Post-COVID-19: How Governments Should Respond to Fiscal Challenges to Spur Economic Recovery

A paper series by the International Tax and Investment Center (ITIC) offering tax policy guidance to developing countries during the post-pandemic recovery phase.

November 2020

Working with a number of highly regarded international experts, the International Tax and Investment Center (ITIC) developed the series, *Post-COVID-19: How Governments Should Respond to Fiscal Challenges to Spur Economic Recovery*, to offer tax policy guidance to developing countries during the post-pandemic recovery.

Covering a half-dozen topics in tax policy, this series analyzes both effective measures to be pursued and problematic options to be avoided for their potential net-negative impact in terms of other revenue streams, employment, and indirect/secondary effects, etc. In short, what should governments consider doing to raise revenue without harming growth and investment?

Beginning with a macroeconomic scene-setter on the fiscal implications of rising debt levels, the series explores the post-crisis environment for best practices in several key aspects of international taxation, including corporate taxation, transfer pricing and withholding tax, VAT, oil and gas fiscal policies, excise taxation, and taxation of SMEs.

The entire series has been published by *Tax Notes International* and is now available on TaxNotes.com.

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Daniel A. Witt
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Post-COVID-19: Responding to the Fiscal Challenges

by Charles E. McLure Jr.

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Post-COVID-19: Responding to the Fiscal Challenges

by Charles E. McLure Jr.

Charles E. McLure Jr. introduces the series, *Post-COVID-19: How Governments Should Respond to Fiscal Challenges to Spur Economic Recovery*, coordinated by the International Tax and Investment Center (ITIC) to offer tax policy guidance to developing countries during the post-pandemic recovery phase.

Charles E. McLure Jr. is a senior fellow, emeritus, with the Hoover Institution.

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The COVID-19 pandemic has had unimaginably horrible effects on the health of people throughout the world, in both developed and developing countries. Social distancing and the widespread lockdowns imposed in the effort to halt the spread of the novel coronavirus, along with disruptions of supply chains and reductions in demand, have had devastating economic and fiscal effects. While tourism and air travel have been particularly hard hit, restaurants, hotels, theaters, car rentals, and activities that require close personal contact have also suffered disproportionately. In May Oxford Economics forecasted a 4 percent drop in world GDP for 2020, and in June the IMF forecasted a 5 percent global contraction. Governments have seen revenues fall, while expenditures — for healthcare, payments to households, and bailouts for business — and thus budget deficits — have skyrocketed.

The International Tax and Investment Center, for which I served as the economic adviser for a few years, beginning with its inception in 1993, has coordinated a set of seven articles dealing with the fiscal issues facing developing countries in the wake of the pandemic. Although the target audience is finance ministers and revenue officials responsible for tax policy in developing countries, a wider audience would benefit from studying these articles.

The first article, "Coronavirus — Fiscal Challenges for Emerging Markets," by Oxford Economics, provides an overview of the problem and how and why it differs both from those in developed countries and among developing countries. It highlights factors that are likely to aggravate the healthcare crises, including inadequate healthcare, demographics (an older population), crowding in urban areas, connectedness with the developed world, and large informal sectors. The severity of economic effects is related to lack of broadband (making working from home and online ordering for delivery unlikely), dependence on tourism and commodity exports, reliance on foreign capital inflows, weak social security systems, and lack of fiscal space. On these criteria, the situation seems worst in the countries of Latin America and best in those of emerging Europe.

On the fiscal side, developing countries as a whole may be in a better position than their developed counterparts for several reasons. Their support packages, especially loans and guarantees, are thus far smaller than those in developed countries, in some cases because the countries lack the requisite institutional infrastructure and financial resources. In some cases, there may be less demand for spending, because the healthcare crisis has not been as bad where populations are younger, there is less international connectedness, and/or a less well-developed social safety net.

Coming articles discuss general aspects of corporate income tax ("Post-COVID Corporate Tax Policy," by Jack M. Mintz) and the more specialized questions related to transfer pricing and withholding taxes ("Global Tax Policy Challenges After COVID-19: Transfer Pricing and Withholding Tax Aspects," by Hafiz Choudhury and Peter Hann). Those making corporate tax policy face several crucial questions: Should

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corporate taxes be raised to increase revenues, or should they be reduced to spur economic growth? If corporate taxes are to be raised or lowered, should it be by changing rates or by changing provisions that have an "up-front" impact, such as the structure of depreciation allowances and investment credits? To set the stage for the discussion of post-COVID policy, Mintz examines what happened to statutory tax rates, tax bases, marginal effective tax rates, and revenues from 2010 to 2019. He then explores COVID's effects on economic activity and considers the relationship between corporate tax policy and employment, (de)leveraging, trade and competitiveness of taxes, climate change, investment and technological adoption, and inequality. He ends with the sober conclusion that "Too much is uncertain now to even make any predictions."

Choudhury and Hann's article on transfer pricing and withholding taxes begins with a survey of the economic effects of COVID-19 that are particularly relevant for those aspects of corporate tax policy. The discussion of post-COVID administration of transfer pricing highlights (the often inadequate) capacity of the tax administration; the need to make use of existing information, including transfer pricing documentation; the difficulty of finding comparable companies and transactions, especially in developing countries, and the possibility of using the profit-split method; and the potential for fruitful exchange of information. Other topics discussed are business restructuring, intangibles, financial transactions, transfer pricing audits, and the taxation of digital services. The authors discuss withholding taxes on payments for the use of intellectual property and technical service and management fees and taxes on branch remittances.

An article by Richard Bird, "VAT in and After the Pandemic," discusses the world's "revenue workhorse." As in 2008-2009, VAT revenues have fallen, but the impact of COVID-19 is likely to be more severe, because consumption, especially that subject to VAT, has fallen, tourism (important in some countries) has plummeted, trade has declined, and governments have reduced VAT in an attempt to shore up economic activity. In addition to rate increases, revenues can, in principle, be increased by closing the "VAT gap" — the difference between actual revenues and the hypothetical yield of a VAT with one rate and no exemptions.

Elizabeth Allen, in "Using Excises to Increase Government Revenue Post-COVID-19," argues that "Of all the direct and indirect tax options" to increase tax revenues, "excise taxes should be the easiest source." She examines the pros and cons of various types of excises, ranging from those on alcohol, tobacco, gambling, and motor fuels to those on sugar-sweetened beverages, other services, and luxuries, cataloguing the pros and cons of each. She then goes through the crucial nuts-and-bolts issues of tax design and administration.

The pandemic and measures to control it, by drastically reducing demand for petroleum products, caused prices to collapse and has reduced investment spending. The article "Oil and Gas Fiscal Policies: The Impact of Oil Price, Investment, and Production Trends," by Carole Nakhle and Theo Acheampong, examines whether petroleum-producing countries should reexamine the fiscal regimes they apply to this sector. Besides providing an overview of the situation, the article presents case studies for 10 countries, of which all but three are developing countries.

There is general agreement that fiscal terms need to be eased to soften the blow on oil companies; the pressure to do so will increase, the longer lower oil prices prevail, but there will be a tendency to ease regulations before pursuing fiscal changes. Countries that depend heavily on revenues are likely to respond most slowly, as are those with nationalistic attitudes toward natural resources. Importantly, fiscal regimes that are profit based and/or emphasize recovery of investment are more likely to generate investment than revenue-oriented regimes such as royalties and signature bonuses, even if tax rates are lower.

The final article, "Taxation of SMEs to Support Economic Recovery Post-COVID-19," by Elizabeth Allen and David Child, emphasizes the need for measures to increase cash flow to an especially hard-hit part of the economies of many developing countries, small and medium-size enterprises. It suggests options for changes in both tax policy and tax administration that would benefit the target businesses, focusing on customs

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duties, excises and environmental duties, VAT, income taxes on business profits, and withholding taxes on employee wages and other payments by SMEs. The articles described above deal with several of these at length. This article also outlines specific options for encouraging post-COVID recovery: simplification and reduction of compliance costs, rationalizing taxation of the informal sector, and new tax regimes that could be introduced to reduce reliance on existing revenue sources. Being realistic, the article also lists constraints on tax policy and administration. Finally, the article emphasizes the need to move quickly.

The fiscal effects of COVID-19 are likely to last longer — and perhaps much longer — than the present crisis. These articles, even though they do not provide cookie-cutter recipes, will provide valuable inputs to policymakers as they try to deal with these effects. ■

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Coronavirus — Fiscal Challenges for Emerging Markets

by International Tax and Investment Center

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Coronavirus — Fiscal Challenges for Emerging Markets

This article is part of the series, *Post-COVID-19: How Governments Should Respond to Fiscal Challenges to Spur Economic Recovery*, coordinated by the International Tax and Investment Center (ITIC) to offer tax policy guidance to developing countries during the post-pandemic recovery phase.

In this installment, Oxford Economics analyzes the impact that the coronavirus pandemic will have on emerging markets and the wider world in 2020.

