endemic diseases, biodiversity preservation and the ecosystem in general.²⁷⁶ This is based on the idea that mining rents are not indefinite and so alternative sources of income should be promoted so that when the mining rents stop these economic alternatives help compensate for the loss of revenues and resources in the area.²⁷⁷

²⁷³ Anthony Bebbington et al., *Contention and Ambiguity: Mining and the Possibilities of Development* (The University of Manchester – Brooks World Poverty Institute, 2008) at 7, online < <http://www.bwpi.manchester.ac.uk/resources/Working-Papers/bwpi-wp-5708.pdf> >

²⁷⁴ “¿Qué hacen las universidades del Estado que reciben canon?”, *El Comercio Peru* (February 13, 2012), online: <<http://elcomercio.pe/economia/1373697/noticia-que-hacen-universidades-estado-que-reciben-canon>>

²⁷⁵ Ibid

²⁷⁶ Ibid

²⁷⁷ Ibid

However, many years have gone by, and although new buildings and labs have been developed in several places, the mining revenues keep accumulating in the educational institutions bank accounts, which still face difficulties to use the funds for these purposes.²⁷⁸ The reason for the accumulation of funds seems to be that the law regulating the distribution of this funds prohibits that professors supervising students during their research receive any benefit from those funds (in addition to their regular salary, which is usually low).²⁷⁹ As a consequence, professors have no incentives to supervise students in their research as it will only mean extra hours of work for the same low salary that they already receive.²⁸⁰ Thus, since by law the funding can only be used for either developing the infrastructure of educational institutions or fund student research, the funding in practice is only used for building physical infrastructure. As a result, the funds end up not being fully used as many students are not able to develop their research due to the lack of supervision.

Historically, the most relevant (and common) trade-off that citizens face when deciding in favour or against a mining project is increased revenues versus the violence resulting from local communities disapproval of the project. In this regard, it is important to keep in mind that almost every time government approves a mining project, local communities living close to the mining area feel affected and voice their concerns with street protests, which most of the time ends in a violent confrontation with police. These in turn affects the rest of the citizens not only with regards to their personal safety but also because of the interruptions experienced in business activities due to highways blockages. During the period of January and September of 2011, the Ombudsman's office reported a total of 243 injured persons and 21 deaths as a consequence of violent social conflicts.²⁸¹ The comparable figures in the last few years are also worrying as 184 injured and 31 deaths were reported in 2010, 604 injured and 52 deaths in 2009, 752 injured and 37 deaths in 2008 and 357 injured and 41 deaths in 2007.²⁸²

²⁷⁸ Ibid

²⁷⁹ Ibid

²⁸⁰ Ibid

²⁸¹ These figures refer to social conflicts originated not only as a consequence of mining activity but to environmental concerns, labor disputes, electoral discontent, etc. Nonetheless this numbers show that part of the idiosyncrasy of the Peruvian population is to recur to violent protest upon the dissatisfaction of a result or decision. (Defensoría del Pueblo, *Violencia en los Conflictos Sociales*, Informe Defensoria No. 156 (Lima, Defensoría del Pueblo, March 2012) at 53, online: <<http://www.defensoria.gob.pe/informes-publicaciones.php>>)

²⁸² Supra note 135 at 53

According to a well-known statistics company in Peru, most of the population believes that social conflicts associated to mining activities are related to concerns of local communities which were not addressed by previous governments.²⁸³ In addition, 63% of the population agrees that when the local communities become violent and reluctant to enter negotiations, the government uses excessive force to maintain the order.²⁸⁴

In general, violence associated with social conflict brings a series of collateral effects. Among other things, the provision of basic services such as education, health or transportation is affected, all of which imply a detriment in the general population's welfare. Violence also affects the overall economy of the country due to the suspension of mining activities, the decrease in tourism revenues, the amount of uncollected taxes, etc.²⁸⁵ This determines a conflicting interest between citizens and government. Citizens want to see all the positive effects of mining (most of which are much contested in the literature) such as country and personal economic growth and better life conditions. Government, on the other side, needs to grant the demands to communities to decrease violence. In most cases granting demands to communities often means not granting concessions, which in turn implies a reduction of the tax base.

An additional trade-off that a regular citizen faces with the approval of a mining project relates to the environmental concerns that may impact not only the mining area, but the surrounding districts or provinces as well. In fact, according to the literature mining activities provoke significant environmental impacts. Mining activities can be regarded as "one of the most environmentally and socially disruptive activities undertaken by business"²⁸⁶ and it is said that the contribution of mining to the GDP (economic benefit) is much lower than the amount of sulphur dioxide emissions (environmental cost) caused by it.²⁸⁷ A concrete example serves to illustrate this problem. La Oroya, a Peruvian smelter town, is considered by the Blacksmith Institute as one of the top ten most polluted places in the world.²⁸⁸ Air pollution is so impressively high that children are taken outside the city during the day to protect them from

²⁸³ "Caso Conga: diálogo de sordos", Editorial, *El Comercio Peru* (December 20, 2011), online: <
<http://elcomercio.pe/opinion/1350547/noticia-editorial-caso-conga-dialogo-sordos>>

²⁸⁴ Ibid

²⁸⁵ Supra note 135 at 4

²⁸⁶ Supra note 273

²⁸⁷ Supra 273 at 8

²⁸⁸ Supra 273 at 3

breathing such a large amount of pollutants.²⁸⁹ The high levels of contamination in La Oroya have caused that children's blood contamination and teenager cancer rates to be significantly above the average.²⁹⁰

Besides the environmental concerns with mining activities in general, illegal mining also provokes significant negative environmental impacts. In fact, it has been estimated that illegal mining has destroyed 18,000 hectares of Amazon so far.²⁹¹

2.1.3.2 How would they like the government to address citizen's interests and concerns

In order to answer this portion it is important to situate the reader in the social context of a country like Peru. Peruvian society is unequal, power is very centralized, and discrimination is widespread. For some, Peru has developed its own definition of "race" based on culture and education rather than following the regular definition of the term.²⁹² This cultural racism is based on a hierarchy embedded in society where the status of the person is determined according to a combination of culture and socio-economic status²⁹³. For example, rural communities are on the lowest side of the hierarchy and the westernized elites composing the wealthiest group of Peruvians are on the upper side of the hierarchy. Discriminatory practices from the upper classes to the lower classes are common.²⁹⁴ This categorization is not fixed as a person can move up when acquiring better educational or socioeconomic levels.²⁹⁵

This social and cultural stratification explains why the opinions regarding the advantages and disadvantages mining activities can bring for the country are much divided. This also explains why the concerns from these two groups may be diametrically opposed. Citizens situated in the upper side of the hierarchy understand mining for its consequences at a macro level, and forget

²⁸⁹ Ibid

²⁹⁰ Ibid

²⁹¹ Cecilia Jamasmie, "Peru's illegal mining exports problem worse than drug trafficking: report" (*Mining.com*, May 18, 2012), online: <<http://www.mining.com/2012/05/18/perus-illegal-mining-exports-problem-is-bigger-than-drug-trafficking-report/>>

²⁹² Marisol de la Cadena, "The Racial Politics of Culture and Silent Racism in Peru" (Conference Paper presented in "Racism and public policy" United Nations Research Institute for Social Development (UNRISD), September 2001), online: <[http://www.unrisd.org/unrisd/website/document.nsf/ab82a6805797760f80256b4f005da1ab/ee7eb1e30a96c11f80256b6d00578643/\\$file/dcadena.pdf](http://www.unrisd.org/unrisd/website/document.nsf/ab82a6805797760f80256b4f005da1ab/ee7eb1e30a96c11f80256b6d00578643/$file/dcadena.pdf)>

²⁹³ Ibid

²⁹⁴ Ibid

²⁹⁵ Ibid

(or simply don't care) about the local impacts that a mine can cause in a remote community. For these citizens, mining projects should be developed at any cost because they see in these projects the possibility of development and the possibility of economic growth for the country.

On the other side of the hierarchy we find that citizens living in the rural areas of the country (a large percentage of them illiterate) focus more on how a mining project may affect them personally or their direct family. The vast majority of these citizens do not have the tools to understand how a mining project may or may not affect the country's economic or fiscal system. Citizens living in rural areas identify themselves with the local communities directly affected by a particular mining project and their opinion is based on how they would like things to be handled if they were to find natural resources underneath their own lands. As indicated above, a family who spent their whole lives in agriculture and who can only perform agricultural activities sees the possibility of losing their land as an unattractive alternative, almost regardless of the terms of the bargain offered by the mining companies and the government.

Given the discrimination that exists in Peru, the lower classes feel left out by the upper groups who usually have more access to government. Certainly, these lower classes would like the government to pay attention to their problems instead of caring for the group they belong to (usually politicians have been associated with upper classes of the hierarchy described above). Upper classes, on the other side, usually underestimate the validity of the lower classes complaints and consider that the government should do the same and accept the mining project since it will increase welfare and growth to the economy as a whole.

For statistics purposes, each socioeconomic level is attributed a letter such that socioeconomic level A corresponds to the highest (wealthiest) group and E to the lowest (poorest) group. According to a study conducted by the Peruvian Association of Market Research from the total country's population, only 1% belong to group A, 6% to group B, 23% to group C, 39% to group D and 32% belongs to group E.²⁹⁶ Only the provinces of Lima and Arequipa show that from the total population in the province, there is a significant percentage of population located in level A (3.6% and 5.2%, respectively) while all provinces show significant percentages of population

²⁹⁶ "Formula APEIM – Niveles Socio Economicos", *Asociacion Peruana de Empresarios de Investigacion de mercado* (no date), online: <<http://www.apeim.com.pe/niveles.html>>

located in levels D and E.²⁹⁷ According to this, it is clear that the lower hierarchy as described in the previous paragraphs are certainly the majority in the country.

In terms of education some universities located in mining zones are receiving massive amounts of money that they are not able to invest. Meanwhile, there are school teachers protesting in the streets for salary increases and better quality of education for children.²⁹⁸ The education in elementary schools in Peru is worrisome. A UNICEF report shows that, many boys and girls finish second grade without been able to read or write.²⁹⁹ Several reasons are provided for this, such as extreme distance from schools, lack of appropriate class environment, low number of hours of education, quality of teaching and language barriers.³⁰⁰ In addition, press reports claim that Peruvian families also criticize the treatment that some children are receiving from their peers at school and in some cases from their teachers. Complaints from parents have been heard more than once, and as a consequence some schools started maintaining an educational psychologist on site, but unfortunately the restricted budget only allows for a few hours per weeks of psychologist available to students or professors.³⁰¹

Some funding from the canon may need to be directed to the elementary or secondary public schools to address the concerns and use the funds wisely, but this has not happened thus far.

²⁹⁷ Ibid

²⁹⁸ "SUTEP anuncio huelga nacional este 14 de Junio", *El Comercio Peru* (June 6, 2012), online: <<http://elcomercio.pe/peru/1424702/noticia-sutep-anuncio-huelga-nacional-este-14-junio>>

²⁹⁹ UNICEF, "Educacion Primaria", Online: <http://www.unicef.org/peru/spanish/children_3787.htm>

³⁰⁰ Ibid

³⁰¹ "Otra victim de bullyin, nina de 12 anos de siucido en SMP", *El Comercio Peru* (May 31, 2012), online: <<http://elcomercio.pe/lima/1421938/noticia-otra-victima-bullying-nina-12-anos-se-suicidio-smp>>

2.1.4 Mining companies: expectations according to literature and real life in Peru

2.1.4.1 What are the companies' interests and concerns

The concerns of mining companies can be basically summarized in four main groups: (i) the maximization of profits, (ii) minimization of expenses (taxation being the most burdensome), (iii) a stable legal system that allows for predictability of the amount of taxes or other obligations to be paid to the Peruvian government and (iv) obtaining a “social licence” to be able to operate without any disturbances from the local communities.

The concerns mentioned above are interrelated. None comes before the other and all of them need to converge in order for the company to be successful on its venture. Maximization of profits, as mentioned in the previous chapter, is very much dependent on the quality of the mineral and the cost of extracting it from the soil; however, in order to maximize profits, the cost of the investment or the expenses associated with it needs to be minimized.

Taxes and fees charged by the Peruvian government are probably one of the largest expenses to be considered by mining investors and for that reason, predictability and stability are required for the mining investor to plan ahead on the payments to be met. In this regard, the literature is supportive of the fact that mining operations' success depends largely on the legal and fiscal framework of the host country.³⁰²

In practical terms, minimization of expenses cannot be achieved if government increases the amount of taxes. In order to avoid changes in the amounts of projected taxes to be paid, most (if not all) mining companies in Peru demand legal and tax stability agreements to be signed with the government as guarantee that the regime in-force at the time of the commitment will be maintained until the end of their operation in Peru. The subscription of stability agreements implies that if the government changes the legislation agreed to be stabilized or any other part of the agreement, the investor can request the controversy to be settle in an arbitration process.

³⁰² Alberto Zamprile & Alberto Ariel Llorente, “Social License to Operate in the Latin American Mining Sector: The Cases of Bajo De La Alumbrera and Michiquillay” (Paper delivered at the 22nd Annual IACM Conference, June 15, 2009) at 4, online: <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1488624>

Maximization of profits and minimization of expenses would simply not be possible to achieve if the local communities affected by the mining project do not provide the “social licence” required to operate. Social license has been described as a “prior fully informed consent from indigenous peoples, or local communities, that may be only acquired through mutual agreements, in a forum that gives communities leverage to negotiate conditions, as well as an offer based on multidisciplinary analysis”.³⁰³ In fact, according to the literature, mining investors who are committed to producing positive social performance outcomes, are most successful in achieving their financial goals (maximization of profits and minimization of costs) and enhance their competitiveness.³⁰⁴ In Peru, the need of social license has also been publicly announced and ratified by the government.³⁰⁵ In fact, the Minister of Energy and Mines stated to the press that mining concessions will be developed *only* as long as they are accepted by the affected communities’.³⁰⁶

Mining companies have also manifested their concern with regards to the attitude of government siding with the communities every time they demand something from government or from the mining investor. In this regard, and with reference to the particular case of the profit sharing increase demand, representatives of Xstrata Tintaya mining company indicated that it would be a huge mistake from the government to request them to increase the amount of required profit sharing from 3% to 30% as local communities demand.³⁰⁷

Despite the government’s announcement and the literature support to social license, the large amount of information and real examples of social conflicts happening in Peru in recent years, due to mining social and environmental concerns, suggests that most mining companies have not been able to develop a good relationship with the local communities. Hence, no social license has been granted to the mining investors. This is a big concern for them because as this problem remains without a permanent solution, investors are not able to exploit minerals and maximize their revenues. Mining companies who have already invested in Peru indicate that there is a need for a stronger government presence in mining areas to help in the resolution of conflict with local

³⁰³ Ibid

³⁰⁴ Ibid

³⁰⁵ “Licencia social podría detener minería”, *Peru 21* (August 2, 2011), online <<http://peru21.pe/noticia/962927/licencia-social-podria-detener-mineria>>

³⁰⁶ Ibid

³⁰⁷ Para Xstrata, acceder a reclamos en Espinar sería “precedente nefasto”, *El Comercio Peru* (May 30, 2012), online: <<http://elcomercio.pe/peru/1421731/noticia-xstrata-acceder-reclamos-espinar-seriaprecedente-nefasto>>

mining communities, to assure respect for the law and to improve the quality of public investment.³⁰⁸ Mining investors expect a government that has presence and legitimacy with the local communities and helps with the community demands.

