Resource Taxation: Recipes for success

Enhancing Domestic Resource Mobilisation in Sub-Saharan Africa

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Views are those of the author and should not be taken as a statement of current British government policy

Wilton Park 28 April 2010

Fairness

- Fairness is not an economic concept but principles of good tax were set out by Adam Smith
- equity - tax payments should be related to income and the tax should apply equally, so as to give no company an advantage nor put any at a disadvantage as compared with others
- Certainty - tax liabilities should be clear and certain (so as to give the least opportunity for corrupt or arbitrary actions on the part of officials and the least temptation to lawbreaking or evasion on the part of taxpayers)
- convenience of payment -the tax should be collected at a time and in a manner convenient for taxpayer, minimising compliance costs
- efficiency (or economy of collection) - the tax should not be expensive to collect and should not discourage business

Framing the right question

- Issue is not fairness but taxation of economic rent in the presence of uncertainty and informational constraints
- A perfect tax on rent would not distort economic activity; this means that potentially profitable projects should not be deferred or cancelled because of the tax. The incidence of such a tax would fall on the taxpayer leaving product prices unchanged

Design Constraints

- the nature of existing new, mid-life and mature resource production, newly discovered prospects and the prospects for exploration.
- requirement to have fiscal terms that are internationally competitive in the world petroleum and mineral industries.
- Avoiding uncertainty - changes to the taxation system create regulatory risks, which can raise the cost of capital, as companies incorporate a political risk premium to compensate for the loss of certainty => less investment

Two Philosophies of Taxation

- Tax system should be primarily designed to raise revenue efficiently and with low administrative and compliance cost

Versus

- Tax system should be used extensively to influence personal and business behaviour (e.g. to help create viable NOC)

Policy Approach

- Second approach could lead to multiple principle agent problems and corruption.
- In second case there is a cost in terms of growing complexity of the tax system
- And questions over how responsive actors are to tax incentives
- And some evidence that complexity and tax expenditures create headroom for greater avoidance activity

Taxation Options

A very wide variety of tax instruments and combinations of instruments.

1. Taxes on Income or Profit
2. Taxes on Output
3. Quasi taxes

But stepping back to company decision making

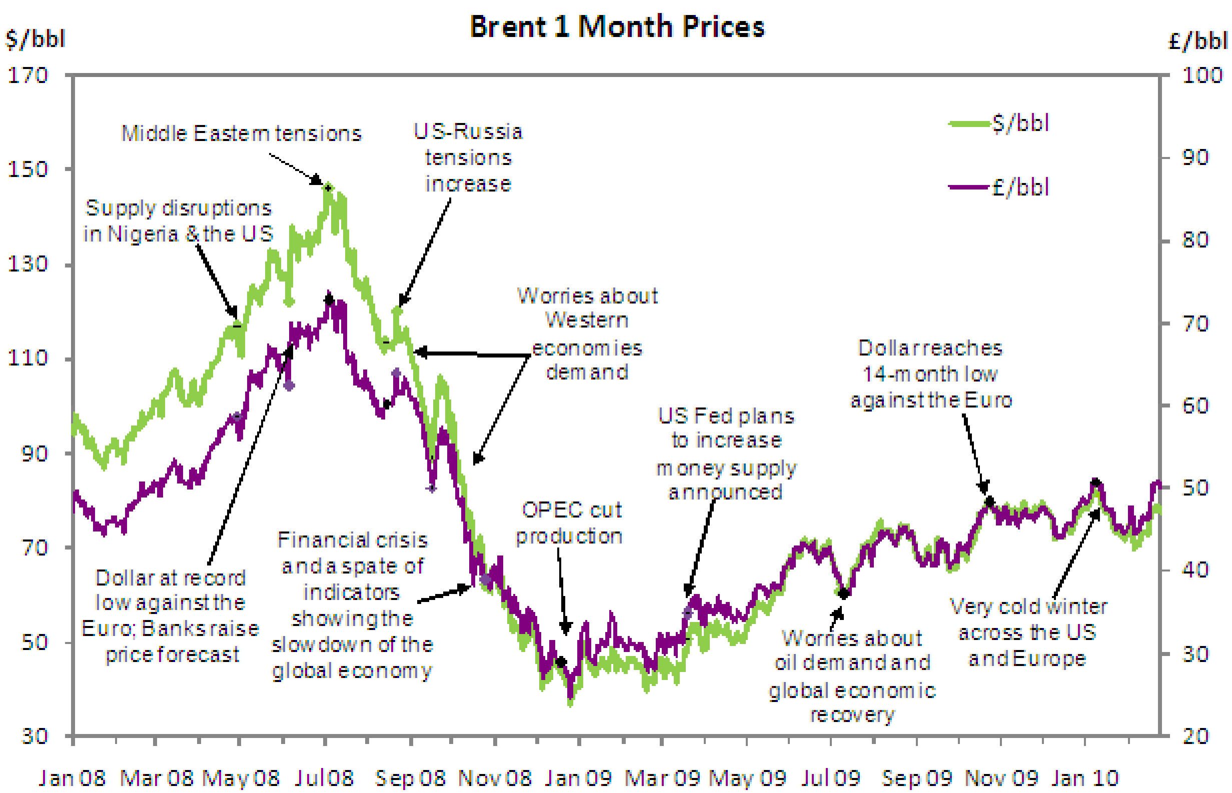
- Tax impact on companies willingness to invest via impact on:
- P/I ratios (Post Tax Profit/Pre Tax Investment)
- Internal Rate of Return (IRR)
- Materiality