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The coronavirus and the policies adopted to fight it are set to have a massive negative impact on output in emerging markets and the wider world in 2020. A variety of factors including demographics, social conditions, health care systems and structural economic vulnerabilities will affect how badly emerging markets are hit, both as a group and individually, with Latin American economies perhaps most at risk. Large rises in budget deficits and public debt are also likely across most emerging markets. The rises in public debt we forecast do not look unmanageable in most cases, but market tolerance for fiscal slippage tends to be lower for emerging economies than for the advanced economies, and there may be a number of economies for which pressures on public finances will be sufficiently large to cause financial jitters this year. The authorities in emerging markets face a balancing act between trying to avoid fiscal efforts spilling over into financial instability and preventing real economic distress that can spill over into social and political unrest.

The Impact of Coronavirus and Containment Policies on the World Economy

The coronavirus is set to have a massive negative impact on world output in 2020. The combination of supply disruptions and demand destruction caused by the virus, and by the policies adopted to combat it, point to global GDP falling this year at the fastest pace since World War II. We forecast a drop of nearly 4 percent in world GDP during 2020, with the decline concentrated in the first half of the year during which we expect a slump of some 7 percent.

A key factor behind this collapse in activity is the economic impact of social distancing and lockdowns. Around 40 percent of consumer spending in sectors such as tourism, restaurants, hotels, and cinemas and also clothing and car purchases, normally occurs in crowded areas or social situations. A large chunk of this "discretionary" consumer spending will be postponed, and some of it will be lost permanently. With much of this spending being on services, the 2020 global recession will be unusually "services heavy" compared to previous recessions.

If we adapt the estimates of lost and postponed consumption by sector in Keogh-Brown et al.[1] (which appears to be borne out by high frequency data for Q1 2020) we can get a sense of how big the impacts might be. Even under a "moderate" lockdown, in which only 50 percent of consumers changed their behavior, consumer spending would drop 5 percent in a quarter if the lockdown lasted three weeks. The decline deepens to 9 percent and 18 percent if the lockdown is extended to six and 12 weeks respectively. In a "strict" lockdown where 90 percent of consumers changed their behavior, consumer spending would fall 8 percent in a quarter if lockdown lasted three weeks, worsening to over 30 percent for a 12-week lockdown.

[1] Marcus Keogh-Brown, Simon Wren-Lewis, W. John Edmunds, Philippe Beutels, and Richard D. Smith, "The Possible Macroeconomic Impact on the UK of an Influenza Pandemic," University of Oxford Department of Economics Discussion Paper Series No. 431 (May 2009).

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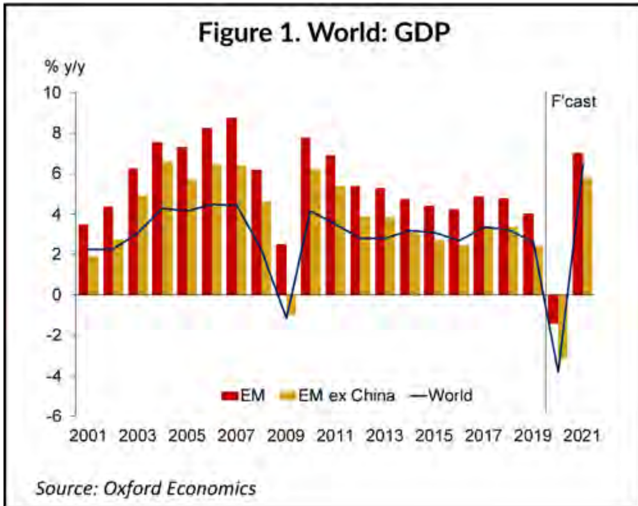

Figure 1. World: GDP

Source: Oxford Economics

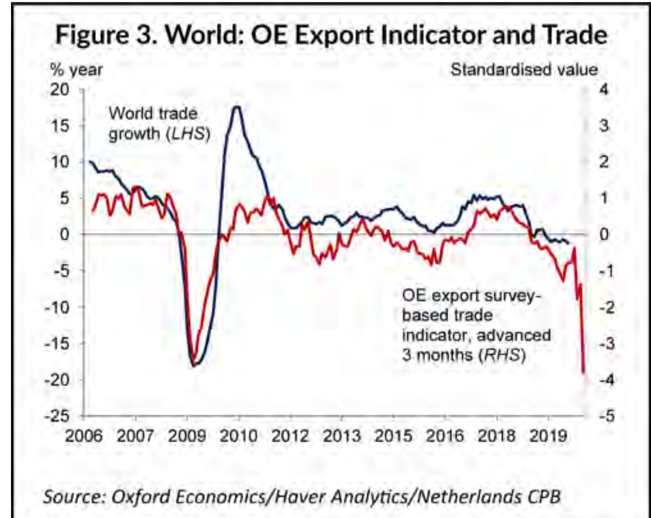

Figure 3. World: OE Export Indicator and Trade

Source: Oxford Economics/Haver Analytics/Netherlands CPB

Drastic declines in consumer spending imply steep declines in production and trade too. On the trade front, the evidence of this is already visible. Leading indicators point to a decline in goods trade of over 10 percent year-on-year in March-April, and services trade is likely to fall even faster as sectors such as tourism and air travel have collapsed. As well as weak final demand, trade is likely to be further disrupted by supply chain problems as producers of final goods struggle to source intermediate inputs because of factory closures in other economies. We think total world trade in goods and services could fall by 10-15 percent this year, versus a 10 percent decline during the global financial crisis.

We expect steep declines in output in both advanced and emerging markets (EM). For EM, our baseline forecast is for a decline in GDP of 1.4 percent this year, with the fall in EM excluding China at 3.1 percent. These declines in annual output are smaller than for advanced economies, but that partly reflects the fact that trend growth in EM is somewhat higher than for advanced economies: In December, we forecast EM growth at 4.3 percent for 2020, so the downward revision has been massive. For ex-China EM the scale of the revision is broadly similar to that in advanced economies.

How the Crisis Might Impact Emerging Markets and Advanced Economies Differently

How might the coronavirus crisis impact EM and advanced economies differently? It is risky to generalize about EM too much as there is a great deal of variation across EM. However, there are

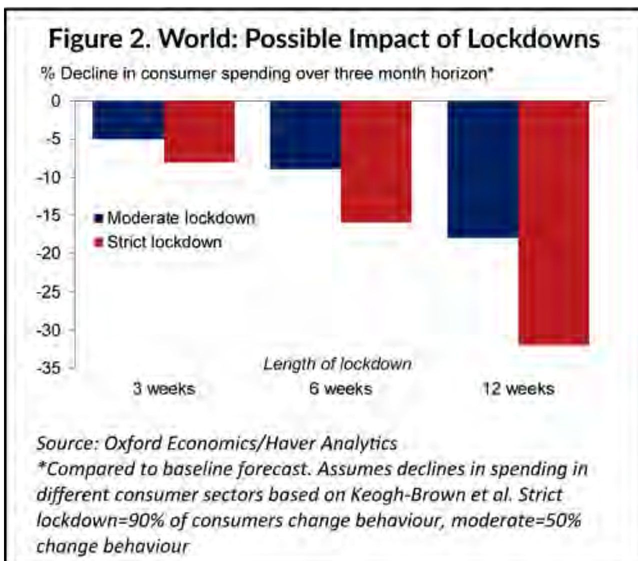

Figure 2. World: Possible Impact of Lockdowns

Source: Oxford Economics/Haver Analytics
**Compared to baseline forecast. Assumes declines in spending in different consumer sectors based on Keogh-Brown et al. Strict lockdown=90% of consumers change behaviour, moderate=50% change behaviour*