The role of government and the mining company has, unfortunately, not been defined properly as there exist some controversy as to who is supposed to assume obligations regarding to social conflicts generated due to mining activities. In fact, the Minister of Energy and Mines, stated that it was worrisome that the mining investors were expecting that government will provide guarantee and security with regard to mining conflict and indicated that arriving to an agreement with affected local communities was the investor's responsibility.³⁰⁹

Based on the information above, mining companies require intervention from government mainly in the solution of the social conflict generated by the disruptions and concerns felt by affected mining communities.

2.2 Supply side: The Government

Government faces several trade-offs that drive its decisions with regards to public policy. On one side of the balance, the government has the citizens of the country (among which are the citizens of mining localities), to whom the government needs to be accountable due to the citizens capacity of evaluating the government's performance through their casting of votes during elections.^{310,311} On the other side of the balance, the government has the potential of receiving large amounts of money from mining investment companies as taxes, royalties, etc.

Given that natural resources have no identifiable owner, resource revenues are not perceived as income by the citizens of the country. This may put the government on a new dilemma as the government retention of the mining revenues may not provoke demands from the citizens.³¹² From a corrupt government's perspective, natural resources are an excellent way to embezzle

³⁰⁸ "Conflictos sociales afectan confianza en inversión minera", *El Comercio Peru* (May 14, 2010), online: <http://elcomercio.pe/economia/478341/noticia-conflictos-sociales-afectan-confianza-inversion-minera_1>

³⁰⁹ Ministro Sanchez: Muchas mineras no trabajaron su relacion con la comunidad", *El Comercio Peru* (July 16, 2011), online: <<http://elcomercio.pe/economia/878803/noticia-ministro-sanchez-muchas-mineras-no-trabajaron-su-relacion-comunidad>>

³¹⁰ Paul Collier, *The plundered planet*. (London: The Penguin Group, 2010) at 50

³¹¹ It is important to bear in mind however that the immediate re-election of the same candidate is not permitted according to the Peruvian Constitution. Peruvian Constitution. Article 112

³¹² Supra note 10 at 50

funds without alerting the citizens.³¹³ A corrupt government may feel tempted to do as much as it is required to keep citizens happy (even if this implies collecting low amount of taxes or not taxing the exploitation of natural resources at all) to be able to access the mining revenues without raising suspicions from citizens.³¹⁴ This strategy may not satisfy the citizens directly affected by the mining activities as they may have bigger concerns than paying their taxes (if they do at all) such as the destruction, contamination or alienation of the natural resources that they use to live. In contrast, this strategy may very well satisfy the citizens outside the local communities.³¹⁵ Citizens directly affected by the mining activities may be misled in several other ways, such as it has happened in the Peruvian case when the government steps back after violent confrontations occur.³¹⁶ An example of this was given above with the removal of the Dragas used by informal miners.³¹⁷

Whether the corrupt government decides to tax mining companies at a low level or not tax them at all to avoid scrutiny, these has several effects in the economy, many of which may not be perceived immediately but have serious consequences in the long run. The reduction of the government revenues that are perceived by the citizens and over which the citizens demand accountability (revenues other than natural resources revenues) imply less funds available for the government to provide basic services such as education or health care.³¹⁸

Lack of transparency and corruption in the appropriation of state revenue undermine good governance in the mineral sector. These two elements facilitate political corruption by allowing government to allocate resources to mining investors as it pleases and without any scrutiny with the expectation that the investors will return the favor with generous revenues.³¹⁹ It is the lack of checks and controls on the quality of institutions in the system that determines whether a mineral rich country will grow or feel the effects of the resource curse.³²⁰

³¹³ Ibid

³¹⁴ Ibid

³¹⁵ Ibid

³¹⁶ Supra note 142

³¹⁷ Supra note 142

³¹⁸ Supra note 310 at 52

³¹⁹ Supra note 273 at 7

³²⁰ Ibid

The quality of institutions serves as an indicative of the democracy levels in a country, and according to empirical findings a reverse causality is also possible³²¹. Peru, unfortunately, has been very unstable in terms of democratic government history. Peruvian history is marked by short periods of democratic government and sudden outbursts where a few military generals in disagreement with the regime in force decide to take the control of the country by force, episodes where government controls the media and other episodes of fraudulent elections where sets of voting records are mysteriously lost. Due to the quality of institutions, the lack of a solid democracy and insufficient checks and balances to force the government to be accountable, a high incentive for corruption exists.³²²

3. Prior Consultation Law

In 1993, the Agreement 169 of the International Labor Organization (ILO) was ratified. It was incorporated into Peruvian Law in 1995, recognizing the rights of the indigenous population and tribes³²³. A few months after the ratification of the agreement, the government approved a Law to regulate the private investment in the development of economic activities in lands pertaining to rural and native communities (known as the “Land Law”), which was in contradiction with the ILO Agreement 169.³²⁴

Also in 1993, a new constitution was enacted. The new constitution contained some provisions by means of which the inalienable character of the lands pertaining to these communities was taken away.³²⁵

Between 2002 and 2009 several bills were presented for Congressional approval, leading to active debates around the rights of rural and native communities.³²⁶ In June 2009 rural communities in Bagua (part of the Peruvian Amazon) staged a riot that took away the life of 24

³²¹ Antonio Cabrales & Esther Hawk, “The Quality of Political Institutions and the Curse of Natural Resources” (2011) 121 *The Economic Journal*

³²² *Supra* note 310 at 55

³²³ Peruvian Congress Bill No. 29-2011-CR “Ley de Derecho a la Consulta Previa a los pueblos indígenas u originarios reconocido en el convenio numero 169 de la Organización Internacional del Trabajo “ August 2011

³²⁴ *Ibid*

³²⁵ *Ibid*

³²⁶ *Ibid*

police officers and 9 citizens.³²⁷ The riot was a reaction to the enactment of two laws that regulated forestry issues and the use of land for agriculture purposes.³²⁸ The reason of the protest was due to the fact that these citizens became aware that the legislation passed was contradicting Agreement 169.³²⁹

This event made the government aware of the sensitivity that rural communities have in terms of their rights³³⁰.

In this context, the Prior Consultation Law (PCL) was approved by the majority of Congress on May 2010.³³¹ However, in order for a Law to be enacted, the signature of the members of the executive branch of government was required. This signature was not granted by the executive adducing several reasons, among which were (i) that it was not clear from the text that when no agreement between the population and the government was achieved after the consultation process, the government was still able to use their *ius imperium* to execute a project, (ii) that the Agreement 169 was not intended to cover programs addressed towards the region or nation's development, (iii) that the consultation process may slow or stop the development of the country, among others.³³² After some discussion about the validity of the observations presented by the executive, the law was approved on September 2011³³³ and the regulations to the PCL were approved in April 2012.³³⁴

The text of the Prior Consultation Law indicates that its text should be interpreted in the lines of the ILO Convention 169 and indicates that indigenous population have a right to be consulted before the approval of any legislative or administrative enactment that may affect their collective rights, cultural identity, life quality or development.³³⁵ According to the text of the law, the intention of the consultation process is to reach an agreement between the government and the affected population by means of a dialogue that guarantees their inclusion in the decision making

³²⁷ La tragedia de Bagua, Blog de Fernando Tuesta Soldevilla, online: <<http://blog.pucp.edu.pe/fernandotuesta/la-tragedia-de-bagua>>

³²⁸ Supra note 323

³²⁹ Ibid

³³⁰ Ibid

³³¹ Ibid

³³² Ibid

³³³ Ley de Derecho a la Consulta Previa a los pueblos indígenas u originarios reconocido en el convenio numero 169 de la Organización Internacional del Trabajo, Statute No. 29785. September 7, 2011.

³³⁴ Reglamento de la ley de Derecho a la Consulta Previa a los pueblos indígenas u originarios reconocido en el convenio numero 169 de la Organización Internacional del Trabajo, Supreme Decree No. 001-2012-MC. April 3, 2012

³³⁵ Ibid

process and enactments that respect their collective rights.³³⁶ The consultation right should be only exercised with the government.³³⁷ The law indicated that when an agreement is not reached, the government should act in good faith to adopt the corresponding measures to protect the rights of these communities.³³⁸ The consultation right ends when the government dialogs with the communities and both parties exchange their ideas.³³⁹ If as a consequence of the exercise of this right an agreement is reached, the agreement should be complied with by government entities.³⁴⁰ In different words, what the law says is that if an agreement is not reached the communities do not have the ability of prevent or contradict the decision made by the government to grant a concession.

According to the literature, the issue of whether the communities should have a right to “consent” (or not) to specific projects, or simply enjoy a “consultation” over the conflicting matter was an issue that involved long discussions during the drafting of Convention 169.³⁴¹ Granting a right to be consulted (and not one to consent) was initially dismissed as it was considered a meaningless right that encouraged ignoring the rights of the communities. However, Convention 169, in the end, settled on the standard of consultation.³⁴² In this regard, the Convention text states that the referred consultations must be undertaken in good faith and with the objective of achieving agreement or consent to the matters discussed.³⁴³ In practice, it is important to consider that the Convention terms do not define a “consultation” neither specifies the ways of determining whether a procedure qualifies as consultation for the purposes of the Convention.³⁴⁴ In fact, the ILO, in reply to the inquiries from the Peruvian Ombudsman’s office, has clarified that the spirit of Convention 169 is not to provide veto power to the communities, given that each state is the one called to decide on issues of development in their jurisdictions.³⁴⁵

³³⁶ Ibid

³³⁷ Ibid

³³⁸ Ibid

³³⁹ Ibid

³⁴⁰ Ibid

³⁴¹ Amanda M. Fulmer, “The Politics of a Strange Right: Consultation, mining and indigenous mobilization in Latin America” (Paper presented on the *APSA 2011 Annual Meeting, September 2011*), online: <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1902259>

³⁴² Ibid

³⁴³ Ibid

³⁴⁴ Ibid

³⁴⁵ Supra note 160

In this regard, it is relevant to consider that while the government retains the legal tools to make the final decision on any particular investment within the boundaries of its territory, the level of pressure imposed by the communities when in disagreement cannot be underestimated as this pressure may force the investor to reconsider its decision to invest in the country.³⁴⁶

At this point it is important to question the effectiveness that the PCL may have. Even before the enactment of the PCL, upon granting a concession, the government requires that an agreement should be reached between the investor and the land owners in order for the investor to be able to start the exploration process.³⁴⁷ This means that the concession is granted to the investor with the condition to reach an agreement with the land owners or otherwise the mining investor simply cannot start its activities. The question in this context becomes if the PCL is bringing anything new to the status quo of the communities. One could argue that some sort of “veto” power has been in force for some time already.

The difference between the agreement that needs to be reached with the land owners (in force before the enactment of the PCL) and the new consultation process enacted by the PCL is given mainly by the fact that the prior consultation law forces the government to mediate the dispute. In cases where an agreement is reached by means of the PCL, the process will create government’s presence in places where the government is now absent. It can possibly provide the communities with much needed feeling of protection from government given the binding nature of the decision. However, since the Prior Consultation Law simply provides the right to be consulted but not the right to consent, the government may later come to a decision that disagrees with the communities’ preferences. In such case, despite the communities have no legal tools to oppose the decision; it only still has the possibility to deny the investment by simply not arriving to an agreement with regards to the lands. In such scenario, some issues may arise if a portion of the community members are willing to transfer their lands but another group is opposed to the situation. This deadlock may generate violent conflicts as the ones described in section 2 of this chapter.

From another perspective, the enactment of the PCL may become a deterrent to mining investors. They are now required not only to go through the formal consultation procedure established in

³⁴⁶ Ibid

³⁴⁷ Ibid

the Prior Consultation Law, but also though the negotiation of an agreement on the superficial properties. Neither the PCL nor its regulations suggests that a successful consultation per the PCL implies or includes an agreement regarding the lands. This is why communities can still use such negotiations to enhance their bargaining power.

In addition to pointing out the weaknesses of the PCL, is not possible at this point to determine with certainty whether the PCL would become a successful tool to reduce social conflict and achieve integration of local communities given the recent enactment of its regulations. However, the enactment of the PCL looks promising from the perspective of the social inclusion aspects, as communities who felt completely abandoned by government, are now starting to feel that their opinion is at least considered as part of the mining project negotiation process.

4. Conclusion

As mentioned in the previous chapter, both the investor and the government want to maximize revenues. Provided the investor is granted a tax regime that allow for minimization of risk and maximization of revenue, the investor will be interested in the project to be approved. On the other side, provided the public interest is not affected, the government will equally be interested on the mining investment agreement to be subscribed. However, neither of them will be able to meet its objective if as a prior step, the confrontations with local communities are not addressed.

If not addressed, social conflict will continue to affect in a detrimental way one of the country's main sources of revenue. The solution to the conflicts with local communities needs to be addressed by the government. The government needs to provide the needed regulations for a mining project to be able to succeed having all parties satisfied, at least to an extent. Mining companies' attitude towards the communities is certainly relevant, but it is the government who needs to start listening to what communities have to say. Listening to the communities and making them know that their opinion is been given consideration in a respectful environment may have a large impact on the mining negotiation process. The PCL, although technically not providing veto power to the communities, seems to have addressed (at least partially) some of the communities' concerns by forcing the government to listen to the communities.

Once the social conflict is addressed, the concerns of citizens living outside the communities' will be satisfied as the violence levels will decrease and business won't be interrupted by the violent riots.

The government needs to consider the best interests of the country as a whole. The tax system and the concept of redistribution are relevant for this purpose as these are the tools that may allow citizens in extreme poverty to start feeling the positive economic effects of the mining industry. The third chapter of the thesis discusses both of these issues in the context of the government goals and the recently implemented reform

Chapter III

Evaluation of the Government Goals

This chapter discusses important legislative reforms implemented by the government between 2011 and 2012 focusing on tax issues, as well as it provides a brief explanation of some pieces of legislation that were enacted in earlier years but are related with the most recent reforms. Drawing on the map provided in previous chapters, this one analyzes how these legislative provisions affect each of the parties involved in the mining process (investors, local communities, illegal miners and governments) and their interests.

