Revenue losses owing to tax incentives in the mining sector: Policy recommendations.

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The overview:
The government of Tanzania has for a long time provided a wide range of tax incentives with the aim of attracting and retaining greater levels of Foreign Direct Investments (FDIs) into the country. The presence of these tax incentives has enabled mining companies to effectively escape taxation altogether. This brief shows how such tax incentives are leading to very large revenue losses in the mining sector and how such incentives are not necessarily needed to attract FDIs. It concludes in recommending a thorough review and constant monitoring of the implementation of government policy on incentives while limiting the rates of incentives with the aim of curtailing the revenue losses now being experienced in the mining sector.

Introduction:

Over the past ten years, tax incentives have in many respects been an important policy tool that the government has used to attract the attention of potential mining sector investors and increase FDI's in the country. This is still the case to date despite the fact that the tax incentives have largely benefited mining companies at the expense of government revenue.

What are Tax Incentives?

A tax incentive is a deduction, exclusion or exemption from a tax liability offered as an enticement to engage in a specified activity such as investment in capital goods for a certain period. Tax incentives are the fiscal form of investment incentives and include corporate income tax holidays and reductions in tax rates. Non-fiscal or non-tax incentives include direct subsidies like government grants, loans and guarantees for target projects. Tax incentives are granted to attract FDI and/or promote specific economic policies, such as to encourage investment in certain sectors[1].

What are FDIs?

In the context of Tanzania, FDI refers to the flows of capital and personnel from abroad for investment in the country. The ownership of such capital can be either by a natural person or an institution such as a company registered outside the country. The shares owned by such a person or institution should be not less than fifty percent (50%) of the total investment. FDI is normally undertaken by Multinational Enterprises (MNEs), which invest huge capital in different nations[2].

Tax incentives for mining companies

Mining companies enjoy various tax incentives and exemptions which are included in their Tanzania Investment Centre Certificate of incentives. These include:

- Zero import duty on fuel (compared to the standard current levy of T.Shs 200 per litre) and on imports of mining-related equipment during prospecting and up to the end of the first year of production after which they pay 5 per cent,
- Exemption from capital gains tax (unlike other companies in Tanzania),
- Special VAT relief, which includes exemption from VAT on imports and local supplies of goods and services to mining companies and their subcontractors,
- The ability to offset against taxable income the cost of all capital equipment (such as machinery or property) incurred in a mining operation,
- A reduced rate of stamp duty, at 0.3 per cent. This is included in several mining agreements signed between the government and the mining companies, even though the rate of stamp duty is set by law at 4 per cent[3],
- A maximum payment of local government taxes of up to $200,000 a year, which is lower than the 0.3 per cent of turnover required by law[4],
- Depreciation allowances for depreciable assets (a deduction equal to the amount of total capital expenditure equivalent to 100% depreciation allowance) in the year of expenditure, which also can be carried forward;
- Import and excise duty for mining

equipment at 0% during exploration and mine development up to the first anniversary of commercial operation, after which a cap limit of 5% applies[5].

Other incentives are:

- **Tax incentives for 'strategic investors'**
  In Tanzania, companies investing more than $20 million – typical of mining companies – are accorded 'Strategic Investor Status'. According to the Tanzania Investment Centre, 'investors of big projects of over US$20 million offering great impact to the society or economy can apply for 'special' incentives from the Government'[6]. Thus some foreign mining companies do have individual fiscal agreements with the government, some of which offer special concessions to individual companies but which have never formally been made public.
- Newly-listed companies on the Dar es Salaam Stock Exchange (DSE) with at least 30 per cent of their shares issued to the public pay only **25% corporate income tax** (compared to the standard 30 per cent) for the first three years. In addition, shares of companies listed on the DSE are **exempted from paying capital gains tax** (whose normal rate is 30 per cent)[7].
- Other VAT exempted items that are not mentioned above include insurance, education, financial services and tourist services.

According to the 2011 Controller and Auditor General (CAG) report, tax exemptions issued to the mining sector alone totaled T.Shs. 109.885 billion while those granted by the TIC totaled T.Shs. 239.667 billion.

Revenue losses in the Mining Sector

Given that Tanzania is one of Africa's largest gold producers, the expectation has been that mining would contribute significantly to its economic development. This expectation has not been fulfilled. The International Monetary Fund (IMF) notes that gold exports have risen from around US$ 500 million to US$ 1.5 billion in the last five years due to rising gold prices, but that government revenues have remained at around US$ 100 million per year. This is largely because of the corporate income tax holidays provided to mining companies. In fact, 'none of the existing gold projects have paid material income tax to date', the IMF notes[8]. It is further reported that, mining revenues will not grow much in the near future. According to the IMF, 'the growing mining sector has so far had little net fiscal impact and this is unlikely to change in the coming years, partly because of large embedded tax holidays'[9]. Although a new Mining Act was passed in 2010, existing gold mines remain governed by their respective agreements signed prior to the law currently in force.

