

ActionAid's Progressive Taxation Briefings

# Extractive Industry Taxation



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# Extractive industry and government revenue

## ► What are extractives?

The extractive industry consists of any operations that remove oil, gas, metals, minerals, stones or sand from the earth.<sup>1</sup> Examples of extractive processes include oil and gas extraction, mining, dredging and quarrying. In other contexts, the scope of the extractive industry has been widened to include forestry and fisheries. This policy brief focuses on the extraction of oil, gas, metals, minerals.

## ► What is so unique about taxing extractives?

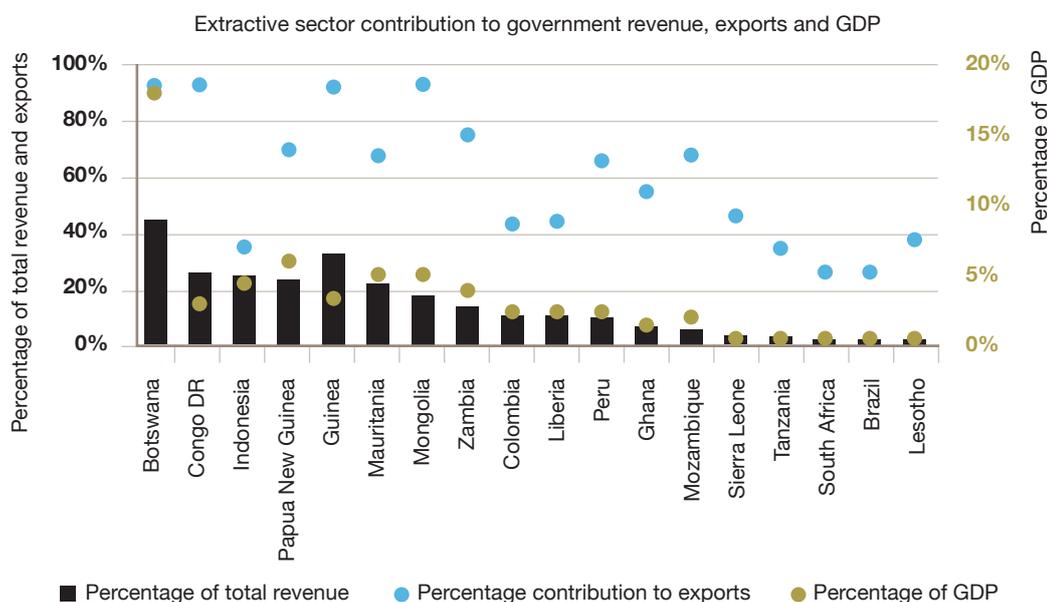
The extractive industry can account for over half of government revenue in petroleum-rich countries, and over 20% in countries with substantial mining sectors.<sup>2</sup> Minerals, metals, oil and gas are non-renewable finite resources. As such, governments must generate returns that are enough to compensate the country for the value of the asset being depleted, but also to mitigate the often-

sizeable environmental impacts and potential disruption of livelihoods.

At the same time, extractive projects require significant upfront investment before revenues begin to flow, and are subject to high risks including limited knowledge of the resource being extracted, technical uncertainties and political risks such as resource nationalisation and corruption. For instance, in petroleum exploration, which is often costly and risky, the International Monetary Fund (IMF) has estimated that a deep water well used in oil exploration can cost over US\$100 million, and the chances of success in a new basin may be one in 20 or even less.<sup>3</sup> The risk of failure during the extraction phase may be greater for mining. Mining is likely to have higher political, environmental and social risks. This is because it is typically based on land rather than offshore, and so is more disruptive for communities.

While some of these risks are not unique to extractive projects, the combination and scale makes them more acute. Countries embarking on natural resource development need to find a balance between achieving maximum benefit for the country in a responsible and sustainable way, while providing investors with a return on their investments commensurate with the risks taken. In doing so, the nation's benefit must come first to fund essential services for women, men and children, and not be compromised.

