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1. Introduction

a) How to use this document

1. This chapter provides a general framework on the design and use of tax incentives (in Section 1-b) and c), as well as specific analysis of their use in the extractives sector in developing countries (in Section 3). It has been written as a reference document and is not intended to replicate the work undertaken by others. A bibliography of reference documents is included for further research.

b) What is a tax incentive?

2. The first challenge in writing a chapter on tax incentives is the definition of a tax incentive. At the simplest level, a tax incentive could be considered a difference between the default regime and the one that is being examined, that results in a reduction in the tax burden (whether in the quantum or timing of the tax liability of the taxpayer). These special provisions would clearly be captured by this definition.

3. However, this definition may be too wide as it captures differences to the default regime that are structural in nature and intended to reflect the particular features of an industry.

4. Consider, as is common in the extractives industry, a cash flow tax. This will seek to tax the taxpayer on a cash basis, rather than on an accruals basis as may be the normal (default) approach for other taxpayers. This is a structural choice of the government, which may create more progressivity in the fiscal regime and encourage investment. This may be achieved by providing immediate offsetting of capital expenditure against income (otherwise known as 100% tax depreciation or capital allowances) and then denying tax relief for the cost of funding (i.e. denying tax relief for interest incurred on debt which would normally be allowed under the default regime). Under the above definition, the 100% tax depreciation would be seen as a tax incentive despite the fact that it is a normal feature of a cash flow tax and may be partly offset by the denial of relief for funding costs. Therefore, it is important to consider the context of the whole tax regime and identify any related (and offsetting) elements of the tax regime.

5. 1 demonstrates the importance of considering incentives in the context of the fiscal regime as a whole.

Box 1

In Norway, under the special petroleum tax regime relating to extraction and transportation by pipeline of oil and gas on the Norwegian Continental Shelf (NCS), costs incurred to acquire relevant fixed assets for production, processing and transportation o
starting in the year of investment. Such straight line depreciation over 6 years deviates from the general rules of the General Tax Act in that it will normally represent earlier depreciation a

The depreciation profile in the petroleum tax regime is one element among others intended to strike a balanced distribution of risks and rewards between the investors and the State. Front loading of recovery of investment costs is beneficial to the investor and contributes to the reduction of investment risks. However, the design of the petroleum tax system as a whole, including the timing aspects of the special tax base, should be understood in the context of a combined tax rate of 78 per cent (compared to the general corporation tax rate of 22 per cent). As the special petroleum tax regime is designed to capture as much as possible of the resource rent for the State and establishes a much higher level of taxation. The special rules on capital allowances should not be seen as a net tax incentive.

6. A potential definition for an incentive could therefore rest on the overall impact of the tax burden on the taxpayer for undertaking the activity. This would involve comparing the effect on the investment as a whole and identifying the total payments to government under the default regime and under the regime that is operating in practice. Such an approach will necessarily look beyond the tax system to all financial contributions. As noted in Chapter 7 on government take, the extractives industry can be subject to commitments to make investments (such as in infrastructure) that go beyond what they would need to operate.

7. Based on careful consideration and the above caveats, this chapter uses this more restricted definition of a tax incentive:

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c) What might be the role for tax incentives?

8. Tax incentives are generally used to attract investment or otherwise change behaviour. They represent a deviation from the default regime that is generally justified on the basis that such investment or behaviour would not have occurred under the default regime.

9. However, the effectiveness of tax incentives at attracting investment is not clear-cut. The UN Handbook on Protecting the Tax Base states that, on the one hand, the rise of the multinational enterprise, and increase in capital mobility have made tax incentives more important. However, while tax incentives may make an investment more attractive, in developing countries in particular they generally will not be sufficient compensate for deficiencies such as a lack of infrastructure, reliable power, or weak rule of law.[1] Moreover, where incentives have been found to have a positive impact on inducing investment, there has been no knock-on effect on increasing fixed assets such as machinery and buildings, which are more likely to generate structural economic growth than other forms of investment.[2] The conclusion is that tax incentives alone will not attract investment.

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Exceptions to state aid rules may be granted where there is a clear need. For example, to enable Liquified Natural Gas (LNG)-related investments in the northernmost part

cent, which was twice as fast as the standard depreciation rate for other petroleum investments. The measure was approved by state aid rules in 2002. It was a deliberate incentive to facilitate the development of the Snøhvit gas field in the Arctic, and the transportation system to bring the natural gas onshore and to the LNG plant at Melkøya.