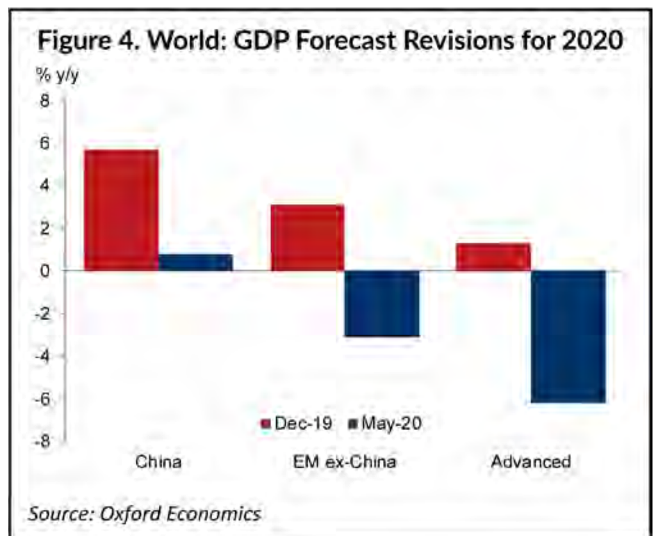

Figure 4. World: GDP Forecast Revisions for 2020

Source: Oxford Economics

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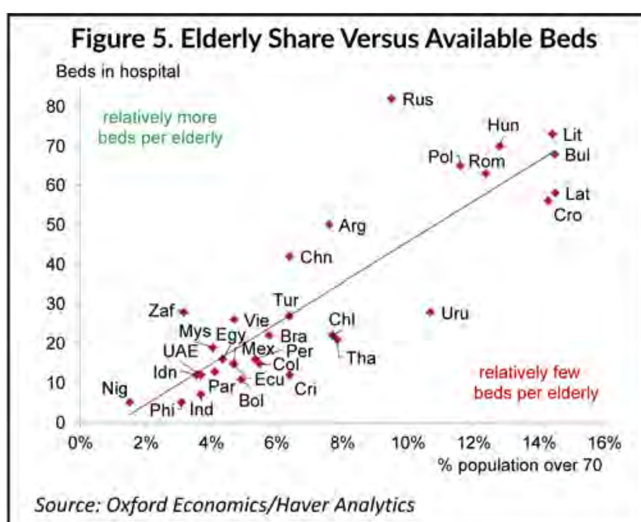
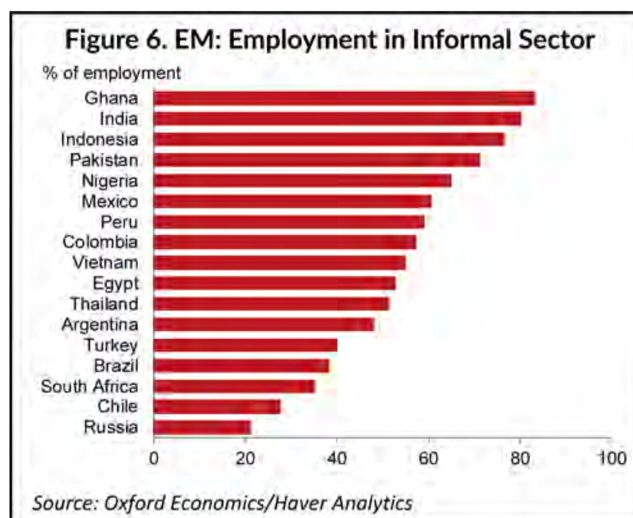




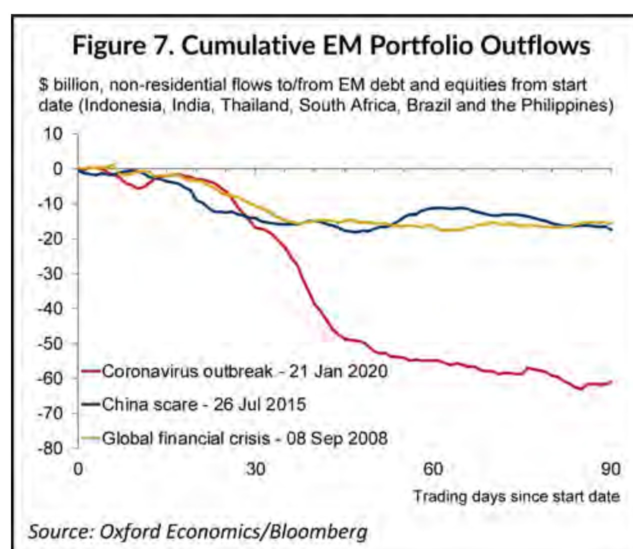
several possible factors that may lead to EM being more severely — or less severely — affected.

Weak healthcare infrastructure. EM tend to have fewer hospital beds, fewer healthcare professionals, and less specialized medical equipment than advanced economies. This risks healthcare systems being overwhelmed by large numbers of coronavirus cases, so that many people do not get appropriate care and death rates are higher.

Demographics. EM tend to have younger populations than advanced economies. This is an advantage given that elderly people tend to be far more at risk from coronavirus. Demographics and the quality of healthcare systems tend to be negatively correlated: A young population in Nigeria is offset by low levels of health provision while an older population in Hungary goes together with more hospital provision. Looking across EM, the most vulnerable are places like Chile, Peru and Thailand which have both weak health systems and comparatively large numbers of over 70s in the population.

Lack of financial buffers/social security systems. It may be hard to enforce or maintain lockdowns in some EM given weak social security systems and a high share of informal employment (often more than 60 percent) which together mean that such lockdowns will quickly lead to widespread hardship. In many poorer EM, household financial buffers (for example, savings) are also often very limited.

Structural economic vulnerabilities. EM may have structural economic vulnerabilities that



make them economically more sensitive to the coronavirus crisis. One of these is reliance on foreign capital inflows to fund budget and/or current account deficits. Since the crisis began, there has been a very strong outflow of foreign capital from EM, worse in scale than in the global financial crisis. This risks leading to rising borrowing costs, liquidity squeezes, and weaker economic growth and government revenues.

Some EM are also heavily reliant on economic sectors that are being especially hard-hit by the crisis such as tourism and commodity production in which huge losses of export earnings are likely. Another potential structural weakness is weak communications infrastructure such as broadband, which may make it hard for workers to work from home/organize online delivery, and

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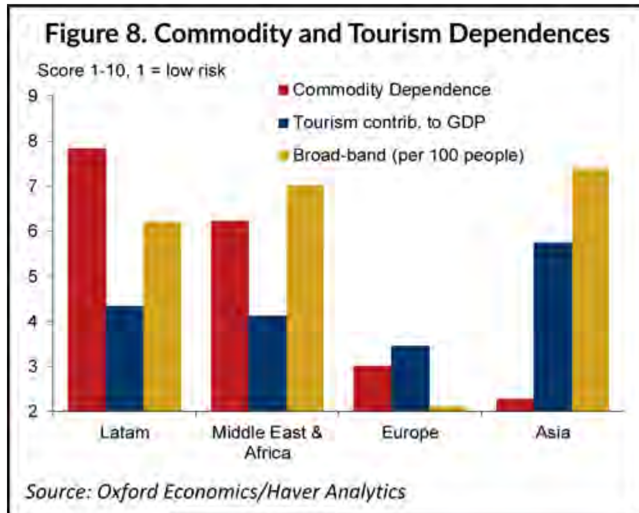
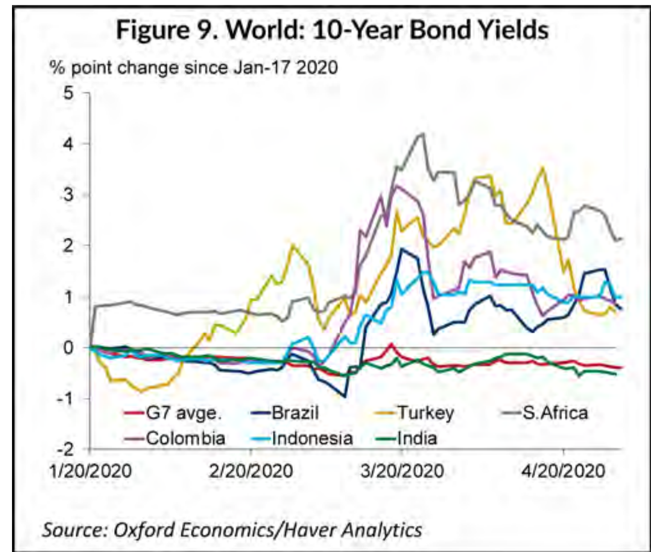


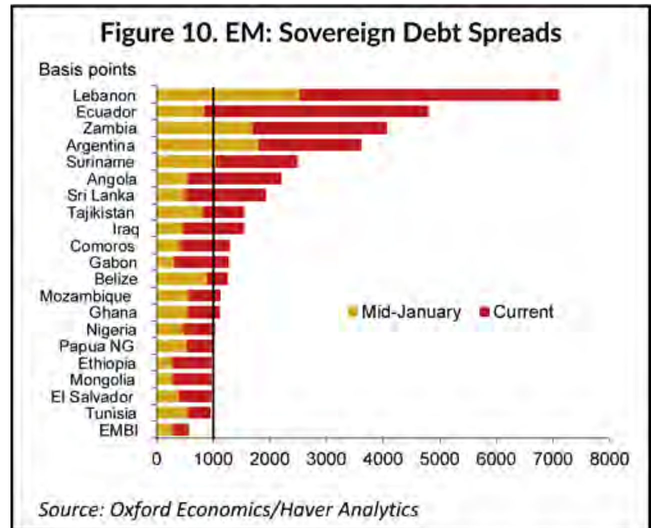
so forth. These sectoral vulnerabilities vary across regions but seem highest in Latin America and lowest in emerging Europe.

Another potential structural weakness is high reliance on foreign currency debt, both by governments and the private sector. The slump in capital inflows and related weakening of local EM currencies (by 10-20 percent in some cases since mid-January) threatens to sharply raise the local currency value of their dollar debt.