Which can be modelled and estimated under different tax assumptions

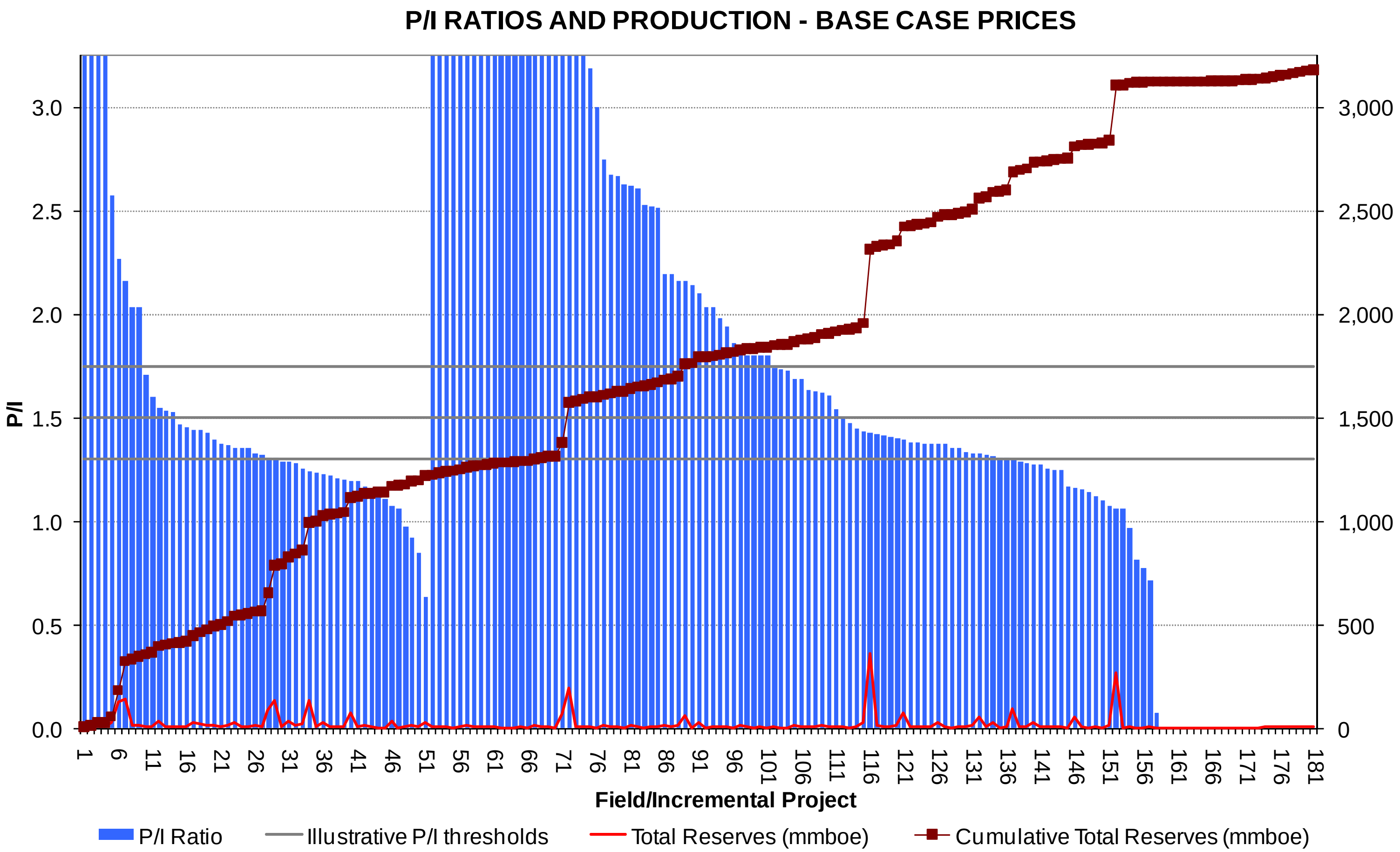
Company Decision Making
Project Economics