The chapter will be structured as follows. First, it will provide a detailed description of the legislative reforms and their inner workings. Second, it will ask what are the potential goals that could have been achieved with these reforms, and which ones are the goals that have actually been achieved. Third, I present some reform proposals that could potentially improve this legislation in the near future by striking a better balance among the interests of all parties involved.

1. Recent legal reforms in the Peruvian Tax system

In recent decades, Peruvian elections have been known for the appearance of out-of-nowhere candidates and the Peruvian current president is certainly not an exception to this.³⁴⁸ Mr. Ollanta Humala, a former army officer with no political experience ran for president's office in the 2006 election process but lost the election.³⁴⁹ In the 2011 election process, Mr. Humala, who at this point had led a coup d'etat and backed the military occupation of a rural police station in Andahuaylas, Apurímac led by his brother, ran for Presidential office for a second time and was successful.³⁵⁰ Mr. Humala was supported mainly by an economically deprived group from the southern Andes, who felt they did not get their share of the Peruvian economic boom.³⁵¹

³⁴⁸ "Peru's Presidential Election Inside Out", *The economist* (March 23, 2011), online: <http://www.economist.com/blogs/americasview/2011/03/perus_presidential_election>

³⁴⁹ Ibid

³⁵⁰ Ibid

³⁵¹ Ibid

During the 2011 election, Mr. Humala's contenders were mainly Mr. Pedro Pablo Kuczynski, a former official and investment banker of the International Monetary Fund and the World Bank who spent much of his life in the USA.³⁵² He is considered a representative of the rich in a poor country and his support was mainly based in Lima, the capital.³⁵³ Ms. Keiko Fujimori, a 35 year old woman, whose father was an autocratic right-wing Peruvian president (currently imprisoned for charges on corruption and human-right abuses) was also a contender of Mr. Humala.³⁵⁴ The run-off of the presidential election (only between Mr. Humala and Ms. Fujimori) was compared to the choice between AIDS and terminal cancer.³⁵⁵

As opposed to Humala's discourse during the 2006 and the first round of the 2011 election, where he avowed statist Venezuelan President Hugo Chavez, during the second round of his 2011 campaign, Mr. Humala dropped the leftist platform (the one which actually allow him to get to the second round of the presidential election) and suddenly adopted the discourse of the social democratic Brazilian president Lula da Silva.³⁵⁶ The uncertainty provoked by this sudden change prompted the biggest-ever daily fall of the Peruvian Stock Market.³⁵⁷

In this context, the most controversial issue of Humala's campaign was the treatment of mining and natural gas investment.³⁵⁸ During his "nationalist" stage he clearly stated his intentions of expropriating foreign mining and gas companies and creating new state enterprises.³⁵⁹ In contrast, after the change in his discourse, he sounded almost like Mr. Kuczynski as he was now referring to legalizing Peru's vast informal economy, negotiating higher taxes on mining and improving schools.³⁶⁰ This change in discourse generated much uncertainty about which platform will be the one finally adopted by Mr. Humala, once elected. This uncertainty was felt heavily all over the country.

³⁵² Ibid

³⁵³ Ibid

³⁵⁴ "Peru's Presidential Election The Populist Crowd" *The economist*, (April 11, 2011), online <http://www.economist.com/blogs/americasview/2011/04/perus_presidential_election_0>

³⁵⁵ "Peru's Presidential Election Second time's the charm", *The economist* (June 6, 2011), online: <<http://www.economist.com/blogs/americasview/2011/06/perus-presidential-election>>

³⁵⁶ "Peru's Presidential Run-off: Victory of the Andean Chameleon", *The economist*, (June 9, 2011), online: <<http://www.economist.com/node/18805443>>

³⁵⁷ Ibid

³⁵⁸ Ibid

³⁵⁹ "Peru's presidential election The masses blow a raspberry", *The Economist* (April 14, 2011), online: <<http://www.economist.com/node/18560545>>

³⁶⁰ Ibid

Soon after his inauguration (July 28, 2011), Mr. Humala enacted a package of reforms addressed to the mining sector, which, according to the forecasts, was expected to increase the amount of tax revenues in approximately 3,000 million of soles (US\$1,150 million) annually.³⁶¹ The reforms enacted in September 2011, contained (i) an amendment to the Mining Royalty Law (in which the tax base was modified to address the regressive nature of the current system and modify the tax rates), (ii) a Special Mining Tax was enacted to create a new levy for companies investing in metallic mineral resources and (iii) a Special Mining Contribution levying the exploitation of non-renewable natural resources in the case of investors who have signed stability agreements. The main difference between the Special Mining Tax and the Special Mining Contribution is that the former levies taxpayers who have not signed stability agreements, while the latter targets investors who signed such stability agreements³⁶² with the Peruvian government.

After the enactment of the above mentioned package, new rules targeting illegal mining activities were also enacted. These rules contain provisions to regulate the interdiction actions to be adopted by the corresponding authorities with regards to illegal mining and to typify illegal mining as a crime and duly incorporate it in the Criminal Code.

The following sub-sections of this first section contain the technical details of each of the reforms mentioned above.

³⁶¹ “El ejecutivo aprobo tres proyectos de ley para viabilizar el aporte minero”, *El Comercio Peru* (September 13, 2011). Online: <<http://elcomercio.pe/economia/1302391/noticia-ejecutivo-aprobo-tres-proyectos-ley-viabilizar-aporte-minero>>

³⁶² In the Peruvian context, stability agreements are contracts (invested with the force of a Law) signed between the Peruvian government and the investor, by means of which the government guarantees (i) that the law will be applied to national and foreign investors equally, (ii) that even when the income tax regime is modified, the changes made after the subscription of the stability agreement will not be applicable to the particular investor, and (iii) that no barriers will be placed to currency exchange and (iv) the permanent availability of transfer of profits, dividends and royalties as may accrue from the foreign capital will be respected. (Superintendencia Nacional de Administracion Tributaria - SUNAT, Online: <http://inversionistaextranjero.sunat.gob.pe/index.php?option=com_content&view=article&id=50:convenios-de-estabilidad-juridica-tributaria&catid=7:legislacion-tributaria-general&Itemid=12&lang=en>. The investor, on the other side, commits to a minimum investment (either by funding the capital stock of an already constituted company or one to be constituted, or risk investments under agreement with third parties, through the National Financial System) of at least ten million American dollars or its currency equivalent (Superintendencia Nacional de Administracion Tributaria - SUNAT, Online: <http://inversionistaextranjero.sunat.gob.pe/index.php?option=com_content&view=article&id=50:convenios-de-estabilidad-juridica-tributaria&catid=7:legislacion-tributaria-general&Itemid=12&lang=en>. These agreements are valid for a period of ten years. (Ministerio de Relaciones Exteriores, online: <<http://www.rree.gob.pe/portal/economia2.nsf/0/a0e3d3d20c0a35d005256c0d005976c0?OpenDocument>>

1.1 Mining Royalty Law (MRL)

The Mining Royalty Law regulates the payment that mining investors should provide to the Peruvian government as compensation for the extraction of natural resources performed in Peruvian soil and constitutes the main source of contribution of the mining sector to the Peruvian economy.³⁶³ Until the recent reforms, the mining royalty regime had two main components: (i) the payments originated in the Mining Royalty Law and (ii) the “voluntary contribution” (in force until 2011).³⁶⁴

The MRL was first enacted in Peru in June 2004, and despite being amended several times since then, the mining royalty had always been calculated using the value of the ore extracted as tax base.³⁶⁵ The latest amendment to the MRL (enacted on September 2011) was said to be only a part of a new mining royalties scheme composed by three laws: (1) Law No. 29788, the actual amendment to the MRL, (2) Law No. 29789, which creates a new Special Mining Tax, and (3) Law No. 29790, which establishes the new Special Mining Contribution.³⁶⁶ The amendment to the MRL will be discussed in this section while a brief explanation of the Special Mining Tax and the Special Mining Contribution will be discussed in the subsequent sections.

The amendment to the MRL modifies the tax base, the rate and the frequency of the payments.³⁶⁷ The MRL (pre and post amendment) is applicable to mining companies that have not entered into a tax stability agreement with the government. The objective of the amendment was to address the regressive nature of the mining royalties.³⁶⁸ The regressive nature was given by the fact that mining companies who had large sales but were not necessarily profitable were paying higher taxes than those with lower sales but higher profits.³⁶⁹

³⁶³ The legal nature of the Mining Royalty became controversial at the time of the MRL enactment. For some, mining royalties are a “compensation” for the exploitation of the minerals while for others it is in fact a “tax”. The determination of its nature has implications regarding who will this amendment will be applicable to. In the scenario of a “compensation” companies that have signed stability agreement would be found liable for payment according to the new regime and, conversely, in the scenario of a “tax” it would be very questionable whether or not companies with stabilized regimes are caught by the modification or not. Mining companies with stabilized regimes are nonetheless not affected by the new rules as their stability agreements guarantee not only tax stability, but some many other benefits that makes the new legislation not applicable to them. Supra note 239

³⁶⁴ Supra note 239 at 12

³⁶⁵ Ibid

³⁶⁶ Ibid

³⁶⁷ Supra note 239 at 13

³⁶⁸ Supra note 361

³⁶⁹ Supra note 361

The main change promoted by the 2011 amendment was to determine that the tax base of the MRL is given by the operating profits (instead of the total ore extraction, as it was determined before 2011).³⁷⁰ The operating profit of the mining companies is obtained by deducting the cost of sales, operating expenses (including sale expenses and administrative expenses) from the income borne on the sales of metallic and non-metallic mining resources as reported by the mining company.³⁷¹

In order to calculate the amount of royalty owing, the taxpayer must divide its quarterly operating profit by the income generated on the sales of such quarter.³⁷² The applicable progressive rate ranges between 1% and 12% (a large increase compared to the rates before the amendment, which ranged between 1% and 3%).³⁷³ The taxpayer needs also to calculate the 1% of gross sales and compare it to the amount of quarterly operating profits; whichever is higher constitutes the payable amount for the quarter.³⁷⁴

Before the amendment, the royalties were payable on a monthly basis. After the amendment, the payment obligation is born at the closing of each quarter (January-March, April-June, July-September and October-December).³⁷⁵ The amounts paid are deductible for Income Tax purposes³⁷⁶ and the deduction shall be taken in the year in which the tax is paid.³⁷⁷

1.2 Special Mining Tax (SMT)

This new tax, approved by Law No. 29789 on September 2011, applies to mining companies who have not signed stability agreements with the government.³⁷⁸ It levies the operating profits³⁷⁹ obtained by mining investors, from sales of metallic mineral resources,³⁸⁰ as well as

³⁷⁰ Supra note 239 at 12

³⁷¹ Ibid

³⁷² Supra note 239 at 13

³⁷³ Supra note 239 at 13

³⁷⁴ Supra note 239 at 13

³⁷⁵ Ley que modifica la Ley 28258, Ley de Regalia Minera, Statute No. 29788, September 28, 2011

³⁷⁶ It is important to keep in mind that the fact that the MRL is deductible for Income Tax purposes, does not imply a contradiction with the government goal of increasing the fiscal resources as the MRL deductible amount is diluted by the income tax rate. The government does receive the applicable amount (as per progressive rates indicated above) and forgoes only a percentage of it when calculating Income taxes

³⁷⁷ Supra note 375

³⁷⁸ Supra note 239 at 14

³⁷⁹ Profits are calculated by deducting from the income generated on the sale of mining resources, the cost of sales, operative expenses (including sale expenses and administrative expenses).

³⁸⁰ Supra 239 at 14

from own consumption and unjustified withdrawals³⁸¹ of those assets.³⁸² The tax accrues quarterly (March, June, September and December) and the Law contains specific provision to help the taxpayer determine the attribution of income and expenses to each quarter, such as amortization of the assets.³⁸³

The SMT rate is determined based on the operating profits,³⁸⁴ depending on the calculation of the “operating margin” (calculated by dividing the quarterly operating income, from the income generated by the sales of each quarter).³⁸⁵ The progressive rates range between 2% and 8.4% of the operating profits.³⁸⁶

The amounts paid are considered a deductible expense for Corporate Income Tax purposes and the expense must be applied in the same year in which the SMT is paid.³⁸⁷ The tax is administered and collected by the central government Tax authority.³⁸⁸

1.3 Special Mining Contribution (SMC)

This newly created contribution, approved by Law No. 29790 on September 2011, levies the exploitation of non-renewable natural resources.³⁸⁹ The main characteristic of the contribution is the fact that is voluntary (mining investors will voluntarily enter into agreements with the Peruvian Government to pay this contribution)³⁹⁰ and it is intended to replace the “voluntary contribution” in force until 2011. In contrast to the MRL and the SMT, the SMC is applicable only to mining companies with stabilized regimes. Although the contribution is voluntary, it is unlikely that a mining investor refuses to pay it due to political pressure.³⁹¹ In fact, even when

³⁸¹ Expenses and costs incurred for own consumption and unjustified withdrawals of mineral resources are not deductible for the purposes of calculating the tax payable.

³⁸² Ley que crea el Impuesto Especial a la Minería, Law No. 29789, September 28, 2011.

³⁸³ Ibid

³⁸⁴ Whether the imposition of two different taxes on the same base represents a double taxation issue is beyond the scope of this thesis

³⁸⁵ Supra note 382

³⁸⁶ Ibid

³⁸⁷ Ibid

³⁸⁸ Ley que crea el Gravamen Especial a la Minería, Law No. 29790, September 28, 2011.

³⁸⁹ Ibid

³⁹⁰ Supra 239 at 15

³⁹¹ Phone discussion with the legal advisor of a foreign mining investor currently operating in Peru

the “voluntary contribution” mentioned above was also paid on a voluntary basis, no company refused to pay it.³⁹²

The SMC also accrues on a quarterly basis from the sale of metallic mineral resources, regardless of their condition. The Law contains specific provisions to help the taxpayer determine the attribution of income and expenses to each quarter, such as amortization of the assets. The applicable tax rate ranges between 4% up to 13.12% of the operative profit (calculated in the same manner as for the SMT).³⁹³

The calculation of SMC allows for a deduction of the amounts paid for mining royalties and contractual mining royalties³⁹⁴ that expire after entering into the agreement with the Peruvian Government. If the amounts paid for royalties are greater than the payable SMC, an indefinite carry-forward is allowed.³⁹⁵

The SMC paid is deductible for Income Tax purposes, and the deduction shall be applied in the year in which the SMC is paid.³⁹⁶ The tax is administered and collected by the central government Tax authority.³⁹⁷

1.4 Illegal Mining

As in the case of the royalties’ regime, the reforms to the illegal mining regime have some history throughout the years. The starting point of the Illegal mining regime is the legal recognition and acceptance of small scale and artisanal mining as part of the Peruvian economy.