Lack of fiscal space. Some studies suggest that early and large-scale fiscal interventions are important in curtailing the costs of pandemics. But some EM may lack the fiscal space to do this. In most advanced economies, governments have engaged in massive budgetary actions to try to soften the economic blow of the coronavirus (and of lockdown policies). They have been helped in this by the fact that their bond yields are low and have generally compressed further since the crisis began (partly the result of a "flight to safety") by investors.

By contrast, many EM look much more constrained on the fiscal side — initial deficits were higher, investors' tolerance for rising debt and deficits is often lower, and borrowing costs have been rising since the crisis began. Most strikingly, around 20 EM sovereigns' external debt is trading at "distressed levels" with spreads over U.S. Treasuries of 1,000 basis points or more. These economies owe about $1 trillion of debt or 13 percent of the EM total. Borrowing costs in local currency have also tended to rise, but not in all cases (for example, India and China, where they have fallen). The initial spikes in local





currency borrowing costs have also moderated somewhat in several EM recently.

Social conditions. The coronavirus is believed to thrive best in crowded conditions, and thus may spread rapidly in the overcrowded urban areas of some poorer EM. Risks connected with the virus are also linked to poorer general health, again potentially an issue for some EM.

International connectedness/megacities. It appears likely that the coronavirus spread quite early to economies with large cities that are highly internationally connected (for example, New York, London). For many EM, levels of international connectivity are relatively low. This may mean that lockdown policies can be more effective in stopping the progress of the virus quickly — this could also mean lower economic costs.

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COVID-19 Vulnerability Scorecard

	Health system Collapse				Goverment Buffer		Activity Shock				
	% Population > 70 (avg 2017-2020)	Hospital beds	Density of doctors	Social insurance programs adequacy	Fiscal Deficit	Debt (% GDP)	Female Labour partic-ipation	Tourism contrib. to GDP	Broad-band (per 100 people)	Commodity Dependence	Reliance on supply chain
Egypt	4.3%	16	8	39	-8.2	85	31%	9%	7	48%	46%
Nigeria	1.5%	5	4	29	-4.8	30	85%	5%	0	96%	40%
UAE	3.7%	12	24	n/a	1.2	20	55%	12%	31	86%	33%
Turkey	6.4%	27	18	45	-2.6	30	46%	11%	16	18%	42%
S.Africa	3.2%	28	9	44	-6.2	60	78%	7%	2	51%	42%
Argentina	7.6%	50	40	43	-4.3	93	67%	9%	19	62%	27%
Brazil	5.8%	22	21	48	-5.8	92	73%	8%	15	63%	32%
Chile	7.7%	22	11	23	-2.5	28	69%	10%	17	86%	39%
Colombia	5.5%	15	21	38	-1.4	51	72%	5%	13	79%	31%
Ecuador	4.7%	15	21	42	-2.9	49	69%	5%	11	94%	35%
Mexico	4.7%	15	22	37	-2.1	54	56%	15%	15	17%	14%
Peru	5.3%	16	13	20	-1.7	27	83%	9%	7	89%	53%
Bulgaria	14.5%	68	40	36	-1.0	19	80%	11%	27	38%	49%
Croatia	14.3%	56	30	43	0.6	71	79%	25%	27	32%	54%
Hungary	12.8%	70	32	61	-1.6	68	75%	8%	32	12%	58%
Latvia	14.5%	58	32	48	-0.8	36	82%	8%	27	37%	51%
Lithuania	14.4%	73	43	51	0.3	32	85%	5%	28	36%	44%
Poland	11.6%	65	24	74	-0.3	48	75%	5%	16	20%	64%
Romania	12.4%	63	23	68	-4.7	37	71%	6%	26	17%	58%
Russia	9.5%	82	40	26	2.3	16	78%	5%	22	65%	51%
China	6.4%	42	18	55	-4.6	56	80%	11%	29	6%	51%
India	3.7%	7	8	5	-3.8	69	30%	7%	1	30%	61%
Indonesia	3.5%	12	4	n/a	-2.1	30	64%	6%	3	55%	48%
Malaysia	4.1%	19	15	30	-3.1	56	66%	11%	9	30%	45%
Philippines	3.1%	5	13	10	-1.3	39	62%	25%	4	16%	47%
Thailand	7.8%	21	8	75	-2.9	42	78%	20%	13	23%	33%
Vietnam	4.7%	26	8	29	-2.6	54	88%	9%	14	17%	31%
Bolivia	4.9%	11	16	34	-8.0	58	71%	6%	4	95%	34%
Costa Rica	6.4%	12	11	33	-6.5	57	62%	12%	17	45%	23%
Paraguay	4.1%	13	14	28	-1.6	24	68%	4%	5	88%	25%
Uruguay	10.7%	28	50	46	-4.7	64	76%	16%	28	78%	24%

Looking across different risk factors, the most worrying region looks to be Latin America given its limited fiscal space and structural vulnerabilities. Emerging Europe looks best placed, although painful economic lockdowns may still be needed to protect its relatively high elderly population.

Fiscal Implications of the Coronavirus Outbreak for EM

The massive declines in GDP we expect because of the coronavirus are set to push up budget deficits sharply across the world. Government revenues will slump as economic activity contracts because of lockdowns, social distancing, and the associated slump in output. Meanwhile, government spending will rise on healthcare, social protection including unemployment payments, and explicit policies to tackle the economic impact of the virus such as wage subsidies and support for firms.

These measures are set to push budget deficits in the advanced economies to levels last seen in wartime — we expect deficits in the U.S. and U.K., for example, to reach 20-25 percent of quarterly GDP in Q2 and be 10-15 percent of GDP for the whole of 2020. Recent IMF estimates put the cost of coronavirus-related direct financial support

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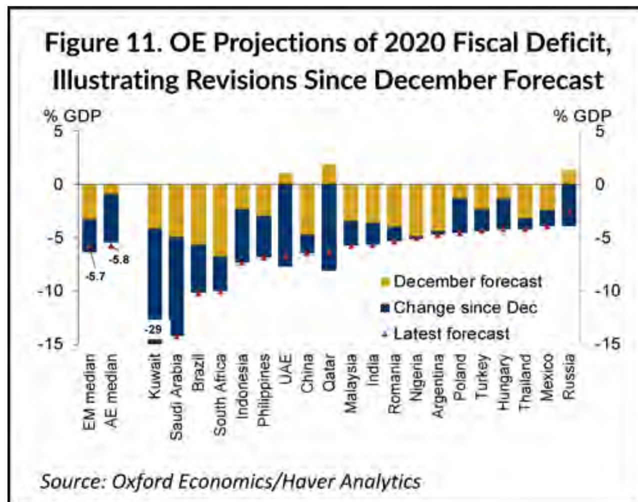
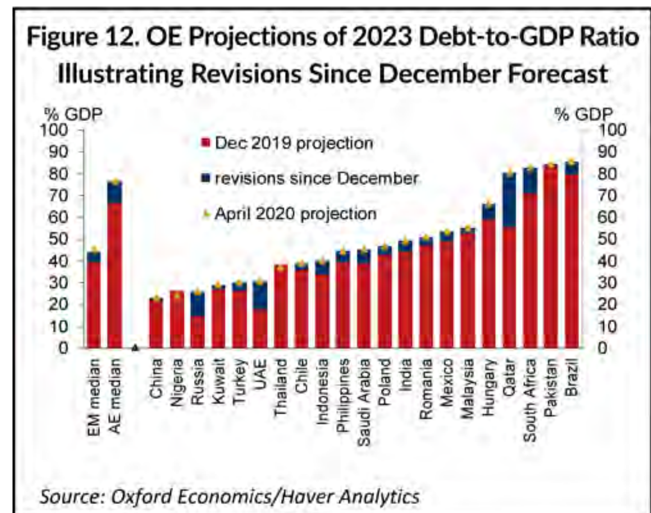
Figure 11. OE Projections of 2020 Fiscal Deficit, Illustrating Revisions Since December Forecast



Source: Oxford Economics/Haver Analytics

Figure 12. OE Projections of 2023 Debt-to-GDP Ratio Illustrating Revisions Since December Forecast



Source: Oxford Economics/Haver Analytics

measures globally at $3.3 trillion, loans at $1.8 trillion and guarantees and other contingent liabilities at $2.7 trillion — altogether $7.8 trillion or 5.2 percent of world GDP.

In general, EM direct fiscal packages reported so far are smaller than for advanced economies. Our estimates suggest their median size is around 1.9 percent of GDP versus 2.7 percent of GDP for the advanced economies. Only four governments (Qatar, Thailand, Peru, and Serbia) have announced direct measures in excess of 4 percent of GDP.

Differences are even bigger when we consider "below the line" items such as loans and guarantees. The median size of such packages for advanced economies is around 5 percent of GDP, but for EM zero — over half of EM have done nothing at all in this area.