2. A critical framework for considering tax incentives

12. As noted above, it is important to consider the role of tax incentives with a clear conceptual framework in mind. Tax incentives have been analysed by economists, academics, governments, NGOs, and industry, and the consensus conclusions as to best practice are set out below.

a) Governance

13. It is important that any deviations from the default tax regime are subject to an impact analysis so that government has a clear understanding of the costs and benefits before it decides to grant an incentive. Incentives should also be governed transparently, so that taxpayers understand the taxes they will pay, and the public can hold government accountable.

14. The following are considered best practice:

- **Prescribed in law.**

- **Monitored.** The value of tax incentives and reliefs should be reported annually by government as part of tax expenditure reports. The International Monetary Fund and other international organisations provide detailed methodology and support to develop tax expenditure assessments.[7] There should be clear parameters for review, as well as sunset clauses to reduce the potential costs of badly designed tax incentive programmes. The revenue authority should also monitor the use of the incentives in its risk and audit programs. Extractive companies should also report on the incentives utilized in order to further strengthen transparency on both sides.

Box 3.

In South Africa, tax incentives are only granted through national legislation. According to section 77 of the Constitution, a money bill imposes national taxes, or reduces or grants exemptions from any national taxes. Furthermore, section 73(2) of the Constitution stipulates that only the Cabinet member responsible for national financial matters may introduce a money bill in the National Assembly; i.e. only the Minister of Finance may introduce a bill dealing with tax exemptions in Parliament, to be considered via the legislative process.

b) Effectiveness

15. Tax incentives are introduced for a purpose, namely to influence a decision which may otherwise result in an answer that was less optimal than the alternative that the government wishes to encourage. This provides a natural framework for examining the effectiveness of the incentive i.e. will the incentive change the behaviour in the way intended.

16. This evaluation needs to go beyond the question of whether the desired behaviour was achieved and question whether the desired behaviour has been stimulated by the incentive if the behaviour would have happened in the absence of the incentive, then the incentive would be ineffective and a dead-weight cost to the budget.

17. The UN Handbook on Protecting the Tax Base notes that most surveys of business executives conclude that taxes were rarely a major consideration in deciding whether and where to invest. The primary question is the probability of recoverable mineral reserves and the factors in Box 4 that impact the ability to produce and market the reserves, after which the effective tax rate becomes relevant. Box 4 is a list of non-tax factors that influence investment decisions (source: UN Handbook on Protecting the Tax Base).

Box 4. Non-tax factors influencing investment decisions

1. Consistent and stable macroeconomic and fiscal policy.
2. Political stability.
3. Adequate physical, financial, legal and institutional infrastructure.
4. Effective, transparent and accountable public administration.

[7] https://www.imf.org/en/Publications/Fiscal-Affairs-Department-How-To-Notes/Issues/2019/03/27/Tax-Expenditure-Reporting-and-Its-Use-in-Fiscal-Management-A-Guide-for-Developing-Economies-46676

5. Skilled labour force and flexible labour code.
6. Availability of adequate dispute resolution mechanisms.
7. Foreign exchange rules and the ability to repatriate profits.
8. Language and cultural conditions.
9. Factor and product markets size and efficiency.

18. -size-

cisions that are optimal when considered in isolation resulting in an outcome that is sub-optimal when considered together.

24. The potential loss of tax revenue through the use of tax incentives should be considered on the basis of the full project, including other risk compensation, economic benefits to the broader economy, and negative externalities. For example, tax incentives that enable first entrants of foreign direct investment into a sector may increase economic growth and development through the broader development of the sector and associated skills and technology. The risk of these developments not occurring needs to be considered in the analysis. Any revenue impacts (positive and negative) should be considered over the life of the investment and this should be in the context of the overall fiscal package, not a standalone incentive. It is important to note, however, that governments may face annual budget cycles and hence may need to explain business cases for investments with a longer payback period.

Box 5 **Analysing and monitoring the cost of incentives**

Cost-benefit analysis is an assessment of the social costs and benefits of a proposed incentive, or package of incentives within an overall fiscal package. This should be done in advance of the granting of an incentive and then used in monitoring the incentive over its duration. It requires estimating the benefits generated by the investment, and the net costs in terms of lost revenues.

Given likely volatility in commodity prices throughout the life of an investment, as well as other uncertainties such as delays and cost increases, governments should model the value of an incentive at various price scenarios.

Tax expenditure analysis is also used to monitor the nominal value of incentives as the

the administrative burden. Incentives that create parallel fiscal regimes, may give rise to concerns over the veracity of transfer prices.

