MAKETAXFAIR

Chapter 7 Extractive Industries (thematic)

Seventy percent of the world's poorest people live in countries rich in oil, natural gas or minerals. Nevertheless, the extractive sector has not yielded meaningful transformational economic and social outcomes for the people, communities and countries involved. Foreign Multinational Corporations (MNCs) benefit more from this sector than the host country governments do because of unfair international trade and investment rules and agreements, which disadvantage host countries. Compounding this is the weak governance systems, arising from inadequate policies, laws, and institutions required to regulate and govern the sector. Poorly negotiated terms of EI contracts have worsened the unfavorable terms with multinational corporations. The lack of transparency and accountability has enabled these corporations to engage in aggressive tax planning to avoid and evade taxes. For example, the extractives sector accounts for around 65% of all African illicit financial flows (IFFs).

The lack of economic diversification, value addition and broad-based community involvement continues to reinforce the resource curse. Efforts have been made to improve the governance of the sector through frameworks like Africa Mining Vision (AMV) and the Extractive Industries Transparency Initiative (EITI). However, effective domestication and implementation of these instruments are still a challenge. As the resources are finite, it is important that extraction of the resources provides sufficient benefits in terms of revenues, employment and balance of payment to counterweight the negative effects. Experience has shown that natural resource extraction comes with many misfortunate implications and cost to human rights, labour rights, health of workers and surrounding communities, risk of conflicts and undemocratic rule/governance, harm to biological diversity, the environment and the climate. Therefore, a country should only start and/or continue to EI activities, if the economic, social and environmental benefits (employment, taxes, balance of payments) outweigh such costs and risks.

Generally, TJNA and Oxfam recommend strong local participation, parliamentary oversight, more state-ownership, less reliance on income-based taxation and more reliance on production-based revenue raising such as royalties, production-sharing, state-ownership and export tariffs.To analyze above issues this chapter will focus on six areas of extractive industries: mapping the industry, governance, transparency, institutional and administrative capacity, progressivity and securing resources and natural resource sharing mechanisms.

Definitions

Royalty

In the extractive industries, the term ‘royalty’ refers to the obligatory payment made by the operator of the extraction project to the state as compensation for the extraction rights. Royalties are generally calculated with reference to the type, quantity, quality and/or value of the extracted mineral resource as a percentage of the gross volume or value of the production (i.e., costs generally do not reduce the base), and are due once production commences. The term ‘royalties’ also refers to the payment for the right to use property (as defined under article 12 of the UN Model).[1]

Topic	**Research Analysis Questions**
7.1 Mapping the EI sector[2]	7.1.1 What EI activities does your country have? 7.1.2 What are the mechanisms through which the state secures revenues from the EI activities in the country: ● Corporate Income Tax (CIT) ● Royalties, ● Export tariffs, ● Capital Gains Tax (CGT), ● Production sharing, ● ownership of projects ● Others 7.1.3 Are there IFF estimates for the EI in your country? If yes, do these include tax avoidance and evasion?

[1] https://www.un.org/esa/ffd/wp-content/uploads/2016/10/12STM_CRP3_AttachmentE_FiscalTake.pdf]

[2] Generally speaking, gas and oil are taxed differently from hard minerals extracted through mining due to differences in their geological nature as well as the cost structure of extraction projects. Where mining operations are usually taxed through a production-based royalty (a fixed or variable percentage of production paid in tax) and corporate income taxes, oil and gas operations can also be subject to production entitlements (also known as production sharing), as well as incidental signing and production bonuses. Read more at http://openoil.net/wp/wp-content/uploads/2016/12/oil-contracts-v1.2-dec-13.pdf

7.2 Governance	7.2.1 Does the government have an official EI policy, mission statement or similar document declaring the values, intentions and goals of the country's EI activities? If yes, what is the declared purpose(s) and what are the policy and legal frameworks for the management of EI? 7.2.2 Is there a sovereign wealth fund? If yes, where do the fund's resources come from? Does it include revenues from the EI? Does the country have different types of sovereign wealth funds? What are the investment objectives? How is the fund(s) structured and governed (e.g. is there parliamentary oversight?)? Are there provisions for public participation, e.g. does it have a consultative council with the participation of the communities affected and civil society etc.? 7.2.3 How does the country determine the payments into the sovereign wealth fund and how does it decide on the withdrawals? 7.2.4 Are there any economic analyses, including a cost-benefit analysis (social, economic, environmental etc.) of the decision of having EI activities? If yes, how frequent are these analyses made and are these analyses publicly available? 7.2.5 Which institutions (parliament, ministries etc.) approve the granting of EI concessions, extraction contracts, investments agreements etc, and what are the reporting mechanisms? 7.2.6 Is the application of tax incentives in the EI in line with current recommendations from civil society, academia, OECD and the IMF concluding: Tax incentives (e.g. stabilization clauses) are ineffective policy tools to attract FDI and should be limited[3].