The smaller fiscal response by EM reflects both negative and positive factors. Negatively, some EM may lack the financial resources, policy credibility, and institutional strength to provide large-scale financial support to the private sector. As a result, their economies could suffer in both the near and longer terms. Notably, some of the biggest packages have come in oil producers such as Kuwait, Qatar, and Saudi Arabia, which have large government assets that they can draw on.

More positively, some EM may have lower requirements for such backstops. The private sector in EM tends to rely less on credit than in advanced economies, reducing the need for loan packages. Lockdowns in EM may also be shorter and less costly given young populations, fewer mortalities, and possibly lower infection rates because of factors like lack of international connectedness mentioned earlier.

Social security systems in EM also tend to be more rudimentary than in advanced economies. As a result, there will be less of a rise in government spending because of "automatic stabilizers," that is, welfare payments resulting from rising unemployment.

What are the overall consequences for EM budget deficits and debt? Our latest projections for 2020 see the median EM budget deficit being 2.8 percent of GDP worse, than was the case in December last year. This compares favorably with advanced economies in which the median deficit is 4.8 percent of GDP larger. However, EM started from a worse position meaning that their median deficit for 2020 is forecast at 5.7 percent of GDP which is almost the same as for the advanced economies.

Are the forecast rises in EM deficits and debt manageable? It's important to note that in general tolerance for larger debt and deficits in EM is lower than in advanced economies, and we have already seen that borrowing costs for many EM have risen in recent months — in contrast to advanced economies. Some EM that have relied heavily on foreign purchases of local debt to finance deficits (such as South Africa, Mexico, Indonesia, Colombia, and Poland) also face a challenge in replacing those inflows. That said, it's notable that many EM have been able to cut interest rates in response to the coronavirus despite looming fiscal deterioration, rather than being forced to put them up as has often happened in crisis periods.

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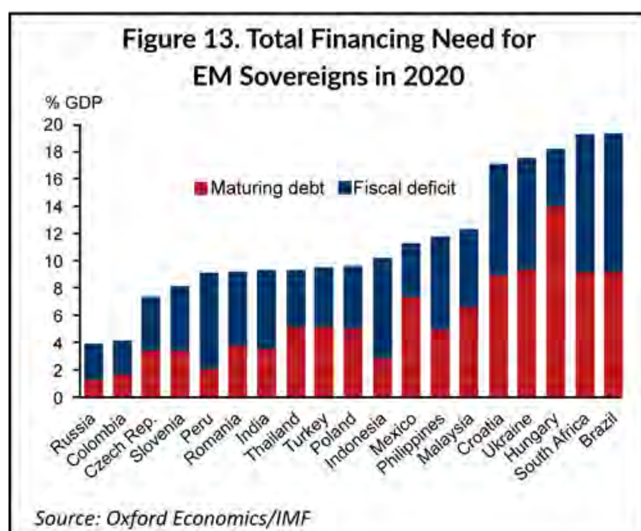

Figure 13. Total Financing Need for EM Sovereigns in 2020

Source: Oxford Economics/IMF

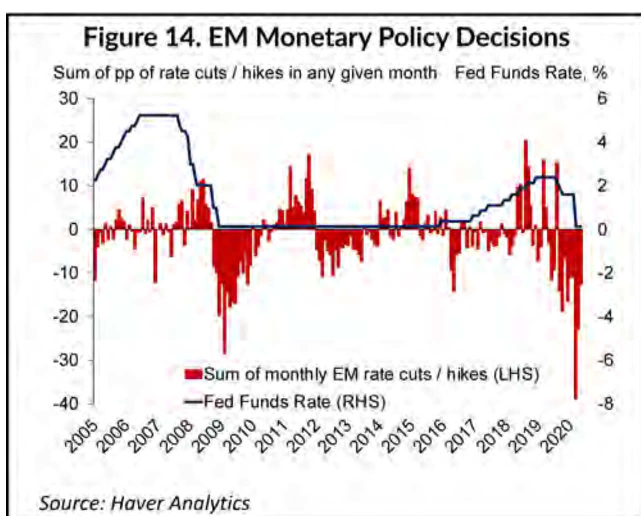

Figure 14. EM Monetary Policy Decisions

Source: Haver Analytics

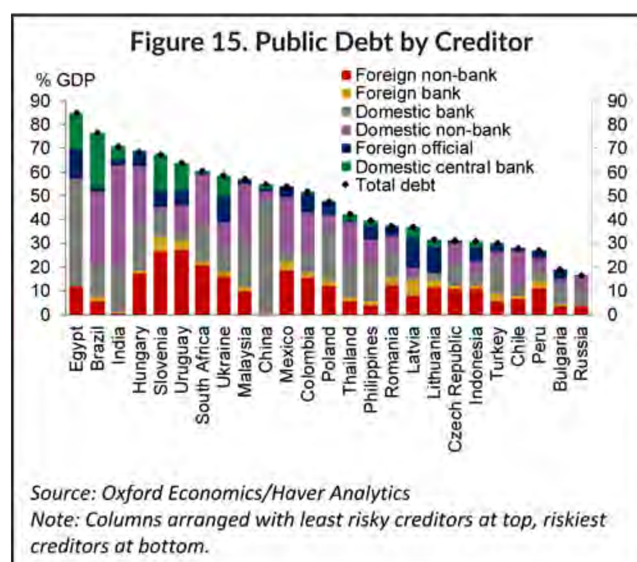

Figure 15. Public Debt by Creditor

Source: Oxford Economics/Haver Analytics

Note: Columns arranged with least risky creditors at top, riskiest creditors at bottom.

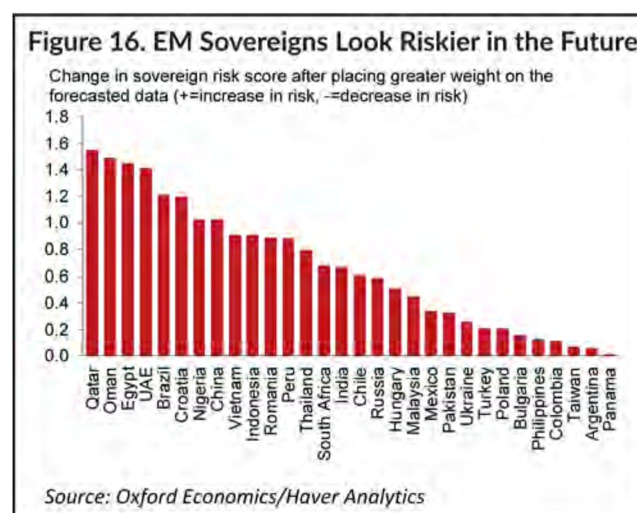

Figure 16. EM Sovereigns Look Riskier in the Future

Source: Oxford Economics/Haver Analytics

The rises in EM government debt in the medium term that we forecast as a result of coronavirus effects also do not look unmanageable in most cases, with the median debt/GDP ratio for EM remaining below 50 percent of GDP. This is helped by the fact that our forecasts suggest there will be a strong rebound in economic growth from 2021 onwards, which will lead to a rapid improvement in public finances after their deterioration this year. We also note that some EM have actually been able to use quantitative easing — until now the exclusive prerogative of a subset of advanced economies — to help finance deficits and preserve financial stability.

Nevertheless, there may be some EM for which financing pressures are large enough to test market tolerance/cause some financial jitters this year. If we look at both the projected deficit and the value of maturing debt, the total financing needs for Brazil, Hungary, and Ukraine, for example, are over 17 percent of GDP for this year. And even where deficits can be successfully financed via local bond markets this may risk "crowding out" lending to the private sector over the medium term given thin domestic money and capital markets, harming growth.

We can look in more detail at the consequences of fiscal (and other economic) deterioration because of coronavirus for different EM using our Sovereign Risk Indicator, which aggregates data from over 30 variables. Using forecast data for 2020 we can capture the effects of widening budget and current account deficits, increased debt, and higher inflation (resulting from weaker currencies). This exercise shows that overall sovereign risk is set to rise fastest in Oman, Egypt, Croatia, Malaysia, and Thailand.