**Figure 1. ActionAid compilation based on IMF 2016 and Extractive Industry Transparency Initiative Data**



## ► Contribution of extractive taxes to government revenue

Taxing the extractive industry is particularly important in low-income countries that have relatively low formal economic activity and so have limited capacity to raise other types of taxes. Often, the value of the resources extracted is much higher than the revenue collected by the government. While the extractive sector contributes a significant share of export earnings in developing countries, 92% for Guinea, 92% for Botswana, 93% for Democratic Republic of Congo and 75% for Zambia, this often doesn't correspond to the share of revenue realised by the government from the sector. The contribution of mining varies significantly across countries, from 3% to 25% of total government revenues. This variation does not always correspond to the productive value of a country's extractive sector, as can be seen in the graph below. Botswana stands out with the most closely corresponding revenue contribution of its extractive sector to its export earnings.

## Approaches to taxing the extractive industries

Natural resources form part of a country's capital asset wealth, and the full value needs to be realised once a resource is unearthed. In most cases, the resource being extracted determines the way a government frames its fiscal regime. Fiscal regime designs vary from country to country, but are usually based on contracts or on tax/royalty schemes. Some countries use a hybrid of the two. For the mining sector, tax/royalty schemes are most common. In all these frameworks, if a country wishes, state participation

can be included. For example, in the case of diamond mining in Zimbabwe, the state-owned Zimbabwe Consolidated Diamond Mining Company reserves the rights to 51% of the controlling stake of mining rights, and investors enter into joint ventures with the company. In such a case the state also benefits directly from dividend payments on profits. A less common approach is a barter system where extractive rights are exchanged for the construction of infrastructure. For example, in 2007, China entered into an US\$6 billion agreement under the Sincomines project with the Democratic Republic of Congo in which 68% of interests in the mining rights for copper and cobalt mines were granted to Chinese firms, in exchange for promised urban roads, highways and hospitals. The agreement included tax exemptions on the project until infrastructure loans are fully repaid.<sup>4</sup> However, such deals do not often work to the benefit of the host country. The Sincomines project has come under criticism as the promised infrastructure is barely being delivered.<sup>5</sup>

The combination and structure of the tax system generally depends on the fiscal objectives of the government.<sup>6</sup> In most cases, governments are aiming to:

- a. Secure revenue collection early in the project life.
- b. Maximise the government's take of revenues throughout the project lifecycle.
- c. Ensure adequate incentives for exploration and possible future projects.
- d. Increase their share of revenue when commodity prices increase.
- e. Maintain strategic ownership and interest.
- f. Minimise the administrative burden and risk.

Below is an analysis of the common fees and tax instruments in the extractive sector against government objectives:<sup>7</sup>

**Table 1: An analysis of the common fees and tax instruments in the extractive sector against government objectives:<sup>7</sup>**

	Bonuses	Royalties	Sliding royalties	Resources rent tax	Corporate income/variable income tax	State participation
Secure revenue collection early in the project life	■	■				
Maximise the government’s take of revenues throughout the project lifecycle				■	■	
Ensure adequate incentives for exploration and possible future projects				■	■	
Increasing share of revenues with commodity price increases			■			
Maintain strategic ownership and interest						■
Minimise administrative burden and risk	■	■				

► **What kind of taxes and fees apply to the industry?**

While like any other industry traditional taxes such as Value Added Tax, Corporate Income Tax, Property Tax and Capital Gains Tax apply, the extractive sector has a few fees and tax instruments unique to the industry including bonuses, royalties and rent tax. In some cases, state participation replaces the levying of tax instruments.

**Bonuses (signature, discovery or production)** are paid to the government as a single or staged lump sum payment triggered by events; they can be set in legislation, or negotiated, or subject to bidding. A signature bonus is paid for the attainment of extraction rights, a discovery bonus is paid on successful discovery of the extractive material, and a production bonus is paid upon achieving a certain level of production. *For example in 2017, Australia’s Armour Energy Limited, which received a petroleum exploration licence from the government of Uganda, paid the required signature bonus of US\$316,000 to the government of Uganda’s Petroleum Fund.<sup>8</sup> Where a project is not successful, bonuses are unrecoverable costs for the investor.*