Revenue losses from tax incentives granted to mining companies are significant, although the overall figures have never been calculated. Selected examples are quoted below:

- The Bomani Commission estimated that the government **lost T.Shs 39.8 billion in 2006/7** and **T.Shs 59 billion in 2007/8** simply as a result of **fuel levy exemptions** granted to the six large mining companies. As of late 2011, mining companies were making claims to the government **for refunds totaling US$ 274 million** related to their fuel levy exemptions for the period since 2002.
- Mining companies have exclusive ownership of their operations and the minerals recovered and the power to dispose of them as they wish including to transfer those rights to other companies **without incurring capital gains tax**. This means that the practice of buying and selling mining operations is legal and is very lucrative.
- Mining companies' ability to **offset against their taxable income** the full costs of their expenditure on items such as plant and machinery has lead to **perpetual declaration of tax losses**, and thus **non-payment of corporate income tax**. In response to this in 2008 government introduced an **Alternative Minimum Tax of 0.3% of turnover**, payable when companies declare three consecutive years of tax losses, although it is likely that revenues from this tax are far lower than the losses caused by the capital allowance.
- In 2010, Tanzania Minerals Audit Agency (TMAA) audited 12 mining companies and reported audit 'queries' comprising **over-declared capital allowances and operating expenditures** of a total of **$705.8 million** implying a tax liability of about $176 million. It was the first time TMAA conducted audits on mining companies. It is therefore possible that similar alleged over-claims were made by some companies in previous years.

Costs of incentives

Tax incentives imply that the money that could be collected as taxes is not collected, which implies fewer funds in the government coffers. This is the money that could otherwise be used to finance some public goods and services in the development and recurrent expenditure budgets. These goods and services include but are not limited to communication, infrastructure such as roads and bridges, and social services such as health, education and water. In economic terms, the exemptions are opportunity costs in that the exempted funds cannot at the same time be available to fund development. It is not prudent therefore to depend so much on donor support while at the same time exempting taxes that should be collected to finance the development and recurrent budgets.

Problems of tax incentives

A lot of evidence suggests that the disadvantages of tax incentives vastly outweigh the advantages and that such incentives are not needed to attract FDI. A 2006 report by the African Department of the IMF, focusing on tax incentives in East Africa, notes that *'… available empirical evidence confirms that investment incentives – particularly tax incentives – are not an important factor in attracting foreign investment'.* In addition, A Joint IMF, OECD, UN and World Bank report for the G-20 states that *'Studies….suggest that tax-driven investment does not provide a stable source of investment in the recipient country'.* The IMF report argues that countries that have been most successful in attracting foreign investors have not offered large tax or other incentives. *Providing such incentives is not sufficient to attract large foreign investment if other conditions such as; good quality infrastructure, low administrative costs of setting up and running businesses, political stability and predictable macro-economic policy, were not in place*. This reasoning partly explains why the IMF, and other international organisations such as the African Development Bank, have been pressing Tanzania to radically reduce their tax exemptions.

In addition, there is a long list of disadvantages with tax incentives, as outlined in a recent IMF report, which argues among other things that they:

- Result in a loss of current and future tax revenue;
- Create differences in effective tax rates and thus distortions between activities that are subsidized and those that are not;
- Could require large administrative resources;
- Could result in rent-seeking and other undesirable activities;
- Could, in the case of income tax holidays, be a particularly ineffective way of promoting investment companies that are not profitable in the early years of operation; and
- Could attract mainly footloose firms.

Tax holidays strongly favour transitory rather than sustainable investments and create glaring opportunities for aggressive tax avoidance. A joint report by the IMF, OECD, UN and World Bank comes to the same conclusion, noting that, *where governance is poor, corporate income tax exemptions 'may do little to attract investment'* and when they do, '*this may well be at the expense of domestic investment*'. Tax incentives are also prone to abuse when the incentive is exhausted and the promoters of the business fraudulently wind it down and simultaneously establish another entity to be accorded the same tax incentives.

The IMF notes that investment incentives, if they are to be of benefit, should be well-targeted and focused narrowly on the activities they seek to promote.

Conclusions

The government recognises that tax exemptions entail a large revenue loss and is taking some steps to reduce them. In May 2011 the then Deputy Minister for Energy and Minerals, Adam Malima, was quoted as saying that the government would 'overhaul the entire tax exemptions package' for mining companies. But this pledge has not yet materialised. Progress is slow on that front and the real extent of government commitment is questionable yet our diminishing mineral resources continue to be exploited. The 2011 report of the Controller and Auditor General correctly reports that, 'exemptions are granted to multinational companies which have the ability to pay the taxes they are exempted from paying' … which should not be the case.

The IMF has called on government to raise taxes on mining companies. Among other changes, it has called for withholding taxes on interest paid on foreign currency loans; limits on the deductibility of debt financing for income taxes; and a tightening of provisions for investment allowances for exploration and development.

Recommendations

In accordance with this backdrop, we urge the government to focus on the following measures:

- Undertake a review of all tax incentives with a view to reducing or removing many of them, especially those that involve the exercise of discretionary powers by Ministers. Those incentives that remain must be simple to administer and shown by the government to be economically beneficial for the public interest.
- Remove tax incentives granted to attract and retain FDIs, especially those provided to the mining sector.
- Provide on an annual basis, during the budget process, a publicly available tax expenditure analysis, showing annual figures on the cost to the government of tax incentives and showing the beneficiaries of such tax exemptions.
- Tax incentives being administered by TIC should be harmonised with those levied by the Tanzania Revenue Authority and other government agencies.
- The Government should either limit exemptions to 5% of the total collected revenues or do away with granting tax exemptions which benefit companies which are able to pay taxes.

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Further Reading: This brief is an extract from a publication by Policy Forum, Actionaid and Tax Justice Network-Africa entitled **'Tax Competition in East Africa - a race to the bottom, Tax Incentives and Revenue Losses in Tanzania' 2012.** *http://www.policyforum-tz.org/files/ARacetotheBottom.pdf*

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