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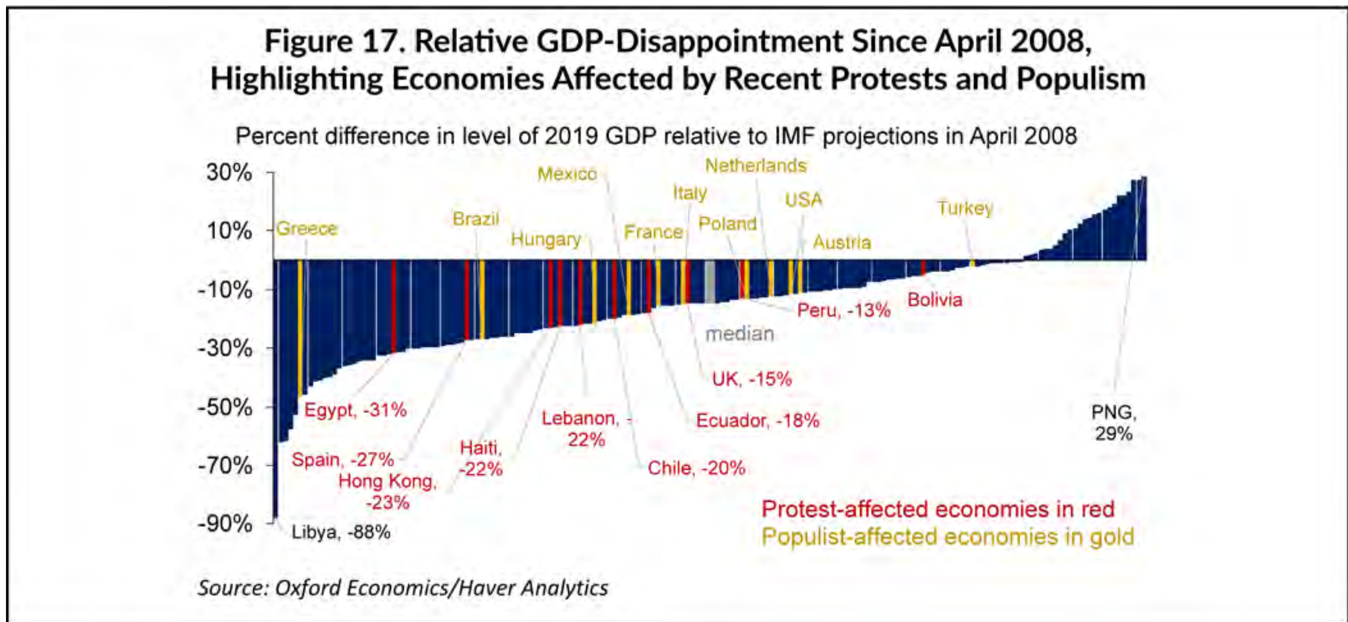

Overall, the deterioration we are forecasting for EM public finances is very significant in some cases, but less so than in advanced economies. This needs to be weighed against generally lower market tolerance for debt and deficits in EM. Similarly, while a less drastic deterioration in public finances is good news in terms of implying less of a debt build-up for EM compared to advanced economies, it is bad news in terms of less of a backstop being offered to firms and households.

The authorities in EM face something of a balancing act between trying to avoid fiscal efforts being seen as unsustainable (and so spilling over into financial instability) and preventing real economic distress that can spill over into social and political unrest. The danger of the latter seems to be borne out by the correlation over the last decade between GDP disappointments and the prominence of populist movements and/or protests. ■

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Post-COVID Corporate Tax Policy

by Jack M. Mintz

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Post-COVID Corporate Tax Policy

by Jack M. Mintz

Jack M. Mintz

This article is part of the series, "Post-COVID-19: How Governments Should Respond to Fiscal Challenges to Spur Economic Recovery," coordinated by the International Tax and Investment Center (ITIC) to offer tax policy guidance to developing countries during the post-pandemic recovery phase.

Jack M. Mintz is President's Fellow at the University of Calgary in Alberta and national policy adviser with EY Canada.

In this installment, the author considers how the COVID-19 pandemic recession will affect the way governments address corporate taxation, comparing the responses to the current recession with the post-2008 financial crisis deficit.

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Introduction

It is no simple matter to predict what the post-COVID economy will look like, given the uncertainties at play. We do not know how long the pandemic will be with us, and therefore its overall damage to the economy. We are not sure how much the workplace will change now that businesses are communicating differently. Nor do we know if countries will be more nationalistic in their trading relationships, resulting in higher border walls.

One fact we do know is that governments have already taken on large fiscal deficits to support the economy. It is likely that deficits for several years will continue unabated, even if at a smaller scale. With growing public debt, many people are already predicting higher future taxes to help close the gap between revenues and expenditures.

A favorite subject for taxation is the corporation, especially big ones. Economists might point out that a corporate tax can be regressive when shifted forward as higher consumer prices or lower wages paid to workers as opposed to shifted back as lower returns accruing to owners. The public, however, view business taxes as a way to ensure that owners, who are rich and powerful, will have something to pay — eliminating the business tax is unfair, as "ordinary" people then have to cover the cost of public services. A clear majority of voters believe that corporations should be taxed more, no matter how well or poor the economy is doing.[1]

While raising corporate taxes is politically popular, is that the actual outcome we see when a recession hits and public deficits soar? Governments may want more revenues, but they also want economic recovery after a recession. As I will show below, corporate income tax rates continued to fall in most countries after the 2008 financial crisis despite higher deficits. While statutory corporate rates decline, many countries introduced new measures to curb multinational profit shifting and base erosion.[2] Some countries also imposed, increased, or reduced levies such as capital taxes on corporations or financial transaction taxes on banks. However, in general, the effective tax on marginal investments,

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[1]For example, Gallup reports that a range of 62 to 73 percent of U.S. voters during the years 2004 to 2019 support higher taxes on corporations. Gallup, "Taxes." A Pew Center U.S. poll taken in December 2019 showed that over four-fifths of Democrats and half of Republicans support raising corporate taxes. Pew Research Center, "In a Politically Polarized Era, Sharp Divides in Both Partisan Coalitions" (Dec. 17, 2019).

[2]The G-20 countries asked the OECD to study base erosion and profit shifting and provide recommendations to counter tax avoidance. See OECD, "BEPS Actions."

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including profit and profit-insensitive taxes, continued to decline across most countries.

Governments will be facing a similar conundrum once the COVID-induced recession has run its course. Will they want to raise corporate taxes to deal with deficits? Or reduce them to help spur economic growth?

In the next section, I lay out the experience with corporate tax policies pursued after the post-2008 financial crisis. This will be followed by a discussion of what corporate tax policies could be expected post-COVID.

Corporate Tax Policy From 2010 to 2019

When Lehman Brothers fell in September 2008, it sparked a sharp decline in world stock market values in anticipation of a global recession. World GDP growth in 2009 was -1.7 percent followed by a slow recovery until 2018, with global GDP growth averaging roughly 3 percent, down a percentage point compared to the years 2003-2007.[3] Public revenues plummeted in most countries and deficits widened. Net debt among advanced countries soared from 49 percent in 2007 to 74 percent of GDP with similar trends for middle- and lower-income countries.[4]

Generally, many governments raised top personal income tax rates. Some increased value-added and excise taxes. One would also expect corporate taxes to have increased, given the popularity to do so by raising tax rates, scaling back preferences, and/or imposing new or higher profit-insensitive taxes.

Corporate Income Tax Rates

Generally, corporate income tax rates were not increased in light of large deficits. If anything, they fell on average. As shown in Table 1, the average OECD corporate income tax rate among 33 countries remained stable from 2009-2012, followed by reductions each year from 2013 to 2019. The most abrupt change happened in 2018 when the United States, accounting for over a fifth of world GDP, lowered its combined federal-state corporate income tax rate dramatically from 39.2 percent to 25.7 percent.

Table 1. GDP-Weighted-Average OECD Corporate Income Tax Rates 2010-2019

Year	General Corporate Income Tax Rate in %
2009	33.3
2010	33.3
2011	33.3
2012	33.2
2013	32.7
2014	32.6
2015	31.9
2016	31.5
2017	31.0
2018	26.8
2019	25.9

Source: Bazel and Mintz 2020.[a] Note that general corporate income tax rates includes the statutory tax rate, surtaxes and profit contributions rates for national and sub-national governments. Fully implemented tax rates as legislated are assumed to apply in 2019.

[a]P. Bazel and J. Mintz, "The 2019 Tax Competitiveness Report: Canada's Investment and Growth Challenge," SPP Research Paper, The School of Public Policy, University of Calgary (Mar. 2020).

For 94 countries that Bazel and Mintz track, the GDP-weighted average corporate income tax rate fell from 31.6 percent in 2010 to 25.6 percent in 2019. On a simple (unweighted) basis, the average corporate income tax rate declined from 25.3 percent to 23.6 percent in the same period. Of the 94 countries, 12 countries raised corporate income tax rates;[5] 33 kept them constant (including low-rate countries like Ireland and Bulgaria); and a majority, 49 countries, reduced rates from 2010 to 2019.

Not all of the world is the same. As shown in Table 2, corporate income tax rates changed little between 2010 and 2019 in Africa and MENA countries. The largest reduction occurred in the Americas, largely driven by U.S. tax reform but

[3]World Bank GDP Statistics, "GDP growth (annual %)."

[4]IMF, "Net Debt."

[5]These include OECD countries Chile, Portugal, and Slovakia, and mid- and less-developed economies Dominican Republic, Egypt, Jordan, Kuwait, Latvia, Morocco, Serbia, Trinidad and Tobago, and Venezuela.