**Royalties** are popularly defined as compensation for the extraction of finite resources. Like bonuses, royalties are often introduced to satisfy a policy objective of achieving an early and predictable revenue stream from the extractive sector. They are typically paid as a percentage of gross revenues rather than as a percentage of profit, most often charged at a specific time, or occasionally as a fixed amount per unit produced. Royalty rates differ according to the type of mineral or metals being extracted, and take no account of the costs of exploration, development or production. Consequently, depending on what those costs are, a fixed royalty on oil of say, 17%, could easily reduce company profits by 45% or more. Therefore, if a fixed royalty is too high, a producer may abandon the project even when production remains feasible. On the other hand, royalties do not account for the profit generated by the company, and if set too low and not complemented by a robust income tax, might result in under-taxing. Royalties can also be levied on a sliding scale. A sliding scale system entails royalties levied at different rates based on either the production volume or price of the commodity. In some cases, royalty rates are negotiated based on the cost model of the project, and are different for different projects. Typically, royalties are usually deductible from income taxes, except in a few cases.<sup>9</sup>

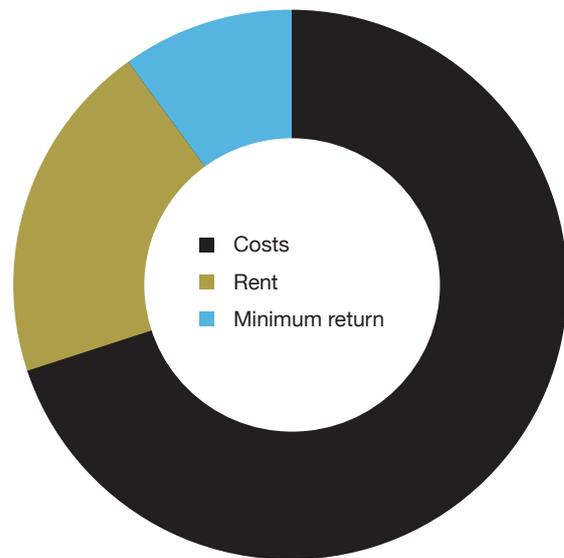
**Corporate Income Tax (CIT)** or corporation tax, is a direct tax levied on the profits of a company.<sup>10</sup> For extractive projects, CIT is determined by the total income of the business minus operating costs. Depending on the structure of the CIT, some taxes payable by the extractive project to the government, such as royalties, import duties and bonuses, will be deducted when determining the company's taxable income. Incentives such as tax holidays, carry forward losses and depreciation costs are commonly given to extractive companies. Costs and incentive deductibility make CIT in the extractive sector a complex tool in comparison to royalties. Different forms of windfall taxes are normally made use of to collect excessive profits from companies. A **Variable Income Tax (VIT)**, a form of windfall tax meant to capture more revenues in times of excess profit, is sometimes introduced to tax regimes to complement CIT.

**Resource Rent Tax.** Resource rent is income above the standard level return to capital invested in extractive projects in the country. Essentially, a resource rent is the excess of the total project lifetime value over the sum of all costs, including compensation to all factors of production.<sup>11</sup> The latter includes the minimum return on capital required by the investor to induce investment. The minimum return on capital is the minimum acceptable compensation for the given level of risk taken by investing in a project.<sup>12</sup> While a high CIT could discourage investment by reducing the profitability of a project, and consequently the dividends paid to investors, a tax on resource rents does not. The tax base of resource rent taxes are earnings above a standard level. In this case the standard level is the minimum return on investment. Rent taxes aim to preserve the surplus, and to transfer a substantial part of it to government. The anticipated earnings are calculated based on the total project lifetime, and are spread across the project lifetime.

### ▶▶ Are taxes on the extractive industry progressive taxes?

The most common example of progressive taxation is personal income tax with graduated rates. That is, higher income earners should pay more, and minimal income earners should be exempt. In the context of oil, gas and mineral resources, firms that exploit valuable resources have a greater ability to pay more, and so their tax liability should increase. Considering that investors in a resource project are very likely to be foreign wealthy shareholders for whom the dividends are the main source of income; any taxes that impact on the overall profit, and therefore dividends, of an extractive company are likely to be progressive in terms of their distributional impact.<sup>13</sup>

Figure 2. Capturing resource rents



Considering extractive resources can generate substantial rent, the best policy option is often considered to be a single tax rate on resource rent approaching 100%. Resource rent tax is an attractive base as projects can, in principle, be taxed at up to 100% without making the activity prohibitively unprofitable.