On January 2002, Law No. 27651, was enacted to promote and to formalize small scale and artisanal mining.³⁹⁸ This Law established for the first time in Peru that the government protects and promotes small scale and artisanal mining (SSAM) and regulates (also for the first time) the SSAM requirement of an environmental study to approve the methods used to exploit the

³⁹² Phone discussion with the legal advisor of a foreign mining investor currently operating in Peru

³⁹³ Supra note 388

³⁹⁴ While the expression “mining royalties” refers to the amount of royalties payable according to the MRL, the phrase “contractual mining royalties” refers to the payment of royalties borne in the stability agreements signed with the Government.

³⁹⁵ Supra note 388

³⁹⁶ Ibid

³⁹⁷ Ibid

³⁹⁸ Ley de Formalizacion y Promocion de la Pequena Minería y la Minería Artesanal, Statute No. 27651, January 25, 2002

minerals.³⁹⁹ The Law also established minimum levels of production for SSAM, which if not met submits the miner to a penalty.

The Rulings of Law 27651 also indicate that the government would help the miners to foster their business consolidation for a maximum period of two years through technical and management training, channeling of information to keep the miners informed of their obligations and the opportunities available for them, facilitation of customers and suppliers and advice regarding sources of funding.⁴⁰⁰ Finally, the Law considers SSAM eligible to subscribe stability agreements provided an established minimum investment is guaranteed.⁴⁰¹

After several years of been left aside, between the months of February and April of 2012, the executive branch of government, based on special powers to legislate on illegal mining issues for a specific period of time, enacted Legislative Decrees No. 1100, to 1107 aimed to stop and condemn illegal mining activities in Peru, such as some other rules to implement them.⁴⁰²

Legislative Decree No. 1100 regulates the actions to be adopted by the corresponding authorities with regards to the banning of illegal mining activities.⁴⁰³ In this regard, the Decree starts by indicating that the sole fact that a person has been granted a concession does not authorize the starting of exploration, exploitation or benefiting from the mining resources, as an additional authorization is required for such purpose.⁴⁰⁴ In addition, the Decree prohibits, among others, the use of “dragas” or similar artifacts and the use of machinery, equipment or supplies for the development of illegal mining activities in the context of small-scale and artisanal mining.⁴⁰⁵

The Legislative Decree allows several authorities as competent to seize, destroy or demolish any goods, machinery, equipment or supplies that have been forbidden or those used for illegal mining purposes.⁴⁰⁶ For the purposes of determining the unauthorized use of assets, the competent authorities are allowed to request from the Ministry of Energy and Mines or their

³⁹⁹ Ibid

⁴⁰⁰ Decreto Legislativo que Regula la Interdicción de la Minería Ilegal en Toda la Republica y Establece Medidas Complementarias, Legislative Decree No. 1100, February 18, 2012

⁴⁰¹ Supra note 398

⁴⁰² Supra note 400

⁴⁰³ Ibid

⁴⁰⁴ Ibid

⁴⁰⁵ Ibid

⁴⁰⁶ Ibid

Regional dependency, a detailed list indicating the name of the concession holder, the machinery authorized to be used and the name of its owner, when applicable.⁴⁰⁷

Legislative Decree No. 1001, in force since March 1, 2012, is aimed at strengthening environmental assessment for SSAM.⁴⁰⁸ The decree includes a list of penalties ranging from “very serious” to “minor” faults.⁴⁰⁹ Faults qualified as “very serious” (such as performing any sort of mining activities prior to the environmental assessment or authorization from the corresponding authorities) are penalized with fines that range between S/.36,500 (US\$14,000) and S/.146,000 (US\$56,000) for small-scale mining and S/.18,000 (US\$6,900) and S/.91,250 (US\$35,000) for artisanal mining activities.⁴¹⁰ Faults qualified as “mild” (such as those related to the mine’s closure plan) are penalized with fines that range from S/.7,300 (US\$2,800) to S/.36,500 (US\$14,000) for small-scale mining and S/.3,650 (US\$1,400) and S/.36,500 (US\$14,000) for artisanal mining activities.⁴¹¹

With regards to the use of water resources of any kind (such as the occupation of water resources for mining purposes without having an approval from the corresponding authority), faults are always considered “very serious” and fines range from S/.36,500 (US\$14,000) to S/.146,000 (US\$56,000) for small-scale mining and S/.18,250 (US\$7,000) and S/.91,250 (US\$35,000) for artisanal mining activities.⁴¹²

Legislative Decree No. 1102 incorporates illegal mining to the Peruvian Penal Code, which implies its categorization as a crime.⁴¹³ In this sense, whoever engages in exploration, extraction, exploitation or any similar act related to mining activities without the appropriate permission from the corresponding mining authorities is considered to fall in the definition of illegal mining.⁴¹⁴ The felony is aggravated if the activities take place in protected areas or in lands

⁴⁰⁷ Ibid

⁴⁰⁸ Decreto Legislativo que establece medidas para el Fortalecimiento de la Fiscalización Ambiental como Mecanismo de Lucha contra la Minería Ilegal, Legislative Decree No. 1101. February 29, 2012

⁴⁰⁹ Ibid

⁴¹⁰ Ibid

⁴¹¹ Ibid

⁴¹² Ibid

⁴¹³ Decreto Legislativo que incorpora al Código Penal los delitos de minería ilegal, Legislative Decree No. 1102, March 1, 2012

⁴¹⁴ Ibid

owned by native communities.⁴¹⁵ Those who facilitate supplies or machinery to be used in illegal mining are also liable for criminal responsibility.⁴¹⁶

Legislative Decree No. 1103 (which aims to establish checks and controls for the distribution, transportation, and commercialization of chemical supplies in order to avoid its use in illegal mining activities) establishes that the chemical supplies transported within the country are compelled to travel only through specific routes designated by the government and should be always accompanied by the proof of payment.⁴¹⁷ The Decree designates the central Tax Administration authority as the entity in charge of ensuring such compliance.⁴¹⁸ If supplies are found outside the route designated, not only the supply but the vehicle that transports them, will be seized and the corresponding criminal legal actions should be started.⁴¹⁹

Legislative Decree No. 1104 regulates the loss of possessory rights. In this regard, the loss of possessory rights is a legal institution by means of which the ownership of objects, earnings, rights, etc. obtained as a consequence of the commission of crimes (such as, among others, illegal mining) are transferred to the government upon the completion of due legal actions.⁴²⁰ The loss of possessory rights is applicable to objects, earning and rights that are obtained as a direct or indirect result of illegal activities.⁴²¹

Legislative Decree 1105 establishes the procedure to formalize illegal mining activities identified within the SSAM sector. According to this law, the “formalization process” ends 24 months after the enactment of the law, but the term established to start the formalization process is only 60 days.⁴²² The formalization process requires miners to file a commitment, show proof of ownership or the agreement that allows them to work on a particular land, demonstrate the concession right, authorization of water use, environmental approvals, and approval to start the mining activity from the appropriate authority.⁴²³ In order to be eligible to start the formalization

⁴¹⁵ Ibid

⁴¹⁶ Ibid

⁴¹⁷ Decreto Legislativo que Establece Medidas de Control y Fiscalización en la Distribución, Transporte y Comercialización de Insumos Químicos que Puedan ser Utilizados en la Minería Ilegal, Legislative Decree No. 1103, March 4, 2012

⁴¹⁸ Ibid

⁴¹⁹ Ibid

⁴²⁰ Decreto Legislativo que Modifica la Legislación sobre Pérdida de Dominio, Legislative Decree No. 1104, April 20, 2012

⁴²¹ Ibid

⁴²² Decreto Legislativo que Establece Disposiciones para el Proceso de Formalización de las Actividades de Pequeña Minería y Minería Artesanal, Legislative Decree No. 1105, April 20, 2012

⁴²³ Supra note 254

process, the miners need to demonstrate basic knowledge of the mining industry. Only with the fulfillment of all the requirements, the activity will be considered legal.⁴²⁴

Supreme Decree No. 1106 (Efficient fight of money laundering, illegal mining and other organized crimes) was enacted because money laundering destabilizes the economic order and affects the normal commercialization of goods and services contaminating the market with goods from unlawful procedures and illegal mining is among the highest contributors to money laundering in Peru.⁴²⁵

2. The Goals of the Peruvian Legislative Reforms

According to the “Guidelines for Social and Economic Policy for a National Consensus Government”⁴²⁶ (hereinafter “the Government’s Plan”), document issued by Mr. Humala’s political party after adopting the social democratic discourse and dropping the leftist platform, the tax reform package for the mining sector enacted is designed to strike an appropriate balance between two conflicting goals: (i) to raise tax revenues, increasing the contribution of the mining sector to the Government’s budget, enabling the government to invest in development programs that would, inter alia, address the social concerns in low income communities and improve infrastructure, and (ii) assure that despite the reform, Peru remains a competitive place for mining companies to invest.

In order to achieve the abovementioned goals, Mr. Humala divided his plan according to the types of goal to be achieved and presented a list of the objectives his government would try to address. The goals that are directly or indirectly related to the mining tax reform objectives are the following:⁴²⁷

Social Policy goals:

⁴²⁴ Ibid

⁴²⁵ Ibid

⁴²⁶ Lineamientos Centrales de Política Económica y Social para un Gobierno de Concertación Nacional, online: <<http://filesocial.com/2904g8z>>

⁴²⁷ Refer to Supra note 426 for a complete list of objectives. This thesis includes only the ones relevant to the goals referred to increase of revenue and maintenance of competitiveness with regards to the mining sector.

- Assure an appropriate endowment of potable water, drainage and electricity is provided to public school.⁴²⁸

Macroeconomic policy and inclusive economic growth goals:

- Sustainable economic growth, emphasizing in social inclusion and the achievement of a better redistribution of resources;⁴²⁹
- Investment in infrastructure to integrate internal markets and decentralize the country;⁴³⁰
- Responsible use and management of natural resources, considering social and environmental sustainability;⁴³¹
- Ensure the enforcement of property rights, especially in the Andes and the Amazon, which specifically includes the formalization of the SSAM producers.⁴³²

Tax Policy goals:

- Assure an increase in tax burden when profitability increases and vice versa, assuring to tax the mining windfall generated as a consequence of the mining boom in Peru⁴³³. A specific line was included to announce that no new taxes would be created.⁴³⁴

Efficiency, Transparency and decentralization goals:

- Personnel training to assure the empowerment of management capacity of regional and local governments;⁴³⁵
- Prioritize public investment in non-mining regions.⁴³⁶

This section will discuss whether the legislative provisions discussed in the first section of this chapter work towards the achievement of these objectives

⁴²⁸ Supra 426

⁴²⁹ Ibid

⁴³⁰ Ibid

⁴³¹ Ibid

⁴³² Ibid

⁴³³ Ibid

⁴³⁴ Ibid

⁴³⁵ Ibid

⁴³⁶ Ibid

2.1 Increasing the tax burden as profitability rises and taxing mining windfalls

From the government plan, one of the goals the government intended to address was the increase the tax burden when profitability increases and vice-versa, what would secure the government's ability to benefit any windfalls to mining companies generated as a consequence of mining booms.⁴³⁷

From the evaluation of the royalties' regime in force before the amendments, the issue of the regressive nature of the regime was brought up. Based on the fact that the Mining Royalty before the amendment levied mining companies on their total sales, it was identified that the mining royalty regime imposed a greater burden on mining companies with lower profitability levels while a higher burden is imposed in mining companies with higher profitability.⁴³⁸ As a consequence, even if two companies had the same level of sales but with different levels of costs and expenses, the resulting royalty payment was higher for the companies with higher expenses and lower profits.⁴³⁹

Given that the government's objective is to increase revenue collection when prices are higher, while allowing mining companies to maintain lower expenses when prices go down, the royalty system was modified to levy the companies' profits rather than their sales.⁴⁴⁰ This addresses the regressive effects of the royalty tax to some extent as now the mining investors earning more are the ones who pay the most. However, the new royalties scheme, based on the fact that royalties are considered a retribution for the exploitation of the mineral resources, a minimum of 1% of the gross sales to the mining investor is levied even in cases where the mining investor is recording financial losses or profits lower than 1% of their gross sales, levies.

The minimum 1% levied may be said to still contain a regressive element as we may see the case of a company generating financial losses and yet having to pay royalties. However, this is justified by the fact that the government has a right to receive a payment as a consequence of the

⁴³⁷ Ibid

⁴³⁸ Explanatory memorandum included as part of the Bill to amend the Mining Royalty Law.

⁴³⁹ Peru, Oficio No. 205-2011-PR, Explanatory memorandum included as part of the Bill to amend the Mining Royalty Law, 2011 (remitted by the Peruvian President to the Congress President).

⁴⁴⁰ Ibid

exploitation of the mineral despite the external factors that may drive the company to generate losses.

In this regard, it is important to mention that the amendment to the royalty law does not necessarily imply a higher accrual of taxes payable.⁴⁴¹ Due to the nature of the MRL amendment, it is understood that the mining royalty revenues for government may not necessarily be increased as the amendment to the MRL only intends to correct its regressive nature but not necessarily to increase the base with the new MRL application. However, the amendment to the MRL is said to be only one additional step towards the government's objective of increasing the revenue base to make the tax burden of mining investors more competitive, i.e. leveling the burden among mining investors.⁴⁴² As mentioned above, in addition the MRL amendment, the first package of reforms also included two additional statutes that incorporated new levies to mining companies.⁴⁴³

Since the amendment to the royalty law is not applicable to mining companies that signed stabilizing agreements, the SMC was enacted with the intention of balancing the overall tax burden among mining companies and to create a new source of funding for government.⁴⁴⁴ The SMT, applicable to companies who have not signed stability agreements, has the same objectives. The question is whether this goal of the SMC and SMT – i.e. increase of the tax burden for companies that had signed the agreement, and consequently, increase in fiscal resources - can be achieved and further, if this can be done without driving away future mining investment in Peru.

Regarding the increase of tax revenue intended with the SMT and SMC, it is important to consider that the government initially announced that the royalty regime reforms should allow an increase in revenue of about 3,000 million soles (US\$1,150 million) on an annual basis.⁴⁴⁵ However, according to recent studies from a NGO called “Propuesta Ciudadana”, the revenue increase during the last quarter of 2011 (first period in which the MRL amendment, the SMT and the SMC were applicable) was only about 411 million soles (US\$158 million), which on annual

⁴⁴¹ Ibid

⁴⁴² Ibid

⁴⁴³ Ibid

⁴⁴⁴ Ibid

⁴⁴⁵ “Mineras no pagarían más de S/.1.000 mlls por regalías con nuevo régimen tributario”, El Comercio Peru (July 16, 2012), online: <<http://elcomercio.pe/economia/1442351/noticia-mineras-no-pagarian-mas-1000-mlls-regalias-nuevo-regimen-tributario>>

basis implies a projected revenue increase of only 1,644 million soles (US\$440 million), i.e. half of the amount estimated by government.⁴⁴⁶

With regards to the question about the incentive or disincentive of future mining investments in Peru, it is relevant to consider that the amendment of the MRL together with the enactment of the SMT and SMC, targeted an overall effective tax burden for the mining sector averaging 39% (instead of the 50% average burden before the amendments).⁴⁴⁷ According to the literature, the ideal effective tax rate that a country should aim at in order to remain competitive is anywhere below 50%.⁴⁴⁸ Thus, this should put Peru one step closer to achieving its goal of remaining a competitive jurisdiction for mining investment.