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also reductions in Canada, Argentina, and Jamaica. The average Asian-Oceania corporate income tax rate dropped by over 4 percentage points, of which India was the most significant in 2019. Europe, with lower corporate income tax rates than other regions, except for the MENA region, had a similar reduction in corporate tax rates as Asia-Oceania.

The reasons for corporate tax rate trends are multitude. In some countries with corporate income tax rates, competitiveness and productivity were concerns — the obvious example being India and the United States. Some reduced or kept their corporate income tax rates the same because their neighbors did the same. Some were broadening their tax bases, such as by limiting interest deductions, and provided a corporate rate reduction as an offset, such as in Scandinavia. Newly elected left-wing parties in some countries decided to raise tax rates, such as in Chile, or right-wing parties reduced rates, such as in the United States.

Table 2. GDP-Weighted Corporate Income Tax Rates by Regional Grouping

	2010	2019
Africa	29.6	29.3
Americas	36.9	26.9
Asia-Oceania	30.9	26.8
Europe	27.8	23.5
Middle East and North Africa	21.2	21.0
Source: Bazel and Mintz 2020.		

Corporate Income Tax Bases

While tax rates were reduced, other corporate income tax provisions were adopted, many of which broadened the corporate income tax base. These included tightening transfer pricing rules, limiting hybrid securities that led to "double-dip" interest deductions, taxation of certain forms of international income even if non-repatriated (e.g., U.S. taxation of low-tax intangible income), limiting treaty benefits on income paid to low-tax jurisdictions, and limitations on interest deductions. Some countries also reduced depreciation deductions (e.g., the U.K. eliminating depreciation for structures and New Zealand ending a super-deduction for depreciation). Accelerated cost deductions and investment tax credits were also scaled backed for fossil fuel sectors in several countries (e.g., Australia, Canada, and Norway) as part of climate change policies.

On the other hand, some countries adopted accelerated depreciation to encourage investment. The United States reintroduced 50 percent bonus depreciation (for assets with less than 20-year recovery rates) in 2008 (and expanded it for 15 months to expensing in 2010-2011). It was to be phased out by 2020, but 2018 tax reform introduced 100 percent bonus depreciation (it is to be phased out starting in 2023). One of the few countries to do so, Canada, in response to U.S. tax reform, introduced accelerated depreciation for most depreciable assets on a five-year temporary basis in 2018. Many countries introduced accelerated depreciation or tax credits for clean technology. Patent boxes for intellectual property held in country were also introduced in several countries, including tax relief for intangible income held in the United States as part of the 2018 tax reform.

Some countries also restructured their corporate taxes by adopting "rent" bases, whereby both current and full capital costs are deducted from taxable profits. A rent base can be implemented by expensing capital (with no deduction for interest expense). Alternatively, capital can be depreciated with a deduction given for both interest and notional equity costs (the notional deduction is typically based on the government bond interest rate, which after the financial crisis is relatively low). Latvia adopted allowance for notional equity financing costs in 2008. In 2011 Italy adopted a similar approach, except for limiting the allowance to new equity financing only. In 2015 Turkey introduced a 50 percent deduction for notional equity cash injections. Both Italy and Latvia have now abandoned the approach, while Brazil and Turkey have retained their equity cost deductions. Belgium, which introduced the notional allowance for corporate equity finance in 2007, scaled back its allowance to only new equity financing in 2018.

While the rent approach for corporate income taxation has generally fallen flat for reasons

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discussed elsewhere,[6] the rent approach is frequently used in resource taxation for mining and oil/gas (for example, in Australia, Canada, Norway, and the United Kingdom).[7] By expensing capital and other costs (with no deduction for borrowing costs), the company's payment to the government becomes a percentage of economic rents.

Another approach to corporate taxation has been introduced by Estonia. Instead of taxing profits, only distributions to shareholders are taxed. Effectively, the corporate tax exempts reinvested profits while a tax is applied to dividends or profits deemed to be distributed. Latvia adopted the Estonian approach in 2019.

Nonprofit Taxes on Corporations

Most governments apply nonprofit taxes on corporations, including payroll taxes (which is a tax on employment), asset-based taxes (including property taxes), sales or excise taxes on capital purchases, and taxes on the transfer of property and financial assets.

The most common form of asset-based tax are property taxes on corporations, particularly in Anglo countries like Australia, Canada, the United Kingdom, and the United States. Wealth or capital taxes have also been levied, although these have been disappearing, such as in Canada and France, since 2008. Nevertheless, they remain in Japan, Russia, and several Latin American (e.g., Argentina, Ecuador, and Uruguay), Caribbean (e.g., Jamaica), and Asian (Kazakhstan and Pakistan) countries.

After the 2008 financial crisis, several countries introduced financial and real estate transfer taxes, financial transaction taxes, or stamp duties to help pay for bailouts. Financial transaction taxes are not a new form of tax, as they have existed previously in Anglo countries as stamp duties such as in Australia, Hong Kong, South America, and the United Kingdom. However, they became more frequently used, especially in Europe, Latin America, and Asia.

Real estate transfer taxes are widely used in many countries and raise the effective tax rate on investments in structures and land. From 2010 to 2017, they have been increased in the Czech Republic (3 to 4 percent), Iceland (0.4 to 1.6 percent), Norway (introduced at 2.5 percent), Sweden (3 to 4.3 percent), and the U.K. (4 to 5 percent). On the other hand, they have been reduced in China (9 to 4 percent), India (eliminated at 11.7 percent), Ireland (reduced from 6 to 2 percent), and Spain (1.4 to 1.1 percent).

Sales and excise taxes on capital purchases are typically found in countries with retail sales taxes, such as three Western Canadian provinces[8] and the United States. China applied a VAT on machinery but made it eligible for an input tax credit in 2009. Specific taxes on certain capital purchases have been more frequently applied in many countries, especially with respect to large or luxury automobiles. Energy and carbon taxes have also become more in vogue, which indirectly increase capital good prices.

Effective Tax Rates on Capital Investments

Overall, corporate tax policies since 2008 have led to lower rates, some scaling back of incentives, and adjustments to or introduction of new nonprofit taxes on corporations. The question, of course, is whether the overall effective tax rate on capital investments has fallen or increased. Taking into account all taxes impinging the capital decision, the marginal effective tax rate (METR)[9]

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[6] Criticism against its adoption is related to revenue cost, the lack of compatibility with a personal income tax, and international tax systems. *See* Jack M. Mintz, "Directions for Corporate Tax Reform," in *Corporate Tax Reform*, ed. by B. Dahlby, Canadian Tax Foundation, Toronto (2018).

[7] *See* Mintz, "Taxes, Royalties and Cross-Border Investments," in *International Taxation and the Extractive Industries*, ed. P. Daniel et al. (Washington, D.C.: International Monetary Fund, Routledge, New York and London, 2016).

[8] Because almost one-third of retail sales taxes are collected on intermediate and capital goods in Canada, provinces have shifted to VATs for competitiveness reasons. Ontario and British Columbia harmonized their sale tax with the federal goods and services tax in 2010 in response to 2008 financial crisis (British Columbia later rescinded after a referendum was held).

[9] The METR is a summary measure that takes into account the annualized value of company income taxes, stamp duties, sales taxes on capital purchases and other capital-related taxes as share of pre-tax rate of return on capital for marginal projects (marginal projects are those just acceptable to owners for profitability). Non-residential property taxes are not included due to data limitations. For example, if the pre-tax rate of return on capital is 15 percent and company paid taxes as a share of pre-tax profits is 50 percent, the post-tax annual rate of return on capital is 7.5 percent (global investors receive this return on investment but further pays national personal taxes on returns depending on where they live). The business will undertake an investment so long as the post-tax rate of return is sufficient to cover returns needed to raise equity and bond capital from international markets to finance investments. *See* P. Bazel and J. Mintz, "The 2019 Tax Competitiveness Report: Canada's Investment and Growth Challenge," SPP Research Paper, The School of Public Policy, University of Calgary (Mar. 2020), for further explanation.

