Knowledge Core

Policy decisions taken about the applicable fiscal regime and careful drafting and administration of the fiscal rules are critical to the overall success of EI sector management. No matter how significant the wider social and economic benefits, it is the prospective state revenue from oil, gas and mining activities that will usually become the principal benefit to the country. This potential to generate very high rents in excess of the minimum required by the investor, due to the limited supply of the resource in question, make the extractives a particularly appealing source of revenue. That prospective outcome, however, presupposes the kind of fiscal regime that encourages investment in exploration that might lead to the discovery and development of the resource.

Clarity and Simplicity The effectiveness of an EI sector fiscal regime depends on the objectives established for that regime, on the fiscal instruments selected to achieve those objectives, on the clarity of the fiscal rules, and on the quality of fiscal administration. Yet common criticisms of fiscal design are that governments choose regimes that are complex and therefore subject to misinterpretations, uncertainties and loopholes, difficult to implement; or insufficiently robust to remain stable over time and therefore likely to lose credibility, or characterized by fragmented responsibilities or adversely affected by capacity constraints\(^1\). These features can have the effect that otherwise simple fiscal instruments become hard to administer.

Faced with the current body of knowledge and the instruments it offers them, governments face challenges greater than ever. Even if a single fiscal instrument could be described as ‘simple’, the fact is that at the extraction phase, oil, gas and mining tend to be subject to a variety of fiscal terms that can include: bonuses, royalties, production sharing (not mining) and windfall profits taxes, as well as corporate income tax. The diversity of fiscal instruments that has emerged in the past 15 years in the hydrocarbons industry alone includes 21 different R-factors; 28 different types, scales or formulas for royalties; 35 different ways to structure profit/cost oil; 31 different ways to organize government participation; and 12

Different price sensitive windfall profit features. A leading authority on fiscal terms has commented: “Many of these features are ineffective in achieving the goals that they were supposed to achieve as a result of poor design or have unintended negative effects”. Further, the very diversity of instruments now available suggests that governments “are rather isolated from each other in terms of world fiscal knowledge... There seems to be a lack of awareness how important fiscal design is to attract investment and optimize resource wealth”.

**Risk-sharing** Designing a tax on rents from the extractive sector requires appreciation of some basic facts of EI life. In the vast majority of cases foreign investment will be required (see Chapters 1 and 3). The drivers to attract such investment are well established. Governments provide mineral and petroleum rights to private sector companies with the expectation that the state will subsequently benefit from tax payments which can then be used for social services and economic growth such as converting a resource in the ground into both social and economic capital. Correspondingly, private companies invest with the expectation of making a profit commensurate with the risks involved and their cost of capital.

For both parties there are potential risks and rewards and the balancing of those risks and rewards will determine ultimately what EI sector development takes place and how beneficial it is to the government, the investor, and the local community. The fiscal regime is a key determinant of how EI sector income is shared between the investor and the government. However, there is no model or guideline to lead one to conclude what is a ‘fair’ or ‘reasonable’ share. Even after initial agreement, there is no guarantee that this sharing of benefits will be sustainable over the long-term, given the volatile and inherently unpredictable investment life-cycle.

**Credibility** A recurring theme in the literature on fiscal design concerns the credibility of a fiscal regime. A fiscal regime has to be credible to attract investment but it also has to be credible to the citizens of the country applying it. The pressures on governments to demonstrate returns on publicly owned resources can act as a powerful incentive to adopt fiscal instruments that deliver early revenues from resource development, for example.

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3 Ibid.
6 For example, see the discussion in Boadway and Keen, Perspectives on Resource Tax Design in Daniel, Keen and McPherson (2010), 13-74, particularly in relation to the time inconsistency issues.
**Context** Differences of approach will arise according to whether the regime is for oil, gas or mining, even if there are significant similarities too. Differences will also emerge according to the context in which a fiscal regime is designed (or re-designed). Some of these contextual differences will have a crucial influence. For some countries, the existence of contracts inherited from the past will constrain the scope for change and force it to be incremental (examples from mining are Guinea, Lao PDR, Sierra Leone, Tanzania). These differences are highlighted in the sections below.

Some understanding of comparable country settings and their tax regimes will also be required, since the number of areas in which exploration and production can take place and investors will favour those offering the more attractive tax treatment to them. Tax competition is a fact of life in the extractives sector. International tax issues can also be expected to play a part in other ways, even if many of these are not peculiar to the extractives sector. Treaty shopping and transfer pricing can have particularly important impacts, especially in the context of resource rich economies. However, programs of regional coordination are less likely to be necessary for fiscal regimes in this sector than in relation to tax incentives for more mobile activities.

**Action** A number of web-based tools are being designed which have the potential to assist governments in addressing these problems. Some are mentioned at the end of this Chapter.