Finally, it is important to note that the government specifically indicated that no new taxes would be created in order to achieve its goal of increasing the tax burden in a fair way.⁴⁴⁹ The political aspects of a government plan are beyond the scope of this chapter, but it is important to note that breaking this promise would be costly for the Peruvian government. On the one hand, investors would be wary. On the other hand, it would only reinforce the lack of trust that already exists among Peruvian citizens. Thus, any intention to break this promise is likely to be considered carefully by the present or future governments.

2.2 Enforcing property rights by formalizing the SSAM producers and committing to a responsible use and management of natural resources

The government was clear when stating that the responsible use and management of natural resources, considering social and environmental sustainability and the enforcement of property rights, especially in the Andes and the Amazon (specifically addressing SSAM producers) were goals to be met during the current government's time in office⁴⁵⁰.

⁴⁴⁶ Ibid

⁴⁴⁷ Supra note 439

⁴⁴⁸ Supra 439 referring to: James M. Otto "Preliminary analysis of Options for the Mining Tax contained in the Government Plan 2011 – 2016" July 2011, Page 28

⁴⁴⁹ Supra note 426

⁴⁵⁰ Ibid

As mentioned in the previous chapter, most of the artisanal and traditional mining activity happens outside the framework of the law.⁴⁵¹ Illegal mining is associated with several side effects to the environment, occupational health and safety of miners and child labor, to mention a few.⁴⁵²

Since there is significant loss of liquid mercury during the amalgamation process to obtain gold, mercury contamination is identified by the literature as the main concern in terms of environmental danger.⁴⁵³ In addition to mercury, the literature recognizes a limitation on the regeneration of flora and fauna on the soil due to the earth movements made during the ore extraction.⁴⁵⁴ As an example, in the Madre de Dios region in Peru, where heavy equipment is used during the illegal mining process, the soil is compacted in such a way that vegetation no longer grows.⁴⁵⁵ The devastating effects of illegal mining in Madre de Dios can be easily seen on satellite images.⁴⁵⁶ This, in addition to the heavy contamination of soil plus its reduced capacity to retain humidity due to the dumps produced during the treatment of gold gravels.⁴⁵⁷

Environmental concerns also refer to the contamination of water sources, the ecosystem in general and the effects on climate.⁴⁵⁸ Waterways contamination is easily seen by the naked eye in the areas where alluvial deposits can be found as gravel washing requires large quantities of water.⁴⁵⁹ Water becomes turbid and this prevents the sun from reaching the bottom of the water source, which in turn prevents the development of any type of life.⁴⁶⁰ In addition, the mercury used in the amalgamation process travels in the water and contaminates the creatures that live in the water (such as fish) and which can be passed on to humans.⁴⁶¹ In addition, when the contaminated water evaporates the molecules suspended in the atmosphere are precipitated down by rainfall and end up in the water sources again, repeating the cycle over and over again.⁴⁶²

⁴⁵¹ César A. Ipenza Peralta. *Manual para entender la pequeña minería y la minería artesanal y los decretos legislativos vinculados a la minería ilegal* (Lima: SPDA, 2012), online: <<http://www.scribd.com/doc/97230652/Manual-mineria-Artesanal-y-Pequeña-Mineria>>

⁴⁵² Supra note 232

⁴⁵³ Supra note 232 at 26

⁴⁵⁴ Ibid

⁴⁵⁵ Supra note 232 at 27

⁴⁵⁶ Informe de la Comisión técnica multisectorial contra la minería ilegal 2011.

⁴⁵⁷ Supra 232 at 27

⁴⁵⁸ upra 232 at 26

⁴⁵⁹ upra 232 at 28

⁴⁶⁰ Ibid

⁴⁶¹ Ibid

⁴⁶² Ibid

There are a number of other concerns. First, the ecosystem is also affected by illegal mining as the animal species leaving close to the illegal mining site are forced to migrate due to the levels of noise or the disappearance of natural forests.⁴⁶³ These migrating creatures transport the mercury in their bodies and are able to contaminate people who consume them, even if they are far away from the illegal mining activity site.⁴⁶⁴ Second, mining safety is also a concern⁴⁶⁵. The lack of resources, the insufficient safety equipment and the ignorance about safety regulations are an explosive combination which certainly has an influence on the probabilities of accidents.⁴⁶⁶

Finally, child labor is not unusual on illegal mining sites as for the most part, the parent's income is very low and not enough to support a family.⁴⁶⁷ Also, the lack of adequate educational infrastructure favors the availability of children for work.⁴⁶⁸ Children who work and study usually don't have good scholastic yield as they are too tired to study or attend to classes,⁴⁶⁹ which in turn limits their future employment possibilities and perpetuates the poverty cycle.⁴⁷⁰ Illegal mining implies, in addition, a revenue loss for the government, which translates into less funding to relief poverty or improvement of living conditions.

In order to unveil the potential of small scale mining without the distorting effect of illegal mining (i.e. the positive aspects that small scale mining has, such as employment opportunities in remote places where most entrepreneurs are not willing to invest, the possibility of miners of achieving a sustainable activity and the possibility of revenues for government to be invested in things like poverty relief, etc.) a legal regime that addresses the specific characteristics of this particular industry should be designed⁴⁷¹. Since one important characteristic of small scale mining in this context is that it presents a high percentage of illegal mining, the design of the new legal regime must contain provisions that address the illegal mining consequences.

⁴⁶³ Supra 232 at 29

⁴⁶⁴ Ibid

⁴⁶⁵ Thomas Hentschel et al., *Global Report on Artisanal & Small-Scale Mining* (Mining, Minerals and Sustainable Development, 2002), online: <<http://pubs.iied.org/pdfs/G00723.pdf>>

⁴⁶⁶ Supra 232 at 29

⁴⁶⁷ Supra 232 at 32

⁴⁶⁸ Ibid

⁴⁶⁹ Supra note 465

⁴⁷⁰ Supra 232 at 33

⁴⁷¹ Fabian Clausen, Maria Laura Barreto, Amir Attaran, "Property Rights Theory and the Reform of Artisanal and Small Scale Mining in Development" (2011 4 Journal of Politics and the Law) at 16

With regards to the way in which governments can enhance the potential of small scale mining, accounting for the negative effects of illegal mining effectively, governments have mainly two alternatives: (a) formalize illegal miners by accepting their existence and try to turn them into formal entrepreneurs or (b) discourage them by imposing penalties to illegal mining, criminalizing the activity, etc.

Literature in favor of the formalization of illegal mining claims that formalizing the current relations between the land possessor and the land is the best alternative because private property is the main ingredient to incentive the investment and development of a resource.⁴⁷² For the formalization process to be successful, the government must consider that not all illegal miners are in the exact same condition neither have the same needs, fears, or objectives, reason for which different strategies must be considered as to include all the different subgroups within illegal mining.⁴⁷³ In this sense, it is relevant to consider that the formalization process is not an event but a gradual process in which the amount of illegality decreases until the point in which it is all integrated to the formal economy.⁴⁷⁴ Also, based on prior experiences, avoiding or denying the regulation of SSAM promotes illegal activity.⁴⁷⁵ In fact, according to the “tragedy of commons” when a person or group of persons have unlimited access to a resource, there is no concern about its use in a sustainable way, plundering the resource when it is clear that his will not benefit any of the users.⁴⁷⁶

Hernando De Soto, one of the most influential law and development scholars, argues that possessory relationships that have already been established and are efficient (such as the relationship between illegal miners and the lands they illegally take possession of) should be formalized.⁴⁷⁷ In practice, the formalization process may be very challenging due to the diversity of actor, the different needs and the conflicting interests between the government, the parties to be formalized and the rest of the population.⁴⁷⁸ Some arguments against De Soto’s proposal are

⁴⁷² Supra note 471 at 17

⁴⁷³ Cesar Mosquera, *El Desafío de la Formalización en la Minería Artesanal y de Pequeña Escala*, online: <
http://198.62.158.214/uploads/user-S/11613675361Estudio_formalizacion_MPE_webI.pdf>

⁴⁷⁴ Ibid

⁴⁷⁵ Ibid

⁴⁷⁶ Supra 471 at 17

⁴⁷⁷ Ibid

⁴⁷⁸ Supra 473

based on the fact that formalization would incentivize illegal mining activity. However, there is now empirical evidence showing that this is not the case.⁴⁷⁹

To implement De Soto's proposal to formalize illegal miners and make the activity efficient, government initiatives to provide legal title to the miners' claims would be required, which in turn will allow miners to get access to micro financing.⁴⁸⁰ Microfinancing is however, one of the most challenging parts of the formalization process given that the circle in which illegal miners are is hard to break: illegality prevents miners to access financing and the lack of financing may be one of the reasons why illegal miners stay in the illegality.⁴⁸¹

In addition, according to De Soto, mining licenses with periods that are as long as the ones granted for regular mining concessions are necessary to attract investment as only then rational investors may feel confident to invest.⁴⁸² Small scale investors may be deterred to invest in a mine with a concession if this is valid for one or two years, an insignificant amount as compared to the average of 30 year term of a mining concession for mid and large scale mining investors.⁴⁸³

A good argument in favor of formalizing illegal mining is based on the fact that miners who have to respond for damage caused to third parties have a strong incentive to act in an environmentally, socially and economically conscious way.⁴⁸⁴ In this sense, the ideal set of rules aimed at formalizing illegal miners should contain provisions regarding the use of toxic substances.⁴⁸⁵ In general, for the formalization to be effective, the government should come up with a set of rules that makes miners feel that contributing to the formal sector is advantageous to them.⁴⁸⁶

Those against formalization of illegal miners in developing economies claim that developing country governments are usually not strong on enforcing rules.⁴⁸⁷ Thus, the government will face a problem when miners consider the consequences of getting caught, as they are likely to decide

⁴⁷⁹ Supra note 471 at 18

⁴⁸⁰ Supra note 471 at 19

⁴⁸¹ Supra note 473

⁴⁸² Supra note 471 at 19

⁴⁸³ Ibid

⁴⁸⁴ Ibid

⁴⁸⁵ Ibid

⁴⁸⁶ Ibid

⁴⁸⁷ Ibid

to continue the activity illegally as the risk of being caught are fairly small. Another difficulty is the fact that illegal mining is usually performed in riverbeds that are easily accessible, so controlling the activity becomes a hassle as the extraction of minerals located in riverbeds is usually not profitable for mid and large mining companies, which allows for a lack of attention to these areas even when the riverbeds are located within the limits of their concession.⁴⁸⁸

The recognition of artisanal and small scale mining as a potentially profitable activity is not very common in most developing countries where this type of mining is treated as a social problem and a criminal activity that should be eliminated by means of creating laws that deter population from it.⁴⁸⁹ However, it has also been proven that illegal mining takes place regardless of the repressive legislation.⁴⁹⁰

Another issue that should be taken in account are the different levels of power and capacity that mining actors have (artisanal or small scale mining is on one side whereas large scale mining companies are on the other side) as the interaction of these two groups can generate conflicts.⁴⁹¹ In developing countries where SSAM and large mining are co-existent, it is not unusual to see conflicts between small miners, large miners and even government.⁴⁹² As an example, large scale miners may complain against the violation of mining tiles made by illegal miners (mostly in the SSAM sector), while SSAM's perspective in this sense may be that they are just been rated unequally.⁴⁹³ Government, on the other side, may try to avoid getting involved, excusing itself by indicating that assisting mining parties in conflict is not the role of government upon the complaint of large miners complaining due to unsecured mining rights.⁴⁹⁴

Also, since artisanal and small scale miners (illegal miners for the most part) do not usually own the lands where minerals are located, the government has to make a decision regarding the allocation of land. This means that the government needs to decide whether specific parcels of

⁴⁸⁸ Ibid

⁴⁸⁹ Supra note 471 at 18

⁴⁹⁰ Ibid

⁴⁹¹ Supra note 471 at 16

⁴⁹² Johanna, Carstens "Conflicts between small and large scale mining in Tanzania and Senegal causes, nature and mitigation strategy, online: < http://sasmin.ku.dk/pdf/asm_lsm_2009.pdf>

⁴⁹³ Ibid

⁴⁹⁴ Ibid

lands should be set aside for artisanal and small scale mining activities and how the current owners of those lands should be compensated in case of expropriation.⁴⁹⁵

In the specific context of Peru, some of the issues pointed out have been addressed by the Peruvian government prior to the latest reform. For instance, the recognition of artisanal and small scale mining (SSAM) as a potentially profitable activity was recognized and in fact promoted in 1992, with the enactment of Statute No. 27651. At that point, the government recognized the need of SSAM to lower concession payments, lower minimum production limits and lower penalties applicable to SSAM when minimum production cannot be demonstrated.⁴⁹⁶ This need is given by the fact that applying the same rates to small and large miners may imply difficulty of access to SSAM to the legal system, indirectly promoting activities outside the law.

The government also intended to put the Peruvian SSAM at the same competitive level of the mid and large sized mining projects by granting concession for equal duration for all types of concessions in consideration to the fact that shorter concession terms for SSAM may deter investors from it. It is important to consider that the recognition of SSAM as a formal activity in the economy certainly indicates the acknowledgment of the different levels of power and capacity that SSAM and big mining investors have as this recognizes that SSAM has not only to abide by the law in respecting other miners concessions and other rights, but also that SSAM has enforceable legal rights that provide access to the legal system and protects them from unequal treatment. Also, in 1992 the Peruvian government enacted legislation regarding the allocation of the lands to SSAM. It did so by granting a preferential right for artisanal miners occupying lands pacifically and publicly to request mining concessions, provided the land had no other concessions or were considered as available for mining purposes. In order to exercise the preferential right the miners were required to go through a formalization process.

With regards to the complicated licensing procedures and onerous fees, the government has tried to address the situation by establishing a special office to explain and guide miners in the process. In this regard, it is important to mention that the regulations to Law No. 27651 establish an alternative to the proof of ownership: The titleholder may sign an agreement with small scale or artisanal miners allowing them to extract minerals on a determined area of their concession in

⁴⁹⁵ Supra note 471 at 16

⁴⁹⁶ Supra note 398

exchange of a payment from the SSAM producers to the titleholder.⁴⁹⁷

Government initiatives to provide legal title to the miners' claims have not only been in the agenda of government in the past, but it has also been promoted during the recent mining reforms. As mentioned earlier, Legislative Decree 1105 establishes the guidelines for the formalization of illegal mining activities, considering not only the miners but also the suppliers. Also, during the recent reform the government has been keen with the enactment of measures to regulate the use of toxic substances by increasing the checks and controls to assure that these substances are only used in formal activities.