27. The abrupt ending of a tax incentive may also create an incentive to accelerate profits to avoid paying taxes when the incentive ends.

3. Application to the extractive industry in developing countries

28. The extractive industry is different from other sectors. Mineral and petroleum resources are finite, and non-renewable, and generally owned by the state (or region) for the benefit of its citizens. There is also the prospect of substantial revenues, which, if managed well, have the potential to create lasting development outcomes. Thus, any use of tax incentives should be considered carefully, to avoid forgoing government revenues unnecessarily.

29. If governments choose to offer tax incentives, these incentives should be carefully designed to align with the special features of the extractive industries:

- capital-intensive, with significant investment in exploration and development mostly sourced from the private sector;
- long periods of pre-production during which no revenue is earned;
- high risk because it depends on exploration being successful, and its profit is sensitive to commodity prices and exchange rates, which can be volatile.

30. These features may require a special fiscal regime, which diverges from the general tax system. In particular, incentives that enable resource companies to recoup their investment faster than other types of businesses: for example, a longer loss carry forward period, or accelerated depreciation. Or, incentives that mitigate environmental and social impacts by encouraging companies to procure supplies locally or restore mine sites, for example.

31. Designing resource tax policy may require certain trade-offs. In some cases, it may be worth forgoing some government revenue in order to attract productive investment. However, the benefits of the investment must outweigh the amount of revenue foregone, as well as other costs. Incentives that are too generous risk being politically unsustainable and may lead to a less stable and predictable fiscal regime.

i. Applying the Evaluative Framework

a) Governance

32. It is common for countries to have numerous laws that set out the extractive industry fiscal regime. Each of those laws may contain tax incentives.

1. The general income tax code, which may include special provisions for mining, oil and gas either in a separate schedule or chapter, or in the main part of the code. E.g., a different rate of corporate income tax.

Box 6. Assessing the cost of a tax incentive Yaoure gold mine

ught to attract international investment to its gold mining sector, which is relatively undeveloped compared to established regional producers. As part of its new mining code developed in 2014, it gave a five-year tax holiday to new mining projects.

The
gold mine, to assess the potential cost of this incentive. The analysis, using information published by Amara Mining, estimated that the investor could achieve an internal rate of return without the tax incentive of between 15% to 34% for a gold price between $1000- $1,500/ oz.[10] The tax incentive was estimated to increase

government also noted that there is a three-percentage point difference between the IRR in their model and that given by the company, possibly due to different cost estimates, and other fiscal costs. The rate of return would also need to be adjusted for country risk.

The government concluded that the tax holiday in the case of the Yaoure mine was not nece

the tax holiday meant it could recover the carried forward tax losses, before getting the benefit from the tax holiday. However, from governments perspective, the first taxable profits may arise a number o

recovery costs. The credit percentage is reduced to the extent the reference price of oil is in excess of the base value (adjusted for inflation) of USD28. This credit is provided for in the U.S. Internal Revenue Code and as such, is available to any investor involved in a qualified enhanced oil recovery project that has qualified enhanced oil recovery costs for the year.

The credit can be viewed as a very effective targeted incentive, achieving the goals of the investor, the government and the public. The incentive is transparent, has certainty of application and can be viewed as equitable to both investor and the government.

The credit is designed to encourage investors to invest in projects to produce oil that might otherwise be less profitable to produce and thereby increase the supply of oil for the country. From the perspective of the government, the cost of the incentive is reduced or eliminated to the extent the value of the oil produced increases beyond a designated level, which might otherwise provide an unintended benefit to the investor.

c) Efficiency

39. Tax incentives should be evaluated against alternative ways that the extractive investment could be induced (e.g., government paying for infrastructure to reduce costs). The option

Table 1. Costs and benefits

Costs	Benefits
• The amount of revenue foregone from the incentive, assuming the investment would have occurred without it • Environmental, economic and social costs • Administrative costs of implementing and monitoring incentives • Economic distortions introduced due to differential treatment of certain investments • Potential for corruption or abuse in the granting and administration of tax incentives	• The amount of economic value the extractive operation brings to the economy (including through the multiplier effect); • Employment: the number of jobs created by the extractive industry operation; • Skills development; • Government revenues: the amount of revenue generated for the host government by the extractive industry operation.

42. A cost-benefit analysis should be considered as part of the broader framework of the

very generous fiscal regime (compared to the default) for almost twenty years,

4. Churning or fictitious investments (lack of recapture rules).
5. Schemes to accelerate income (or defer deductions) at the end of a tax holiday period.
6. Overvaluation of assets for depreciation, tax credit, or other purposes.
7.

i. Income tax holiday

50. A tax holiday applies during a specified tax-free period. The duration may vary from one year to the full term of the project. It may take the form of a complete exemption from profits tax, or a reduced rate, or a combination of the two (Zolt, 2017).