The resource rent potential of an extractive resource varies according to the quality of the resource. In the case of mineral deposits, among the key determinants of quality are the volume of the mineral extracted, its quality, ease of extraction and efficiency of post-extraction processing. In the case of oil deposits some key factors are the size of recoverable reserves, the quality of the oil, pressure of the reservoir, efficiency of oil extraction methods and degree of processing necessary to achieve a saleable product.<sup>14</sup>

However, in the practical sense no host government has relied fully on resource rent taxes. This is because of imperfections in tax system information and the conflicting fiscal objectives that governments have for revenue collection. Instead, resource rent taxes are combined with other taxes and charges.<sup>15</sup> The practice has been to combine taxes on income, which potentially captures resource rents, with other fees and taxes on production that provide revenue in the early stage and are less prone to abuse.

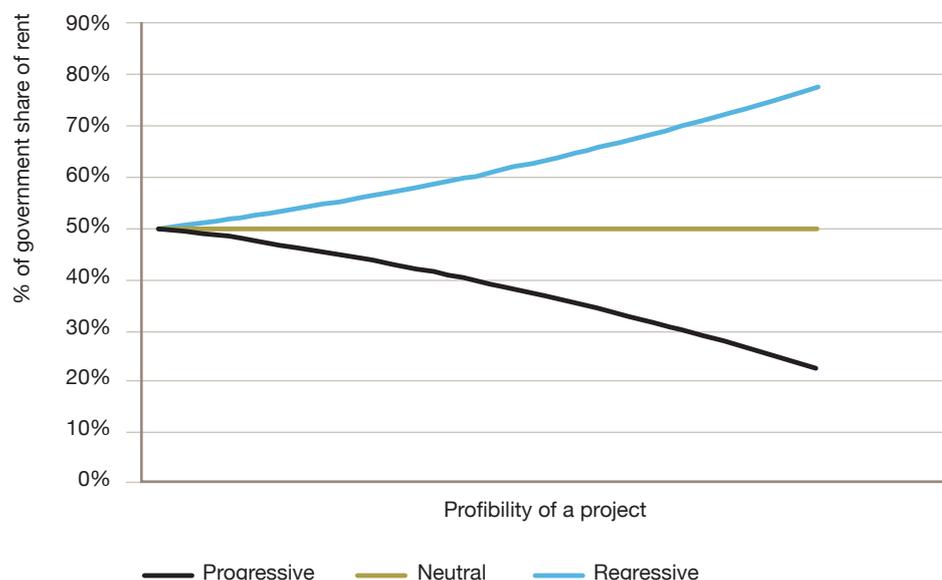
## How can taxation of the extractive sector be made more progressive?

### ► Maximising revenue through progressive tax instruments

As owners of the resource, citizens through their government are entitled to maximise the return on a finite resource. The fluctuation price of a resource, costs and production rates means that the profitability of an extractive operation changes over time. While most fiscal tools may generate extra income for governments as prices rise and fall, some do so better than others.

Fiscal systems can react to these changes in one of three ways. A regressive fiscal regime gives the state a lesser share of revenues when profitability increases. A neutral fiscal regime gives the state the same share of revenues when profitability increases. A progressive fiscal regime gives the state an increasing share of revenues when profitability increases. In the context of taxing extractives, progressivity refers to a rising government share of the net cash flows of a project.

**Figure 3. Illustration of progressivity, neutrality and retrogressivity**



The **Average Effective Tax Rate (AETR)** is the measure of a project's tax contribution, and a useful tool to measure the progressivity of the tax regime, when it is compared with for example the price of the resource. An AETR rising as profitability increases means a progressive system.

## Elements of a flexible and effective tax regime

The profitability of an extractive project is a function of the price of sales, the cost of extraction and production levels. As such, because progressivity of an entire tax regime is measured by the collective performance of individual tax instruments, it is essential to ensure the progressive elements of tax instruments outweigh the regressive elements. One way to do this is to add progressive elements to regressive taxes and fees.

For example, some countries opt for **sliding royalties** as opposed to fixed royalties as a way to ensure progressivity. Sliding royalties are often pegged to either the level of production, price of the extractive commodity, operating loss/profit margin, or the extraction method used. Sliding royalties on levels of production are a useful tool to ensure fair tax for artisanal and small-scale miners.