Finally, to address the complexities of "sentimental value" that may be attached to land, the prior consultation discussed in chapter 2 was enacted.

The reforms seem, on one side, to follow closely the proposals recommended by the academic literature. On the other side, however, it is not clear why the government seems to be focusing so much effort in penalizing illegal miners and suppliers and regulating the to the prohibition of illegal mining activities to be adopted by the corresponding authorities with regards to illegal mining. The government seems to be applying rewarding (providing SSAM with legal protection on their activity, providing preferential right for artisanal miners occupying lands pacifically and publicly, simplifying procedures by establishing a special office to explain and guide miners the formalization process, providing alternatives to the proof of ownership, enacting the prior consultation law to address the concerns and mainly, providing a period of time without the application of penalties for illegal miners to start the formalization process) and punishing strategies (penalizing illegal mining activities and establishing several checks and controls to make sure that those who break the law be caught) at the same time. The question is whether both strategies can be used together and still be effective. For Herold, both strategies can work in concert.⁴⁹⁸ According to Herold, it is "much easier to change an established behavior by offering rewards, rather than threatening with punishments."⁴⁹⁹ However, once the behavior has been

⁴⁹⁷ Ministerio de Energía y Minas, *Guía para los pequeños mineros y mineros*, at 24, online: <<http://www.minem.gob.pe/minem/archivos/file/institucional/regionales/Publicaciones/Guia-Peque%C3%B1os-Artesanales.pdf>>

⁴⁹⁸ "Reward Now, Punish Later", Kellogg Insight focus on research, online:

<http://insight.kellogg.northwestern.edu/index.php/kellogg/article/reward_now_punish_later>

⁴⁹⁹ Ibid

established “sustaining it by the threat of punishment is cheap”.⁵⁰⁰ In essence, the punishing strategy by itself is not the ideal during the first period of implementation as the majority may end up getting punished as it may take some time to adjust to the new requirements.⁵⁰¹ During the initial period of implementation it is more effective to reward as only a few will be able to follow though.⁵⁰² After a period of adjustment though, only a few will be doing the wrong thing and consequently, only those few will get punished⁵⁰³. In other words, Herold indicate, “a reward may help to get you to a situation in which you can establish punishment”.⁵⁰⁴

Based on the literature above, the Peruvian government may have lost sight of the timing issue as both punishment and incentive are being enacted at the same time. Should the government disregard the penalties and sanctions established during the first stage (until a vast majority of illegal miners have already gone through the formalization process) to only then start applying the sanctions, it will be expected that Peruvian illegal miners slowly take the formalization path by following the incentives established by the government.

2.3. Redistributive Goals

The objectives presented in the government plan were clear in terms of indicating an intention of government to work towards a fairer redistribution of the mining revenues. The question is whether the legislative reform, and especially the tax reforms have provisions that aim at guaranteeing such redistributive outcomes and whether they are likely to be effective.

As mentioned earlier in this thesis, regional and local governments where the mineral resources are exploited receive a generous percentage of the mining canon and mining royalty.⁵⁰⁵ Mining Canon and Mining royalties represent in some provinces the main source of revenue for the local government.⁵⁰⁶ So it is important to consider at this point how the manner in which the mining revenue is redistributed has impacted on the Peruvian economy and how citizens of provinces or

⁵⁰⁰ Ibid

⁵⁰¹ Ibid

⁵⁰² Ibid

⁵⁰³ Ibid

⁵⁰⁴ Ibid

⁵⁰⁵ Local and regional government receive, in addition to mining canon and mining royalty, other revenues from the mining sector, such as “fondoempleo” (fund created with the excess profit sharing recorded by mining companies that exceeds the maximum payable by law) or the “voluntary contribution” made by mining companies with stabilized regimes, which are purposely excluded from this discussion as these do not imply a redistribution of revenues on the side of the government.

⁵⁰⁶ Supra note 239

localities receiving these transfers feel about it as their opinion should be a good guidance for government to be able to identify the places where resources are simply not reaching all the population intended. This will be discussed considering the following aspects: (i) poverty, (ii) health, (iii) education and (iv) social infrastructure.⁵⁰⁷

With regards to poverty, mining has significant positive effects over the poverty in districts where mining activity is developed as poverty and extreme poverty levels decreased up to 9% more than non-mining provinces.⁵⁰⁸ The family income of families living in the places where mining activities are developed are up to 50% higher than in places where no mining activity is registered due to the dynamization of the labor market in these places.⁵⁰⁹ In this sense, it is interesting to note that the fact that a home is located in a mining district increases its probabilities of not been considered as “poor”, however, the fact that the district receives or not mining canon or the amounts of mining canon received does not influence the probability.⁵¹⁰ This may be attributed to the way in which the canon is spent and the population feels it does not reach them to satisfy their needs.

In terms of health, districts receiving mining revenues show improvements in health conditions, particularly in chronic malnutrition in children⁵¹¹ due to the fact that most cities or provinces that receive funding for canon utilizes its resources in the provision of potable water, the construction of schools and health infrastructure.⁵¹² In fact, during the period 2005-2011 the government has tried to correct the infrastructure deficit of water and drainage, transportation, health and education by means of a strong increase in infrastructure spending.⁵¹³ However, in districts where small scale mining is the predominant activity, some negative effects (such as a lower life expectancy and higher mortality rates on children under 5) are registered.⁵¹⁴

⁵⁰⁷ However, it is important to keep in mind that the analysis is made based on information from 2007 (date of the last census) at the provincial level and with information from 2010 at the district level (In the Peruvian context, districts are subdivisions of provinces)

⁵⁰⁸ Supra note 239

⁵⁰⁹ Ibid

⁵¹⁰ Roxana Barrantes, *Mineria, Desarrollo y Pobreza en el Peru* (Lima, Instituto de Estudios Peruanos), at 37, online: <<http://ibcperu.org/doc/isis/6177.pdf>>

⁵¹¹ Supra note 239

⁵¹² Supra note 510

⁵¹³ Supra note 239

⁵¹⁴ Ibid

Education for this purpose includes school attendance, level of delay in school learning and illiteracy. The level of illiteracy is lower in districts receiving mining revenues⁵¹⁵ mainly due to the presence of social programs aimed at the elimination of child work in the mines and the emphasis of these programs in create awareness among the parents about the importance of children attending to school.⁵¹⁶ In this context, while during the years 1998 and 1999 the number of children enrolled in a particular school was between 60-70 children, by the year 2004 the number increased to around 200 children.⁵¹⁷ Many factors influence these results, but in particular, it is the presence of the teacher due to the constant monitoring of the social programs at school that influences the most as the parents are able to see that classes are held on a regular basis and start to see results of what is taught to the children.⁵¹⁸ In this sense, it is understandable why school attendance and level of delay in school learning shows an overall improvement in districts with mining activities and why a higher percentage of delay in school learning can be seen in places where small scale mining is performed.⁵¹⁹

Finally, the impact of mining revenues on social infrastructure is showed mainly in districts where medium to large mining projects are performed.⁵²⁰ The increase in infrastructure is given due to the legal requirement of the transfers to be used in infrastructure projects only and is also influenced by commitments made by mining companies in relation to their social involvement with the community, which are usually paired with the participation of several NGOs.⁵²¹ The effect is seen mostly in electrical and telecommunication networks. In this sense, the percentage of houses without access to electricity and cellular phones is higher in non-mining districts. Districts where only small scale mining is performed show no effect.⁵²²

⁵¹⁵ Ibid

⁵¹⁶ Patricia Ames, *Experiencias relevantes de educación orientada al desarrollo rural alternativo en el Perú*, Lima: Ayuda en Acción, 2004), online:

<http://www.ipae.pe/media/201110/Experiencias_relevantes_de_educacion_orientada_al_desarrollo_rural.pdf>

⁵¹⁷ Ibid

⁵¹⁸ Ibid

⁵¹⁹ Supra 239

⁵²⁰ Ibid

⁵²¹ Refer to <http://www.losandes.org.pe/proyectos/infraestructura.htm>, http://www.antamina.com/temp/resp_social.html, <http://www.buenaventura.com/>

⁵²² Supra note 239

2.3.1 Investing in Infrastructure with the objective of integrating the territory and decentralizing

Why is the government considering infrastructure as the tool to diversify and decentralize? The answer may be found in the fact that, according to the literature, infrastructure investment has an immediate impact on poverty reduction as the development of infrastructure generates employment and it implies a long term achievement of lower transactions and transportations costs, expanded trade, which in turn promotes higher income.⁵²³ Higher income promotes human capital formation through better health management and higher education, raising the earning potential of the population, which allows for a decrease in income inequality.⁵²⁴

Despite the desirable effects of spending in infrastructure, we should keep in mind that infrastructure spending may also be associated with growing regional inequality. Regional inequality is generated due to the fact that government resources are disproportionately allocated to different geographic areas but leaving, for instance, road networks in the poorer regions still very much underdeveloped.

In Peru, there has been in fact an impact from the transfers of mining revenues to mining producing localities, mostly where medium to large mining projects are performed. The specific effect has been a decrease in the percentage of houses without access to electricity and cellular phones in mining districts.⁵²⁵ However, inequality and social conflict has also been present due to the request of non-generating mining provinces to receive mining transfers or be able to benefit in some way from the country's economic growth.⁵²⁶

In addition to regional inequalities, there is yet another problem: excessive (and wasteful) investment in infrastructure in mining regions. This spending in infrastructure is caused by the fact that governments need to spend the canon and royalty funds in infrastructure projects. This may be negatively affecting the economic environment in places where transfers are received.

⁵²³ Stefano Paternostro; Anand Rajaram; Erwin R. Tiongson, *How Does the Composition of Public Spending Matter?* (Oxford Development Studies, 2007)

⁵²⁴ Ibid

⁵²⁵ Supra note 239

⁵²⁶ "Redistribucion de canon minero crea discrepancias", *El Comercio Peru* (June 29, 2011), online: <http://elcomercio.pe/economia/833504/noticia-redistribucion-canon-minero-crea-discrepancias_1>

The main issue at this point seems to be, not only that Peru has not done anything about this consequences, but it is in fact willing to go ahead with the rate of investment on infrastructure on the misbelieve that this would help to fight inequality. It is relevant to recognize though, that government may have realized that in order to address inequality a need to invest in non-mining provinces is necessary.

It is not possible yet to determine whether the objective stated by the government referring to “Prioritize public investment in non-mining regions” refers only to infrastructure investment (such as it is the restriction for current use of royalties and canon in mining regions) or if this should be understood as a more broad recognition of the need of other types of social investment (such it may be the provision of an appropriate endowment of potable water, drainage and electricity to localities where this is not yet provided).). Until the government plan is explicit as to how it will prioritize the public investment in non-mining regions it is not possible to arrive to a conclusion. At this point, it is only possible to state that (i) infrastructure overcrowding is certainly distorting the economy and so the level of infrastructure investment in mining provinces should be re-evaluated and (ii) investment in non-mining provinces may address inequality to an extent but it will all depend on how such investments are structured.

3. Reforming the recent Peruvian tax reform

The Peruvian tax reform was performed with the intention of increasing the amount of taxes collected and attracting more investment to Peru. The increase of tax revenue was intended to address poverty concerns throughout the country and help manage inequality. While the previous section has discussed in which aspects the Peruvian reform has achieved its objectives, this section will discuss how it can be improved.

3.1 Improving Redistribution

As mentioned in chapter 1 of this thesis, the government has several goals to achieve and for those it needs funding. Among those goals, we mentioned the address of market failures, the proper allocation of goods and services (such as public health and public education), the redistribution of economic resources on the basis of need and the application of fiscal and monetary policies in such a way as to achieve price stability, full employment and economic

growth.⁵²⁷ In addition, chapter 2 makes a brief summary of how the revenue collected by the different levels of government is distributed and spent (or expected to be spent).

In this sense, it is useful to determine how ideally those revenues should be spent in order to achieve the government goals of raising tax revenues, and attracting investment to the mining sector to be able to fund its activities.

3.1.1. Ideal government targets for public spending:

The objective of this section is mainly to point out that before restricting the use of mining canon and mining royalty to infrastructure projects almost exclusively, the government should determine whether the use of funding for infrastructure investment aligns with the government objectives. It is relevant at this point to consider that, on one side, most municipalities receiving mining revenues are not fully using them and, on the other side, when the local government do use the funds for infrastructure (such as it was the case of Ite described below) the population still seems unhappy due to not been able to see any benefits from mining. In this sense, it is relevant for government to re-evaluate whether the current structure and rules for the mining transfers are helping to meet its objectives. This section provides some insight on how should the government start to re-evaluate its objectives and to target the right group of people in order to meet its objective.

According to the literature, public spending should be oriented towards promoting efficiency (addressing market failures) and equity (improvement of the distribution of economic welfare).⁵²⁸ It is clear by now that the redistribution goal of the Peruvian government is not being met by the current spending practices (as showed in the massive number of social conflict generated by mining and the request of non-mining provinces to be able to benefit from the country growth) so the first thing in the government's agenda should be to understand the reasons behind this failure.⁵²⁹

⁵²⁷ Supra note 24 at 5.

⁵²⁸ Dominique Van de Walle, *Public Spending and the Poor: What we know, what we need to know* Washington DC, The World Bank, 1995) at 1, online: <

http://books.google.ca/books?id=wtYIhIgaUVIC&printsec=frontcover&source=gbs_ge_summary_r&cad=0#v=onepage&q&f=false>

⁵²⁹ Ibid

In order for the government to be able to determine the most suitable areas to which public spending should be canalized, the government needs to ask a variety of questions such as how the redistribution goal is (or should be) defined (i.e. which objectives in particular is government trying to address with the public spending), or how poverty is measured to assure that the right groups are been targeted.⁵³⁰ The answer to these questions will provide the government with the direction to which the public spending should be pointed.