- Financial and decision making criteria easy to model but final decision has to take into account:
- Technical risks and potential cost over-runs e.g. HPHT where technical problems can be very costly
- Political Risk – e.g. Venezuela and the risk of expropriation or BP’s Russian experiences

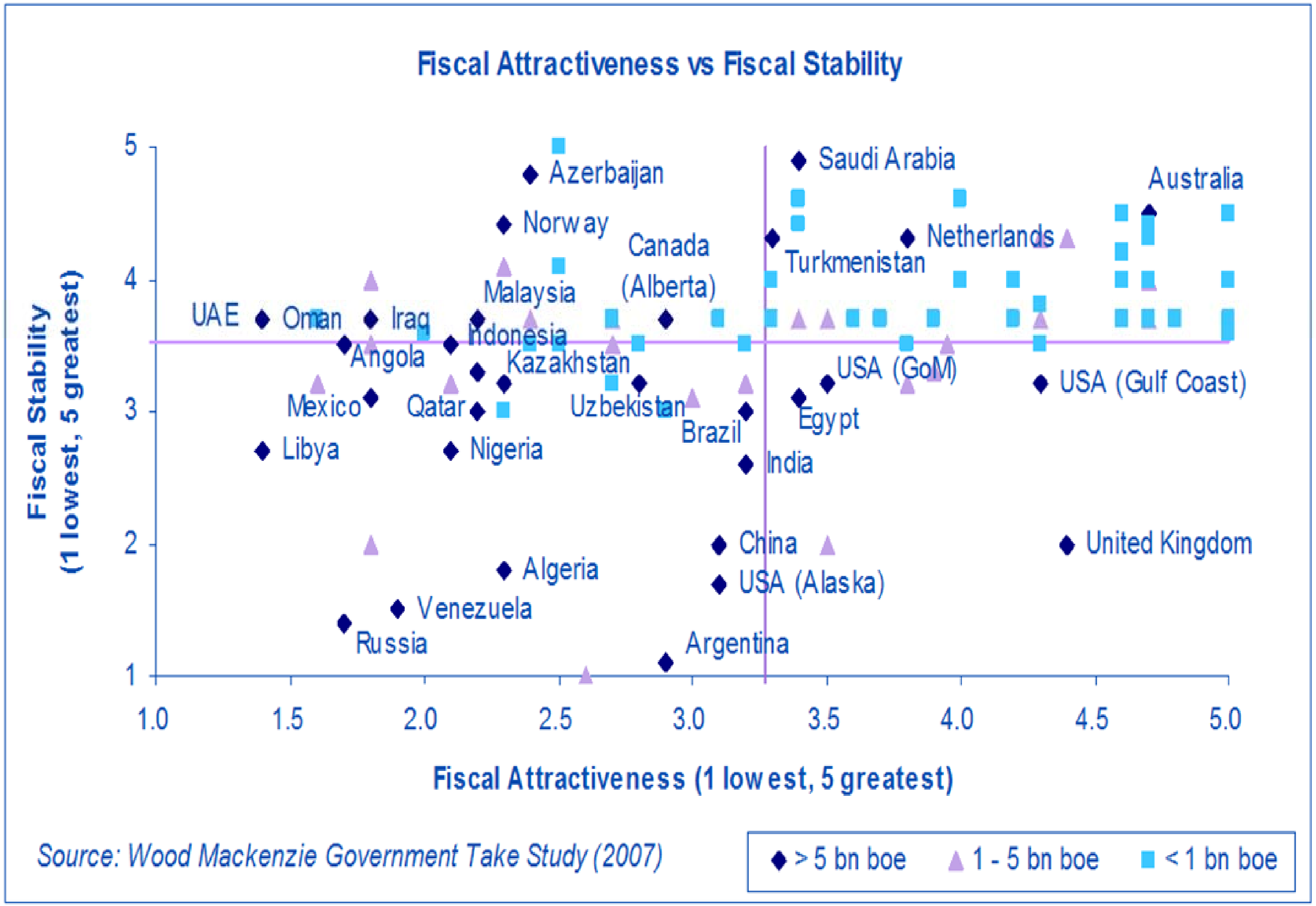
An Uncertain World



Variation in project profitability – an illustration of economic constraints



Huge Variation in outcomes and opportunities



High-Level Objectives

- Maximise revenue by taxing the “economic rent”
- To attract foreign investment (and not impose disincentives)
- To encourage technical development
- Recognise the specific characteristics of the sector
- To encourage most efficient use of resource
- State-building
- To mitigate environmental impact
- To compensate affected communities and ensure local benefit

What criteria does UK Government use to assess <u>changes</u> to it's regime?