In Zambia, in a bid to make the tax regime more progressive, the government introduced a sliding mineral royalty scale on copper production, based on the price of copper on the London Metal Stock Exchange. The introduction of the sliding scale was also motivated by both flexibility and stability of mineral royalty rates in Zambia. The table below shows Zambia's sliding scale mineral royalty tax regime.

**Table 2: Zambia's progressive royalty rate tax bands for copper 2016 and 2019**

Copper Price Per ton	Tax rate 2016	Tax rate 2019
Less than US\$4,500/ton	4%	5.5%
US\$4,500-US\$6,000/ton	5%	6.5%
Above US\$6,000/ton	6%	7.5%
Above US\$7,500/ton	6%	10%

By using price, production and costs as a proxy for profitability, it is possible to create a fiscal system that is designed to generate a higher rate of government revenues as a project becomes more profitable. This can happen without measuring the actual profitability of a project, which is an administratively difficult and expensive process. A

common method is to determine the ratio of cumulative revenues divided by cumulative costs. For Peruvian petroleum production for example, an initial royalty rate of 15% would jump by steps to 35% as the cumulative revenues increase and costs reduce.

**CIT** is a useful tool to ensure a return to equity. CIT is at least partly borne by the company owner or shareholders, since they receive reduced dividends. Wealthy individuals, often men, usually represent most shareholders.<sup>16</sup> Since it taxes the full return to investors, including the required return to equity holders, the CIT is a blunt instrument for reaching rents.

However, a fixed corporate income tax on extractive profits is a neutral fiscal tool because the tax is applied to a corporation's net income (or profit). The tax rate is the same, regardless of whether that profit is large or small. Fixed percentage profit sharing in some oil projects works the same way – it is also a neutral fiscal tool.

The base of the CIT is the difference between revenues and deductible expenses. Deductible expenses include actual expenses (operating costs, financial expenses, deductible taxes) and fictitious expenses (depreciation, loss carry forwards). A sliding CIT is used by some countries to ensure adequate capture of resource rents: South Africa uses a formula to calculate a progressive rate between 0% and 34%,<sup>17</sup> while Madagascar has three rates of 25%, 35% and 40% that increase with the internal rate of return of industrial gold mines.<sup>18</sup>

CIT can also be complemented by a **VIT** that uses the CIT base, but varies the rate of tax according to the ratio of profits to gross revenues. To complement CIT, Zambia introduced a VIT in 2008 with a rate of up to 15%, calculated on the ratio between taxable profits and sales revenue when this ratio exceeded 8%.

**Resource rent taxes** are useful tools to ensure progressivity, as they directly attempt to tax the rent of an extractive company. Examples of inclusion of these taxes in country fiscal frameworks are those of the additional profit taxes in Zimbabwe and the mineral resource rent taxes in Sierra Leone. The rate of the first tax is determined by the formula:  $(41.5 - T) / (100 - T)$ , where T refers to the rate of income tax on mining companies. With the current CIT in Zimbabwe set at 15%, the payable tax is 32%. Similarly, in Sierra Leone mineral rent tax is determined by the formula:  $(40 - \text{Income Tax Rate}) / (100 - \text{Income Tax Rate})$ , where Income Tax Rate refers to the corporate income tax rate on mining companies. Both taxes make use of the level of profitability as their base.

## ▶ Artisanal and small-scale mining

Artisanal and small-scale mining (ASM) consists of formal and informal mining operations that predominately make use of simplified forms of exploration, extraction and processing. ASM is often low capital intensive and very high labour intensive, mostly carried out by indigenous workers. In the Democratic Republic of Congo, ASM is estimated to employ up to two million people,<sup>19</sup> 15% of total employment.<sup>20</sup> ASM contributes an estimated 25% of the world's production of gold, tin and tantalum, while accounting for less than 5% of the worldwide production of iron, lead, zinc and copper.<sup>21</sup> Around 34% of Ghana's total gold production is produced by the ASM sector, in Central African Republic ASM accounted for more than 371,000 carats of diamonds, half of the country's total exports,<sup>22</sup> and in Zimbabwe over 60% of total gold produced in the past three years was through ASM.<sup>23</sup> While artisanal and small-scale mining differs significantly across countries and resources, the problems faced by artisanal and small miners are often poor geological mapping, lack of appropriate mining technology and price exploitation. In most countries the sector is poverty driven, and is used as a subsistence means of livelihood. It can be argued that if costed, the cost of labour incurred for most ASM projects is significantly higher than the income earned from sales. From that perspective, an income tax on ASM could be considered generally regressive. To ensure that the tax on extractives from artisanal mining does not unfairly affect those already struggling to make ends meet, and who would likely fall below the threshold for PIT, it should be paid by buyers and traders of the products.