The first question that requires an answer is how the redistribution goal of government is defined. In general, the main concern of governments for public spending is to address poverty, but it is important to keep in mind that social security may involve a variety of objectives.⁵³¹ Even if we were to consider the reduction of poverty as the single objective, it is crucial to determine how poverty is measured. It is important to acknowledge concerns such as errors of targeting (including in the group to which the welfare should flow, some people who are not in the same need as the rest).⁵³²

Once, the target groups have been properly identified, the question becomes how the benefits of public spending are currently distributed.⁵³³ This analysis goes beyond simply indicating that 50% of the mining canon is distributed to the population. Measuring the amount of benefit that a person, a family or a group of persons is receiving is not an easy task mainly due to two reasons: (i) prices and household characteristics attributable to a family or group varies across individuals, which implies that even when a certain quantity of a good or service is identical than the one provided to a different group, it may be worth more or less to a particular individual or family and (ii) even we were to assume that prices are fixed for every single individual in a group across the country and we were to provide exact amounts of a specific benefit to all, the value that each person attributes to the benefit is different depending on their particular situation (such as it would be the case of a school which will be more beneficial to a family with children than to a family with no children).⁵³⁴

⁵³⁰ Ibid

⁵³¹ Supra note 528 at 2

⁵³² Supra note 528 at 3

⁵³³ Supra note 528 at 5

⁵³⁴ Ibid

3.1.2 Transfers to local governments

According to the government's plan, one of the first objectives is to achieve a significant impact in poverty levels and an expansion of the number of citizens able to enjoy the benefits of country's economic growth.⁵³⁵ Transfers to local governments (such as are the mining canon and royalty amounts) are in fact a way of redistributing some of the revenue the government receives. The importance of analyzing how these transfers should ideally be done is relevant because intergovernmental transfers constitute (in most mining localities) the main source of revenue and so the most powerful tool that the government has to redistribute its revenues. Indeed, according to several sources regional and local governments are spending only a small percentage of what they receive and the rest (which add up to a total of 3.5 million dollars) passively sits in a bank account.⁵³⁶ The case of Ite, a town located in Tacna, Peru provides a good example.

Ite used to be an agricultural and cattle town.⁵³⁷ The massive increase of funding received by Ite due to the mining canon during the last decade (the local budget went from less than US\$500,000 to more than US\$13 million per year) has had several effects. Changes have not been restricted to how the city looks like but have, as a matter of fact, had an impact into its economy.⁵³⁸

As a consequence of the restriction to the use of canon funds received, Ite embarked on a race to build the infrastructure that the city required, but since funding was not getting any short, they continued to build things like an ocean side statue, a stadium, a mirror sided town hall, a football court, a playground, and many more.⁵³⁹

In addition to being wasteful, such large investment in construction has also affected the economy, since there was an increased in demand for municipal workers to build and maintain the newly constructed public infrastructure.⁵⁴⁰ To increase supply, salaries went up and became

⁵³⁵ Supra note 426

⁵³⁶ <http://gestion.pe/2012/06/14/economia/gobierno-regionales-tienen-estancados-us-3500-millones-canon-minero-2005175>, <http://www.larepublica.pe/27-11-2011/regiones-que-mas-canon-minero-reciben-tienen-menor-ejecucion-presupuestal>, http://www.rpp.com.pe/2011-12-04-confiep-pide-mejorar-gasto-del-canon-minero-noticia_428469.html, <http://peru21.pe/2011/12/04/actualidad/se-gastar-mejor-canon-minero-evitar-conflictos-2001775>

⁵³⁷ Claudia Viale, *Paradox in Peru: The Challenges of Mining Revenue in Ite*. (Revenue Watch Institute, 2011), online: <<http://www.revenuewatch.org/news/blog/paradox-peru-challenges-mining-revenue-ite>>

⁵³⁸ Ibid

⁵³⁹ Ibid

⁵⁴⁰ Ibid

much higher than income from farm activities. This, in turn has created a shortage in the agricultural sector, since there is no migration from other towns to fill those shortages⁵⁴¹. As a consequence of the agricultural shortages, the local authorities, as requested by local communities, sent municipal workers to work on private farms (this public employees are paid out from the mining revenues received by Ite).⁵⁴² Whether this can be considered a “Peruvian Dutch Disease”⁵⁴³ is beyond the scope of this thesis. The intention at this point is to call the attention of government to the matters that may be relevant analyzing when implementing redistribution policies.

With regards to what the government; intentions are in this regard, the closest mention to this subject in the government’s plan refers to “Personnel training to empower local and regional governments”. In the context of the government’s plan this may be understood as a way of governing where power is not delegated but transferred to local and regional governments for them to act within the boundaries of their own jurisdiction.⁵⁴⁴ This may imply providing governments with the adequate training and ability to decide how to invest the transfers received from the mining sector. However, these are not more than assumptions as to what the government’s plan may have referred to. The government plan includes no mention to improvements to the distribution of intergovernmental transfer process. Some possible amendments to the transfer system regime have been announced already but no details on it are available and no concrete action has been taken up to August 2012.⁵⁴⁵

It is clear that the current transfer system has vast room for improvements. To provide an example of where improvement can be aimed at, the district of Cochas (which has approximately 964 inhabitants), located in the province of Ancash, received around 491,000 soles (US\$188,000) as of 2011 from the canon.⁵⁴⁶ 45 kilometers further we find the district of Manas

⁵⁴¹ Ibid

⁵⁴² Ibid

⁵⁴³ Ibid

⁵⁴⁴ Oswaldo Carpio, “La descentralización y la reforma del Estado en el discurso del Presidente” (2012), online: <<http://www.sjl.pe/noticias/noticia.asp?id=2572>>

⁵⁴⁵ See http://www.rpp.com.pe/2011-11-16-gobierno-enviara-al-congreso-nueva-distribucion-del-canon-minero-noticia_422911.html, <http://www.larepublica.pe/01-01-2012/eguren-propone-que-la-redistribucion-del-canon-minero-se-haga-dentro-de-cada-region>

⁵⁴⁶ “Canon minero: De cómo lograr una mejor distribución de la riqueza generada (II)” (May 16, 2012), online: <<http://enfoquederecho.com/canon-minero-de-como-lograr-una-mejor-distribucion-de-la-riqueza-generada-ii/>>

(which has approximately 1000 inhabitants) located in the Province of Cajatambo.⁵⁴⁷ The question becomes why Cochabamba received more canon than Manas? Can the difference be justified saying that Cochabamba was more “affected” by mining, considering that these two cities are just 50km apart? The answer according to the current law is that Cochabamba is located inside the province of Ancash while Manas is simply not.⁵⁴⁸

This illustrates the importance of determining the best way to structure the intergovernmental transfer regime to assure efficient redistribution in order to allow for lower poverty levels and inclusive economic growth. In this regard, the academic scholarship offers a series of proposals that seem interesting to Peru. The first important aspect to consider is how to determine the amount to be transferred to lower level governments. According to the academic literature, there are mainly 3 alternatives to determine the amount of the transfer: (i) as a fix proportion of central government revenues, (ii) on an ad-hoc basis or (iii) based on a formula, which may be driven for instance on the amount of expenditures to be reimbursed by government or factoring some of the characteristics of the recipient jurisdiction (such as it could be population or area).⁵⁴⁹ Considering that stability and flexibility are important characteristic of intergovernmental fiscal transfers, the literature recommends transferring a fixed percentage of all central taxes or revenues.⁵⁵⁰ Transferring a percentage of some taxes or revenues (as it happens currently in Peru) is not as desirable as government will always tend to increase more the taxes that are not shared, biasing tax policy.⁵⁵¹ Transfers based on a percentage of all taxes or revenues assure that provincial governments participate of the “pain” or “gain” of central government equally.⁵⁵² A good transfer system should allocate funds based on formulas that take into consideration (i) the needs, (ii) the capacity to raise revenues and (iii) the effort of the recipients in raising such revenues.⁵⁵³ Population needs can be generally estimated by considering population and the category or type of local government.⁵⁵⁴

⁵⁴⁷ Ibid

⁵⁴⁸ Ibid

⁵⁴⁹ Richard M. Bird & Michael Smart, “Intergovernmental Fiscal Transfers: International Lessons for Developing Countries” (2002) 3 World Development

⁵⁵⁰ Ibid

⁵⁵¹ Ibid

⁵⁵² Ibid

⁵⁵³ Ibid

⁵⁵⁴ Ibid

With regards to fiscal capacity, the literature indicates that is usual to see that many developing countries use the transfers to return some of the taxes or revenue to the place where they were collected.⁵⁵⁵ However, this ends up benefiting the localities where revenues or taxes were collected, i.e. the ones with greater fiscal capacity.⁵⁵⁶ Allocation of transfers based on population is more equalizing when referring to the costs of publicly provided goods which increase in direct correlation to the number of inhabitants but not when the costs decrease as the numbers of consumers increases.⁵⁵⁷ Even though fiscal effort is an important element, it is not advisable to put too much weight in measuring fiscal effort as this may end up penalizing the poorest areas, as in these areas an increase in collections is hard to achieve.⁵⁵⁸ It is important to consider as well that the reason why poorer localities require equalization or redistribution is exactly because their fiscal capacity (tax base) is too low, so giving much weight fiscal effort would be counterproductive.⁵⁵⁹ In fact, according to the OECD, during the latest years, sub-national taxing power declined or remained stable in most developing countries.⁵⁶⁰ On the other side, some measure of fiscal capacity needs to be added as to create constituency; if the population feels that the money spent by the authorities is collected based on the other's effort no pressure is put in local governments to spend the money efficiently.⁵⁶¹

With regards to the purpose of the transfers, whether the transfers are aimed at financing basic package of services at the local level or not is a factor to consider since the same services may not be required in all jurisdictions in the same way.⁵⁶² As a consequence, transfers provided under the condition to be spent in a specific manner may not be the most effective alternative.⁵⁶³ Transfers without condition may in addition create better incentives to local governments to seek opportunities for cost savings.⁵⁶⁴

An aspect to be careful about is the fact that the government plan includes decentralization objectives, which may be impacted by the intergovernmental transfers if these are not carefully

⁵⁵⁵ Ibid

⁵⁵⁶ Ibid

⁵⁵⁷ Daniel Bergvall et al., "Intergovernmental Transfers and Decentralised Public Spending" (2006) 5-4 OECD Journal on Budgeting

⁵⁵⁸ Supra 549

⁵⁵⁹ Ibid

⁵⁶⁰ Supra 557

⁵⁶¹ Supra 549

⁵⁶² Supra 557

⁵⁶³ Ibid

⁵⁶⁴ Ibid

structured. Fiscal decentralization (understood as the share of lower levels of government expenditure with relation to the total government expenditure) leads to increased responsibilities on the side of local governments with regards to spending, but implies a higher level of economic dependence from central government.⁵⁶⁵

3.2. Risk Management

As discussed in the previous chapter, one of the risks inherent to the natural resource sectors is that it is not uncommon for the revenues generated by these resources to be restricted to a small power group instead of been distributed broadly.⁵⁶⁶ In addition, it has also been mentioned by the literature that income from natural resources usually tempts governments to neglect other economic sectors (such as agriculture).⁵⁶⁷ The inequalities that result from the management as described, more often than not become sources of tension and in some cases may to violent protests or even civil war.⁵⁶⁸

These conflicts are important because companies looking for a country to invest may try to avoid new investments in conflict zones.⁵⁶⁹ Companies with existing investments tend to resist pressure to leave due to the nature of their investments, i.e. the high sunk costs associated with mining.⁵⁷⁰

The mining industry could, if properly managed, contribute to the solution to address this type of risks as the investment and the expertise brought by these foreign companies can help to finance the institutions needed to ensure instablity.⁵⁷¹ On the other side, foreign investors may also benefit from the opportunities that a developing country presents due to the untapped pools of human, social and natural capital, unmet basic needs, unmet expansion opportunities and lower operating costs.⁵⁷² However, as mentioned in the first chapter, foreign mining investors face

⁵⁶⁵ Ibid

⁵⁶⁶ John Bray, "Attracting Reputable Companies" In *Natural resources and violent conflict, Options and Actions* (Washington D.C: The World Bank, 2003) 287.

⁵⁶⁷ Ibid

⁵⁶⁸ Ibid

⁵⁶⁹ Ibid

⁵⁷⁰ Ibid

⁵⁷¹ Ibid

⁵⁷² Ibid

several types of risks that will need to be overcome or at least addressed before a decision to invest is made.⁵⁷³

Decisions regarding new investments in a specific country depend on things like the potential economic value of the deposits, the precise location of conflict, and the possibility of peace settlement.⁵⁷⁴ The existence of conflict in a new host country does not necessarily deter new entrants. Junior sized mining companies usually find a competitive advantage to invest in a place that has suffered from political violence but has a good chance of recovery⁵⁷⁵ (an example of this is found in the case of the Newmont investment in Peru when the country was still suffering from terrorist insurgency).⁵⁷⁶ However, a key point to keep in mind is the fact that these junior mining companies have less incentive to acquire stability.

With regards to political risk, it is important to recap political leaders are usually faced with an internal conflict between (a) having to satisfy domestic interests that allow them to be reelected or (b) improving conditions for foreign investment which in some cases will generate tension between government and the population.⁵⁷⁷ On the other side, foreign investors are highly influenced in their investment decisions, by the security of tenure and the extent to which this can be threatened by political unrest, legal uncertainties, changes in government policy, expropriation or limitations to currency transfers.⁵⁷⁸ Political risk weighs heavily on the mining industry as sudden changes in a host government policy could lead to breaches of contracts, cancellation of concession agreements or even expropriation of mining assets.⁵⁷⁹ Where foreign investors cannot find the predictability and security of tenure required, they request commercial agreements that provide greater compensation for what regard as greater risk. An important consideration implies the possibility for arbitration in case of disputes.⁵⁸⁰

Uncertainty over security of tenure is also influenced by the lack of confidence in the viability and transparency of legal reforms as this discourages investors in major, long term infrastructure

⁵⁷³ Ibid

⁵⁷⁴ Ibid

⁵⁷⁵ John Bray, *International Companies and Post-Conflict Reconstruction Cross-Sectoral Comparisons*. (Washington DC: The World Bank Social Development Papers – Conflict Prevention and Reconstruction Paper No. 22, 2005) at 8, online: <
http://www.international-alert.org/sites/default/files/publications/Int_companies&post-conflict.pdf>

⁵⁷⁶ Supra note 566

⁵⁷⁷ Ibid

⁵⁷⁸ Daniel Riordan, "Mitigating Emerging-Markets Risks in Mining Projects" (2007) 208 54,56-57.

⁵⁷⁹ Supra 566

⁵⁸⁰ Ibid

projects.⁵⁸¹ Also, security of tenure depends heavily on intangible qualities of trust like the ones foreign investors are able to develop with the local communities.⁵⁸²

Another type of risk contemplated by foreign investors is certainly the ethic and reputation risk. Investment may be deterred in countries where the government is accused of extensive human right abuses, as foreign companies run a risk of being accused of complicity with such actions.⁵⁸³ This issue interrelates with the fact that local communities lands and lifestyle are involved, reason for which a particular mining project may become controversial.⁵⁸⁴ Seeking local approval is usually a complicated aspect of the mining decision to invest or not in a particular place.⁵⁸⁵ In several cases, it involves violent conflict where local population is confronted with police or army and this is where human rights issues can be brought up.