[3] Read more in Publish What You Pay, 2017, *Many Ways to Lose a Billion* https://www.pwyp.org/wp-content/uploads/2017/07/PWYP-Report-ManyWaysToLoseABillion-EN-INTERACTIVE.pdf
This paper provides an extensive overview of the risks to extractives tax collection for states' tax authorities. As such, it provides valuable insights for how to judge whether tax legislation and regulation have managed to counter these pitfalls. Tax revenue risks from extractive industries are categorized into four groups:

1. Tax breaks
2. Treaty shopping
3. Under-reported project revenues
4. Over-reported project costs

2024 EU Commissioned study of the role between FDI and Tax havens: https://www.europarl.europa.eu/RegData/etudes/IDAN/2023/754198/IPOL_IDA(2023)754198_EN.pdf

7.3 Transparency	7.3.1 Do EI companies register their beneficial owners? If so, where? Is this information publicly available? 7.3.2 Are production-sharing agreements and investment agreements between the government and extractive companies published? 7.3.3 What are the legal requirements and practices for publishing payments by EI companies? What are the legal requirements and practices regarding the transparency around the government publishing payments received by the EI ? 7.3.4 Is the information on mineral revenue and the spending thereof publicly accessible? If yes, how is this information made available? 7.3.5 Are there expenditure-reporting guidelines and transparency around cost-auditing, in general and in particular for natural resources revenue? 7.3.6 Has the country signed the EITI?
7.4 Institutional capacity and administrative effectiveness	7.4.1 Who is responsible for collecting taxes (local and national levels, specific office/department/unit/team) from the EI? Is there dedicated capacity to adequately tax and monitor EI companies? Does the tax administration's capacity allow thorough assessments of companies' structures, challenge of transfer pricing and profit-shifting? 7.4.2 Are there reports, assessments, media articles, complaints or similar discussing capacity constraints or shortcomings of the (national or local) administration of the EI? 7.4.3 Is there an auditor general? Do the auditor general audit revenues from the EI (how often)? Are these audit reports publicly available? 7.4.4[4] Have the government legally secured its right to audit costs? And does the revenue authorities have the capacity to effectively do cost auditing of extractive companies?

[4] Governments' essential tool to combat petroleum cost overstatement is the right to audit costs, but there is limited data on whether governments use this right effectively. Cost auditing practices in Ghana, Kenya, and Peru suggest

7.5 Progressivity and securing revenue[5]	7.5.1 To what extent is the system of taxation of extractives able to generate revenue for the government? In what way is revenue secured in situations where there is no profit. 7.5.2 To what extent has the government's share of revenues increased during extractive commodity booms? Does the country have excess profit taxes 7.5.3 Is there a windfall tax in your country (targeting excess and unexpected profits)? If so, does this apply to the EI? And/or does your country have well-designed sliding royalty rates (a proxy for flexibility and progressivity as envisaged in the AMV[6]). 7.5.4 How are royalties defined and calculated in your country (on value or volume or right to use property)? What royalties are levied on EI production? And are these flat or dynamically linked to commodity prices and/or other external factors? 7.5.5 In relation to EI, how is the balance between production-based revenue-raising mechanisms (e.g. royalties, production entitlements[7], ownership in EI project) and profit-based taxes?

that governments face significant challenges. Oxfam proposes recommendations to address these challenges and ensure that governments collect the taxes owed for the exploitation of their finite, non-renewable petroleum resources. - see more in Oxfam, 2018, "Examining the crude details", https://www.oxfam.org/en/research/examining-crude-details

[5] TJNA and Oxfam shares the concern described by ICTD, 2016: *Improving the Performance of Natural Resource Taxation in Developing Countries*
https://opendocs.ids.ac.uk/opendocs/bitstream/handle/20.500.12413/12797/ICTD_WP60.pdf
Income-based taxation of the extractive industry (EI) cannot stand alone as it does not guarantee that the country and communities benefit from EI, and it implies too high risk of profit-shifting and IFFs. Revenues from EI need to be guaranteed even when/if companies turn out to be not-profitable. Therefore, EI taxation needs to balance both production-based taxes (e.g. royalties, shared ownership, export tariffs) and income-based taxes.

[6] Tax Justice Network Africa (TJNA), 2023, "*FISCAL POLICY NOTES ON MINING*
An Africa Mining Vision Minerals (AMV) Governance Framework Assessment January 2023 IN LIBERIA, GHANA, UGANDA AND ZAMBIA"
https://taxjusticeafrica.net/sites/default/files/publications/Fiscal%20Policy%20Notes%20on%20Mining%20Paper%20AMI%202023%20.pdf

[7] Production entitlement levies are often a percentage of the revenue generated by a gas or oil project, minus the costs incurred by the company. To determine production entitlements, companies identify the amount of oil or gas they need to sell to cover their costs, which is known as "cost oil" or "cost gas". The amount that remains when the "cost oil/gas" is subtracted from total production is known as the project's "profit oil/gas". The government then takes a percentage of this profit oil or gas as its profit share (or production entitlement).
Although this type of taxation only regards the oil and gas sector, it is important to note, because production entitlements can make up a large percentage of taxes paid by oil and gas companies.

7.6 Natural Resource Revenue Sharing Mechanism	7.6.1 Are there laws and mechanisms for sharing EI revenue with affected communities? Are there challenges with implementing EI revenue-sharing? 7.6.2 Is the EI revenue-sharing formula publicly available? Is there public participation of the affected communities in the decision-making process? 7.6.3 Are there regular public disclosures of distributed EI revenue to the recipients (e.g. host communities and local and regional governments)? 7.6.4 What are the accountability mechanisms that apply to the mineral revenue-sharing system?