The principle of progressive taxation is to ensure that the higher the income that one earns, the more tax is due. Progressivity also means minimal income earners are exempt from making tax payments. In the case of the ASM, a good practice in ensuring progressivity to support the formalisation of the sector is charging only progressive royalties based on production volumes, and an environmental tax in case environmental damage occurs without rehabilitation. In Zimbabwe, royalty rates for gold production greater than 0.5kg are charged at 5%, while the rate for amounts under 0.5kg is charged at 1%, thus making tax fair for artisanal and small-scale miners who have less ability to pay.<sup>24</sup> In Tanzania, which has a fast growing ASM sector, in order to make taxes more progressive, the sector was relieved of the tax burden of paying withholding tax of 5% and 18% VAT, leaving the sector with a primary licence fee and a 7% tax obligation on the value of sells only.<sup>25</sup>

## ▶ Flexibility and stability

A common feature of contracts in the extractives sector is stabilisation clauses. Stabilisation clauses are guarantees on the stability of the legal and fiscal regimes governing investment projects.<sup>26</sup> From an investor's perspective, stabilisation clauses constitute a risk-mitigation tool to protect foreign investments from political risks, in which the host state could use changes in circumstances to impose new requirements on investors.<sup>27</sup> New requirements are often useful for governments and communities, as these can include requirements on environmental protection. Stabilisation clauses tend to be problematic from a tax perspective, as they can freeze the fiscal terms in the law or contract at the time a project begins, such that changes in tax law may not be applicable to existing mines. Poorly

negotiated contracts with stabilisation clauses can result in significant loss of potential revenues for governments.

In contrast, a progressive tax system that adapts to changes in commodity prices provides a better guarantee of sufficient government revenue, while providing a clear frame to investors. If the tax system is progressive, then it is more likely to be stable, in the sense that a progressive tax regime is designed to adjust to different instances that affect the cash flow and profitability of an extractive.<sup>28</sup> A progressive tax regime does not get subjected to political or bureaucratic pressure when the economic conditions of a natural resource project change, and so might actually be more stable than regimes that rely on stabilisation clauses. A good system should leave the government the tools to ensure collection of a fair level of revenue from extractive projects.

## ► Challenges in collection and compliance

The collection of taxes through the different tax instruments is heavily dependent on tax administration capacity. While revenue-based payments are often considered easy to administer, the under-declaring of production and manipulation of sales is common in the extractive sector. Revenue-based taxes require an aggressive approach for governments to monitor extractive projects from the point of exploration to the point of sale.

Even more challenging and requiring frequent cost audits are profit-based taxes. Profit is a function of revenue and costs of a project. Depending on the structure of a tax such as the CIT, some taxes payable by the extractive project to the government, such as royalties, import duties and bonuses, will be deducted by determining the company's taxable income, in addition to other incurred costs. Extractive companies can also lower their CIT liability by making use of fragmented supply chains, outsourcing services such as marketing services in low-tax jurisdictions for the purpose of splitting functions and risks to divide profits. Intra-group charges (e.g. technical fees and management fees)<sup>29</sup> are also often used by extractive companies to lower their tax burden. Facilitating this most times are Double Tax Treaties (DTTs).