Ethical risks may also be a deterrent for foreign investors especially where democratic processes are weak or inexistent or where revenues are used for controversial purposes.⁵⁸⁶ As mentioned before, the extractive industry is especially vulnerable to corruption both because of the large investments involved (as it may tempt dishonest officials) and because of the frequent interaction with government.⁵⁸⁷

Despite the relevance of the risks mentioned above, mining investors are realizing that they have no choice but to invest in the developing world as the more-developed areas are being depleted.⁵⁸⁸

With regards to the ways in which, according to the literature, the risks iterated above should be handled, it is important to consider that since forecasting predictability is very challenging because there are many variables to consider, effective government structures need to provide a framework for decision making and a means of resolving disputes.⁵⁸⁹ However, in zones of actual or potential conflict commercial development is unlikely to be smooth.⁵⁹⁰

⁵⁸¹ Ibid

⁵⁸² Ibid

⁵⁸³ Ibid

⁵⁸⁴ Supra 578

⁵⁸⁵ Ibid

⁵⁸⁶ Supra 566

⁵⁸⁷ Ibid

⁵⁸⁸ Supra 578

⁵⁸⁹ Supra 566

⁵⁹⁰ Ibid

In addition, among the literature recommendations to address the risks above, we find that the engagement of southern governments in voluntary principles on Human Rights and Security may help.⁵⁹¹

Also, the literature recommends avoiding the exclusion of local communities in the process of accepting new investment or in the development of already ongoing projects and, in general, the engagement of all stakeholders (governments, investors, academic and NGOs) in the field of social impact assessment in order to anticipate complex problems.⁵⁹² In this regard, the literature indicates that agreements should be in place to clearly determine the requirements and responsibilities each interest group.⁵⁹³ Provisions allowing for dispute resolution (preferably international arbitration) should also be included as according to experience, "one-sided" deals are, for the most part, unsustainable in the long term.⁵⁹⁴

Finally, working with industry groups may also help as they help to disseminate best practices.⁵⁹⁵ In this regard, Alignment with local commercial and technical experts is a necessary ingredient for both government and investors.⁵⁹⁶ This local support can help a project overcome governmental changes and other volatility.⁵⁹⁷

With regards to the involvement of the insurance sector in aiding to address the peculiar risks to the mining industry, the risks intrinsic in developing countries such as those determined by the uncertainty about the actions of governments, political institutions, minority groups and separatist movements,⁵⁹⁸ could be now addressed using a single portfolio policy with a single limit of coverage (as opposed to purchasing individual policies and coverage limits).⁵⁹⁹ This approach is said to be better for costumers exposed to risks in several jurisdictions from the cost point of view, which seems to be a positive change as mining companies are operating in areas they would not have entered otherwise.⁶⁰⁰

⁵⁹¹ Ibid

⁵⁹² Ibid

⁵⁹³ Supra 578

⁵⁹⁴ Ibid

⁵⁹⁵ Supra 566

⁵⁹⁶ Supra 578

⁵⁹⁷ Supra 578

⁵⁹⁸ Stephan Dreyhaupt et al., "Political Risk: The Missing Link in Understanding Investment Climate Reform?" (2012) 20 Investment Climate in Practice Policy 1-8

⁵⁹⁹ Supra 578

⁶⁰⁰ Ibid

In the specific Peruvian context, even though risk management was not included in the government's plan neither mentioned as one of the reform immediate objectives, it seems that the recent reform accomplish the mitigation of some of the legal uncertainties that change in legal framework may cause among investors. This was seen when the Peruvian government did not intend to force mining companies to negotiate royalty agreements once their mines have come into profitable production, but on the contrary, it decided to negotiate with them for a voluntary contribution based on a contractual obligation agreed by both parties rather than a legal imposition.

In addition, the formal inclusion of local communities in the process of accepting new investment or in the development of already ongoing projects has been an important milestone. However, as mentioned in the previous chapter, the Prior Consultation Law has several flaws that will need to be addressed by government before it can be an effective tool to fight risk concerns.

In addition, there apparently is an intention of Peruvian government to engage stakeholders in the field of social impact assessment. This can be seen from the large availability of government and private publications analyzing the concerns surrounding the mining industry in Peru and analyzing the reasons for social conflict.

3.3. Considering Transparency and the Improvement of Procedures for Revenue Reporting goals

Even though the current government plan contains a section containing specific goals to ensure transparency in government activity, none of the goals mentioned in the Government's plan follow the best practices and proposals suggested by the specialized literature in this specific field.

Publicly available reporting is a way in which mining companies can be transparent about the amount of taxes being paid and also a way to make government accountable and transparent to

citizens with regard to the funds received and how these are spent.⁶⁰¹ Public availability of tax revenues per activity by itself may not put enough popular pressure on the government to make better spending decisions, but it may certainly help in reducing corruption.⁶⁰²

Some OECD countries like the UK, and Norway, most often than not have transparent and well-documented reporting methods.⁶⁰³ For example, in the UK, a specific department collects the revenue of specific sectors (the Oil Taxation office, for instance) and reports periodically to the senior management of the central administrative revenue authority (like would be Inland Revenue in the case of the UK).⁶⁰⁴ In turn, the central revenue authority reports periodically to the Parliament and published this information. In addition, within the central revenue authority several levels of checks and controls are in place to avoid misappropriation of funds from those reporting the assessments.⁶⁰⁵ In addition, most OECD jurisdictions require mining investors to file financial information to specific official government offices on a periodical basis and this information provided is often accessible to the public.⁶⁰⁶

In contrast, developing countries generally have either rudimentary or inexistent reporting methods.⁶⁰⁷ This could be either associated with lack of knowledge or it could be just a strategy of elites who control resources or officials who illegally appropriate them to avoid accountability.⁶⁰⁸ Unfortunately, very little information is available about the internal procedures followed by host governments in developing countries.⁶⁰⁹

Despite the fact that developing countries have done little in terms of reporting methods, the fact is that availability of tax information has now become a corporate responsibility issue to a large group of stakeholders such as investors, governments, finance department, media, and

⁶⁰¹ Swanson, Philip et al, "Who gets the Money? Reporting Resource Revenues in Natural Resources and Violent Conflicts" in Ian Bannon & Paul Ollier Eds *Natural Resources in Violent Conflicts Options and Actions* (Washington DC: The World Bank 2003) at 43.

⁶⁰² Ibid

⁶⁰³ Supra 601 at 46

⁶⁰⁴ Ibid.

⁶⁰⁵ Ibid

⁶⁰⁶ Supra 601 at 49.

⁶⁰⁷ Supra 601 at 47.

⁶⁰⁸ Ibid

⁶⁰⁹ Ibid

employees.⁶¹⁰ There is general pressure from interest groups to boost transparency in terms of the amount of taxes paid per operating jurisdiction.⁶¹¹

Even though the goals mentioned in the current government plan aiming to achieve transparency are in general not aligned with the recommended best practices when working towards achieving transparency, it is relevant to recognize that some measures have been enacted throughout time (during different governments) that put Peru in a good position in this sense.

In fact, due to the enactment of the “Law of Transparency and Access to Public Information” (2003) and the “Law of Responsibility and Fiscal Transparency” (2001), the legal framework that guarantees access to information about extractive industries revenues, their distribution and usage, Peru has been considered to perform better than many resource abundant countries, both in revenue and expenditure transparency levels.⁶¹² Access to information is protected in the Constitution and the Constitutional Court also protects this right under the *habeas data* provision. An Ombudsman has the power to investigate acts of non-compliance and to issue recommendations to public officers.⁶¹³

According to “Propuesta Ciudadana”, a NGO that reports on transparency and accountability, the majority of governmental agencies provide timely and complete information when citizens request information.⁶¹⁴ However, information on contracts, corporate income tax payments and corporate social contributions at the sub-national level are not available even when requested.⁶¹⁵

In 1997, Peru established its Financial Management Information System, a tool to monitor fiscal expenditures and budget execution.⁶¹⁶ In addition, there is a specific entity (the National System of Public Investment) in charge of assessing projects that regional and local authorities are able to execute.⁶¹⁷ However, many local and provincial governments are failing to invest a great

⁶¹⁰ Charles Bowman, “Increasing disclosure over tax” (May 29, 2012), online: <<http://pwc.blogs.com/corporatereporting/2012/05/increasing-disclosure-over-tax.html>>

⁶¹¹ Ibid

⁶¹² *Peru Transparency Snapshot* (Revenue Watch Institute), online: <<http://www.revenuwatch.org/countries/latin-america/peru/transparency-snapshot>>

⁶¹³ Ibid

⁶¹⁴ Ibid

⁶¹⁵ Ibid

⁶¹⁶ Ibid

⁶¹⁷ Ibid

portion of the transfers they receive from central government in account of the extraction of natural resources in their circumscription.⁶¹⁸

In addition, between 2011 and 2012, the government worked successfully toward its accreditation as a compliant member of the Extractive Industries Transparency Initiative (EITI) and established the “Multi-stakeholder Standing Committee for Transparency in Extractive Industries”,⁶¹⁹ a permanent commission that counts with the participation of not only government representatives but also industry and civil society representatives.⁶²⁰

The EITI is an international partnership between governments, private sector and civil society that aims at reinforcing governance structures in countries where extractive industries represent a significant portion of the economy. The initiative tries to foster the development of local and national governance structures that allow exchange of relevant information among all stakeholders (government, citizens and companies) and to encourage and promote dialogue among them.⁶²¹ The EITI is a globally developed standard to ensure revenue transparency.⁶²² In Peru, the aim is to ensure that the population has available information with regards to the revenues received by government from companies that extract Peruvian natural resources.⁶²³

The EITI has an important impact once it is adopted by a country, because it forces all companies purchasing that specific country’s extracted resources to comply with EITI standards regarding transparency⁶²⁴ (i.e. forces them to make their information available to the public).⁶²⁵ In the Peruvian context, this is relevant: before ascribing to the EITI, information regarding corporate income taxation had a legal right to confidentiality under Peruvian Law.⁶²⁶ The government became compliant with the EITI on February 15, 2012,⁶²⁷ and the transparency reforms described above can be directly associated with this affiliation.

⁶¹⁸ Ibid

⁶¹⁹ Decreto Supremo que crea la Comisión Multisectorial Permanente para el Seguimiento y Supervisión de la Transparencia en el empleo de los recursos que obtiene el Estado por el desarrollo, Supreme Decree No. 028-2011-EM, June 11, 2011

⁶²⁰ The World Bank, Press Release, “Peru became the first country of Latin America to be declared compliant with the standard of the Extractive Industries Transparency Initiative – EITI” (June 28, 2012), online: <<http://www.worldbank.org/en/news/2012/06/26/peru-first-of-latin-america-to-be-declared-compliant-with-the-standard-of-eiti>>

⁶²¹ Ibid

⁶²² What is EITI?, online: <<http://eiti.org/eiti>>

⁶²³ Supra note 620

⁶²⁴ Unless the individual country makes participation voluntary

⁶²⁵ Mara V J Senn; Rachel Frankel, «Firms can avoid EITI, FCPA pitfalls» (2008) 106-27 *The Oil and Gas Journal*

⁶²⁶ Supra note 612

⁶²⁷ Peru Overview of Extractive Industries, online: <<http://eiti.org/Peru>>

The benefits of transparency, however, may not be fully achieved in Peru. A layer of difficulty is added by high levels of illiteracy and the fact that only a small percentage of the population has access to such level of education as to be able to understand the importance of the information provided to them. A large percentage would just probably see a large amount of money without been able to digest the complexities of a budget or to follow the cash to understand where it goes. In addition, even if adequate reporting transparency was achieved, the outstanding question is how the information would be made available to all the population. It is important to keep in mind the economic and cultural reality of Peru in the sense that most of the population does not have access to the Internet or cable. Spreading the information across the country may end up been more costly than the benefit it will render. According to this, publicly available information may only benefit the elites.

3.4. Conclusion

The Peruvian Government seems to be well on track to achieving its intended objective of increasing the tax base. However, in order for the government to achieve its goal referred to remain a competitive place to invest, some additional action needs to be taken.

Local communities are an important group of stakeholders and in order for their concerns to be addressed it is important that the government makes sure that the communities living in poverty are able to enjoy the benefits of mining revenues by means of redistribution. In order to achieve its objective of redistribution of economic resources on the basis of need, the government needs to re-evaluate whether the current structure and rules for the mining transfers to local governments are helping the government to meet its objectives. Particularly, if the use of canon and royalties almost exclusively for infrastructure purposes by local government aligns with the government objectives and allows from proper redistribution of the revenues.

The Peruvian government also needs to consider aspects of risk management to remain competitive. Despite not explicitly considering risk management objectives in the government plan, the government has been able to accomplish the mitigation of some of the legal uncertainties that change in legal framework may cause among investors. In addition, the formal inclusion of local communities in the process of accepting new investment or in the development of already ongoing projects has been an important milestone in terms of risk management.

In terms of transparency, the compliance with EITI puts Peru in a competitive position. However, in order for this transparency to benefit not only the foreign investors but also the local population, attention needs to be given to way in which population lacking of access to internet or cable will benefit from this information.

Conclusions

The parties to a mining investment agreement have diametrically opposed interests and concerns. Both parties will always try to maximize their revenues and minimize their level of risk in order to meet their different needs. Government, on one side needs to balance the reception of tax revenues to fund its activities, while keeping the public interest as a priority. On the other side, investors require a tax policy specifically tailored to balance and manage the huge financial commitments of investing firms. The government, as the supplier of reforms, needs to provide the appropriate legal framework for all these interests and concerns to be addressed.

Provided the investor is granted a tax regime that allow for minimization of risk and maximization of revenue, the investor will be interested in the project to be approved. On the other side, provided the public interest is not affected, the government will equally be interested on the mining investment agreement to be subscribed. Mining communities living in or close to the place where the mining project will develop constitute an important group of stakeholders in terms of allowing government and mining investors to achieve the aforementioned objectives. The capacity of local communities to exert pressure against a mining project should never be underestimated. The enactment of the PCL seems to have been a positive step in terms of allowing communities to access government to be able to formally provide their opinion. The PCL may also be expected to have an impact on the concerns of citizens living outside the communities' as the violence levels will decrease and business won't be interrupted by the violent riots.

The recent Peruvian tax mining reform achieved its intended objective of increasing the tax base. However, the goal referred to remain a competitive place to invest requires further action. In this regard, in addition the enactment of the PCL, some actions need to be taken, mainly in terms of revisiting the government transfer system to improve redistribution, aid investors to manage the political risk and make relevant information available to all stakeholders.

In order to achieve its objective of redistribution of economic resources on the basis of need to allow the citizens living in extreme poverty to benefit from the mining revenues, the government will need to re-evaluate whether the current structure and rules for the mining transfers are helping the government to meet its objectives. Particularly, if the use of canon and royalties almost exclusively for infrastructure purposes by local government aligns with the government

objectives. Before deciding how should the funds be invested it is important to determine whether the right group is been targeted.

In terms of risk management, a positive impact may be expected as a consequence of the enactment of the PCL. Trasnparency in revenue reporting has been partialy achieved with the compliance with the EITI, but in order for this transparency to benefit not only the foreign investors but also the local population, attention needs to be given to way in which population lacking of access to internet or cable will benefit from this information.

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