51. For the reasons highlighted above, income tax holidays may be a less efficient and effective incentive for the extractive industries.[15]

52. Income tax holidays for mining projects tend to incentivise commercial behaviour which moves profitable activity into the time period covered by the incentive. For example, mining companies may increase the rate of extraction, or preferentially extract high-grade ore during tax free periods. Governments report the problem of high- - g ng the rate of extraction, or preferentially extracting high-grade ore, compared to what they would otherwise do absent tax considerations. Of course, tax may not be the only factor companies will generally want to mine high value, easy to access ore first, to improve their cash flow. Nonetheless in estimating what the overall cost of a tax holiday will be, governments should anticipate behavioural responses that the tax incentive will generate.

53. From an investor point of view, a tax holiday which begins development will be of uncertain value (and hence less effective as an incentive), since project delays will reduce the tax

shifting. By lowering or exempting withholding tax, developing countries become more vulnerable to cross-border tax planning by multinational companies.[16]

56. In the case of loans from foreign related parties, governments will end up with interest as a deductible expense, and no tax on the interest income received by the related party, unless they charge withholding tax.[17] Moreover, subject to thin capitalisation and transfer pricing rules, the group will have an added incentive to highly leverage its subsidiary in order to strip profits out via interest expense. The

reduce its tax liability to minus $60. This balance could be carried forward to offset tax liabilities in future years or expire. Depending on the tax rate, the investment credit is four times more generous than the investment allowance..

ii. Customs duty reductions or exemptions

64. Import tax is usually based on the value of the good. For example, if import duty is 10 per cent on mining inputs, a company that brings in drilling equipment valued at $500,000 will have to pay $50,000 in duties.

65. Customs duty relief is often provided to enable the company investor to import specific plant and equipment duty free and to obtain refunds of excise paid in relation to fuel used to power machinery or in off road vehicles. These incentives are common in developed countries, where mining investments are very reliant on imported equipment, fuel and construction material. The major issue for developing countries is usually administering and policing of the relief to ensure it is targeted.

Box 13. Import duty exemptions target exploration and development phases

The Petroleum Code of Senegal from 1998 provides an exemption from Customs Duties and VAT during the exploration and development phase of an oil and gas project. Although the Petroleum Code from 1998 has been replaced by the Petroleum Code enacted in 2019, the 1998 Petroleum Code continues to apply to license holders granted prior to 2019. This incentive is provided in Articles 48 and 49 of the Petroleum Code and applies during the exploration and development stage of all oil and gas projects in Senegal. This incentive allows the import of materials during the relevant phases of the project free of customs duties and VAT. In addition, exports of petroleum products are not subject to export duties. After completion of the specified phases of the project the general rates of customs duties and VAT apply.

This type of incentive can be viewed from the perspective of the government as an enticement to investors to assume the risk of proving the existence and economic production of oil or gas in a new or unproven resource prospect. This position is reflected in the "Explanatory Statement" to the Draft Bill 98-05 establishing the Petroleum Code, which provides the following: "In order to be competitive, Senegal must not only take into account the evolution of the worldwide energy

The other issue about REPETRO was the presence of different lists of products eligible to the tax incentives, for Federal Tax Administration and subnational States Tax Administrations (Customs duties X VAT), which create a problem of transparency in tax legislation.

ownership of production equipment and vessels (subsea and top side) must be

distribution between taxpayers and government and deals with it through import tax exemptions and a capital allowance, which includes a higher amortization rate, based on the fact that the technical and financial feasibility studies consider that the cash flow of enterprises, and the timing to charge the corporate tax, have a key role in the decision-making process of the investors.

The new oil and gas federal tax legislation is aligned with the subnational States indirect taxation of VAT, since both the Union and the States now share the same

making the legislation more transparent. Some VAT distortions were addressed by extending the exemption for two more layers of the domestic supply chain in order to avoid the credit refund problem for export companies in the extractive industry. The new scheme also gives Brazilian suppliers the same conditions of the foreign ones.

iv. Production royalty-based incentives

67. Royalty based incentives may be agreed to reduce the burden on the project during the first phase until recovery of sunk costs. They are

4. Conclusions

Perhaps have a checklist of actions for governments:

- Considering providing for new incentives
- Examining existing incentives