Changes should:

- Promote investment and production
- Ensure a fair return for the UK taxpayer
- Be non-distortionary
- Be equitable
- Improve stability
- Be sustainable
- Reduce the administrative burden

Key Tax Policy Decisions

- Balance between tax and quasi-tax options
- Balance between various taxation instruments
- The extent to which risk is shared with the enterprise
- The timing of tax receipts
- Whether to introduce specific tax instruments for mineral activities

Key Tax Policy Decisions

- The balance between federal and sub-federal levels
- Whether to negotiate specific project agreements
- Ensuring the tax authority has the capacity to administer the tax system

Specific Tax Regime for Mineral Extraction

- Specific taxes can be more aligned with policy to tax economic rent (e.g. a resource rent tax)
- Weigh against advantages of adapting existing taxes (e.g. stepped rates for corporate income tax)
- Administrative cost
- Compliance cost
- Potential for lobbying for privileged treatment

Sharing of Risk

- Taxes on Profit (e.g. CIT, resource rent tax or royalties on profit) shift risk towards the government
- Taxes on production (e.g. ad valorum royalties or production royalties) shift risk towards the taxpayer.

Timing of Tax Receipts

- Taxes on profit - delayed tax receipts, particularly if accelerated depreciation allowed for development and exploration costs
- Taxes on output - earlier revenue stream

The Good the Bad and the Ugly

- For most tax policy advisers general mantra on tax systems is:
- broad base and low rates good
- Sector based incentives (aside from resource extraction) bad
- The ugly – tax holidays (especially negotiated corruptly) have poor reputation when evaluated (e.g. by OECD in Balkans)

Why Not?

- The dangers of special incentives
  - low or zero additionality (they would come anyway)
  - winners curse (officials bid too much for FDI)
  - me too (or how to complicate your tax code with sectoral special measures e.g. a recent oil tax change led to a me too from the video games industry!)
  - more abusive tax shelters(“tax forests” and film tax credits)
  - governance and corruption issues: especially in LDCS
  - re- labelling of domestic investment to get incentives (e.g. Chinese investment round tripped through Hong Kong or BVI)
  - revenue effects

Why incentives?

- To attract inwards foreign investment
- …. and encourage continuing production
- .. and take account of specific features of the sector
- .. Because the resource tax system in use deters low rent projects that are economic but not commercial

Policy Lessons and Framework: Policy Design

- Collect evidence about taxpayer behaviour before introduction of any tax incentive.
- Plan to evaluate tax incentives from outset.
- Be aware that some policies won't work - it is better to be prepared to abolish these than keep tinkering with them for face saving reasons.
- Tax incentives often go hand in hand with enhanced avoidance opportunities. Need to be able to spot and counter these if you go down this road.

UK regime – why not use a mix?

The fiscal regime which applies to exploration for and extraction of oil and gas from the UK and the UK Continental Shelf (UKCS) consists of three elements:

- "Ring Fence" Corporation Tax (CT)
- Supplementary Charge (a stepped rate)
- Petroleum Revenue Tax (PRT) – a rent resource tax that applies to fields developed before 1993
- But mix like this not ideal if you can avoid it! (And we used to have royalties.)

Mixed Regimes

- Complexity
- Distorts investment decisions on incremental investment decisions
- Unwinding can create winners and losers arbitrarily
- Adding incentives can create further undesirable distortions

Myths – Government needs to own the oil

- Popular debate often assumes that allowing IOCs to operate results in loss of control, e.g. in Iraq over new oil law
- Little evidence that this is true in practice as UK shows that regulation of production in terms of e.g. field development plan sign off can be dealt with separately from taxation.

Important Insights

- Tax structure where oil taxation is the only important source of revenue tends to hold back development of effective states
- Negotiation over the tax bargain – what do we get for paying our taxes? – is crucial for states to make progress in meeting the needs of the majority of its citizens
- The rest of the tax structure has important political economy implications for oil and gas investments!

Planning ahead and foresight pays dividends

- Time horizon should be long
- Tax system will “grow”
- With enough planning and foresight the mature tax system that results may even look good even though the starting point was less promising!