CIT also incentivises debt-financing, since (with rare exceptions) interest is deductible whereas investment capital is not. If taken advantage of, this can potentially create an incentive for a multinational company to lend funds to a subsidiary at a high rate of interest in order to reduce

the subsidiary's taxable profits, a form of transfer pricing abuse known as thin capitalisation. In a study of five mining companies operating in Zambia, it was found that they have leverage levels ranging from 63% (0.63:1 debt:equity ratio) to 1,329% (13:1 debt:equity ratio). Three of the five had at some point in the review period exceeded the 3:1 limit legally prescribed under Schedule 5 of the Zambia Income Tax Act. This essentially means that thin capitalisation is prevalent in the mining sector, as such income tax liabilities are reduced using debt and interest payments.<sup>30</sup>

Considering the multiple tax agreements that apply to corporate taxes, multinational corporations can exploit these complex and often incompatible systems, using various techniques to shift taxable profits to countries that offer lower corporate tax rates (i.e. tax havens), while also benefiting from tax incentives offered by other countries, giving rise to tax avoidance. The Intergovernmental Forum on Mining, Metals and Sustainable Development estimate that there are an average of 4.7 tax incentives per mining contract. Cost-based incentives such as investment allowances and tax credits are uncommon, despite being better suited to attracting mining investments. Most of the tax incentives offered are on corporate income tax, tax stabilisation and royalties. These incentives have proved in several instances to be wasteful and limit the ability of a nation to optimise revenue collection from mining. Between 2009 and 2014, Malawi lost approximately US\$15.53 million from Paladin mine, which was given an incentive to pay a reduced royalty rate of 1.5% for the first three years, and 3% in its other years of operation. The normal royalty rate in Malawi is 5%.<sup>31</sup>

## Recommendations

### ▶▶ Ensure sufficient capacity of the tax administration

The starting point of ensuring that the tax framework in the extractive sector is fair and effective is improving the administrative capability of the government's revenue collection body, to be able to understand the scope of the sector and identify opportunities and risk that may arise from a different blend of tax instruments. Improving the administrative capacity of a revenue authority would require creation of a dedicated unit for the extractive industry, considering the uniqueness of the sector. Coordination among different government agencies working with extractive industries is also pivotal. Understanding and having information on the geological information of the project, cost structure and break-even scenarios are of utmost importance for extractive tax framework development. This can also be useful for countries in developing a model contract. A dedicated unit needs to also have a specialised transfer pricing unit, considering the high transfer pricing risks in the extractive sector.

### ▶▶ Set up a fair and effective fiscal tax regime

The fairness and effectiveness of tax regimes is determined by the blend of a variety of tax instruments. Governments need to introduce elements that help maximise revenue potential and adapt to changes in commodity prices and profitability of businesses. Sliding royalties should be considered as opposed to fixed royalty rates, as well as a resource rent tax or VIT to accompany CIT. Governments need to further ensure that tax trickles down to host communities where the economic activity is taking place and where value is created.

### ▶▶ Set up strong anti-avoidance and enforcement rules and structures

Governments must limit opportunities for profit-based tax avoidance by introducing and enforcing anti-avoidance rules, inclusive of strict interest deduction limitations rules. Governments must also ensure that a legislative framework with punitive measures is enacted if an extractive company is under-declaring the value of their production or overstating their costs of production. To ensure enforcing such a law, governments need to undertake frequent production and cost audits of the extractive sector to ensure that the correct tax liability is paid by extractive companies.

### ▶▶ Review and revise tax treaties and tax incentives

Governments must prioritise the review of tax treaties that might restrict their taxing rights of revenue from extractive companies, and open up opportunities for tax avoidance. Reviewing tax treaties means that revenue impact assessments of tax incentives need to be done to identify wasteful incentives. Impact assessments should be subject to greater public scrutiny.

### ▶▶ Ensure high levels of transparency around extractive industry taxation

Transparency is key to taxing the extractive sector, playing a critical role in tackling corruption. There is a need to improve the transparency of global multinational transactions and tax payments by: introducing robust automatic exchange of information systems with other tax authorities; considering introducing mandatory public country-by-country or project-by-project reporting for large companies as required by the European Union, UK and Canadian mandatory disclosure laws;<sup>32</sup> and signing onto the Extractive Industry Transparency Initiative (EITI), a global standard for disclosures in the extractive industries. Contract transparency and public beneficial ownership registers are also crucial components of transparency, helping to ensure accountability of both the government and extractive companies.

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**ActionAid** is a global movement of people working together to achieve greater human rights for all and defeat poverty. We believe people in poverty have the power within them to create change for themselves, their families and communities.

ActionAid is a catalyst for that change.

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August 2020