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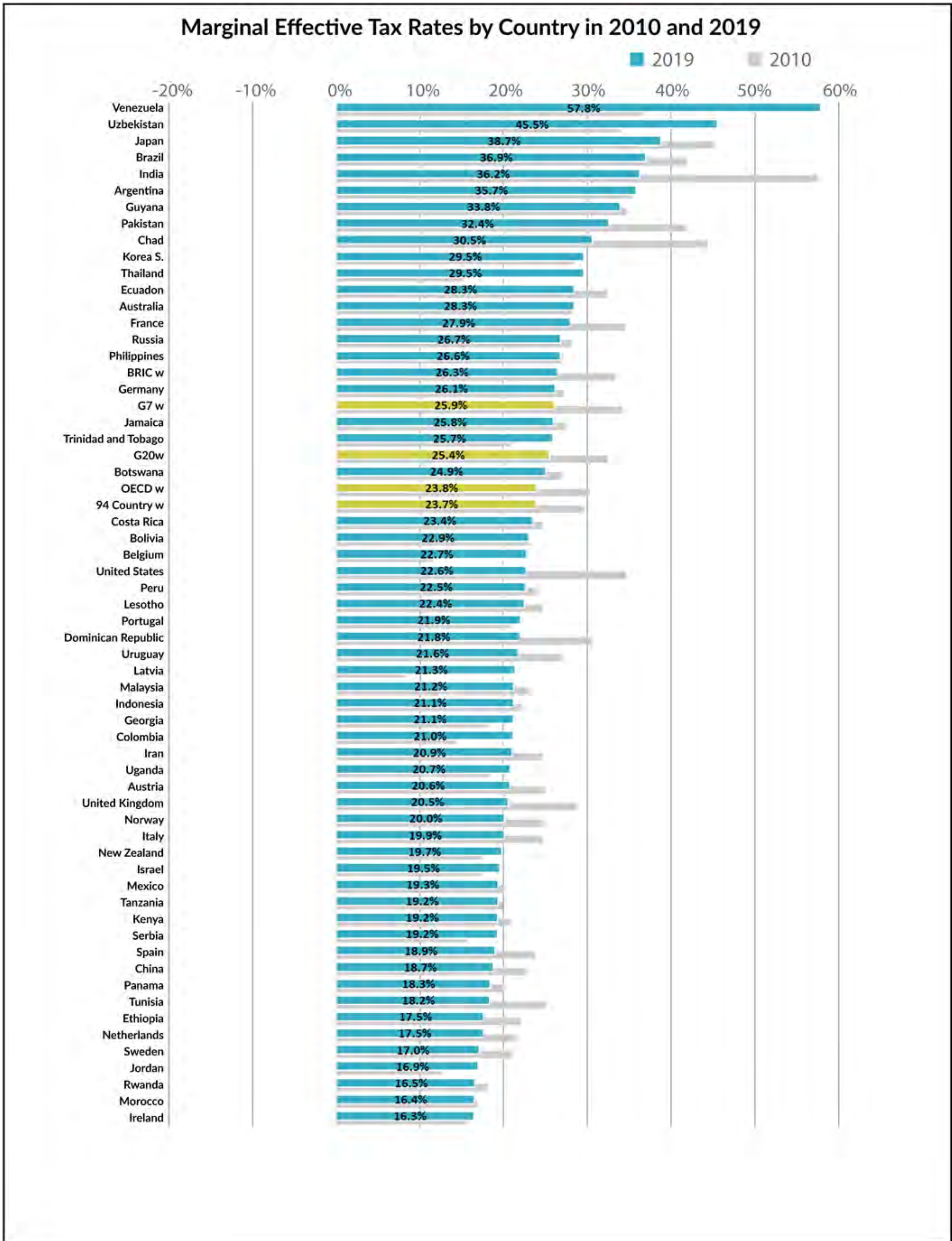

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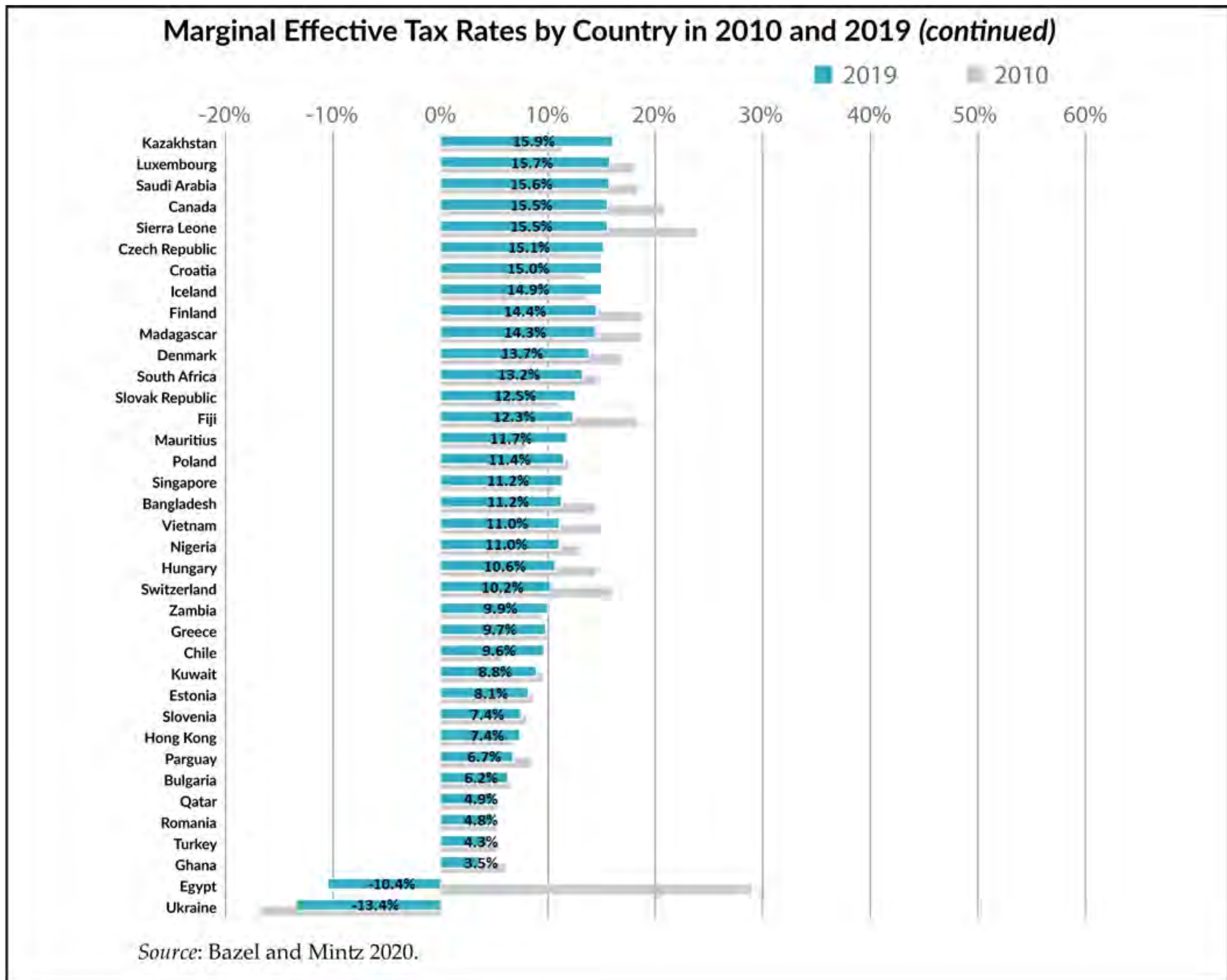

Source: Bazel and Mintz 2020.

has generally declined in countries since 2008 (see figure).

For 94 countries, the GDP-weighted average METR has declined from 29.6 percent in 2010 to 27.3 percent in 2017 and 23.7 percent in 2019 (the reduction from 2017 to 2019 largely reflecting corporate tax reductions in United States, as well as some other large countries, such as Canada, France, and India). Among OECD countries, the GDP-weighted METR on capital investments fell from 29.6 percent in 2010 to 27.3 percent in 2017 and to 23.7 percent in 2019.

Revenues

Given the shifts in corporate tax policies, particularly the reduction in corporate income tax rates, did revenues fall? It is not easy to answer this question since there is little data on nonprofit taxes paid by corporations. However, one can at least focus on corporate profit taxes, including taxes on corporate capital gains paid to central and subnational governments.[10]

Across OECD countries, corporate profit tax as a share of GDP was virtually constant from 2009 to 2018. It averaged 2.8 percent of GDP with little variation (the lowest ratio was 2.6 percent in 2018 and the highest was 3 percent in 2017). Despite the sharp decline in corporate income tax rates, the stability in the ratio reflects several factors. First, government policies that broadened the tax base helped offset some of the revenue

[10] See OECD, "Taxation Statistics."

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losses resulting from lower corporate income tax rates. Second, lower statutory corporate income tax rates expanded the tax base due to increased investment. Third, the lower corporate tax rate reduced profit shifting to other countries where corporate rates were lower.[11] Fourth, corporate owners shifted assets held personally to the corporation in those countries with corporate income tax rates below the personal tax rates — this is especially important at the small business level.

Overall, countries post-2008 used corporate tax policy as a growth strategy, not to raise revenues. Neither did they lose corporate tax revenues.

A Post-COVID Corporate Tax Policy

Economic growth and job creation will be key objectives for managing economies in the coming years. Employment depends on private sector expansion. Growth in itself will provide more tax revenues to governments. As GDP expands, the economy is better able to cope with both public and private debt.

It is important to consider what labor markets will look like in a post-COVID world. The medium-term implications are the following:

- Some business sectors, such as technology and transportation services linked to home delivery, have grown during the recession. Retail and household services markets that do not depend on personal contact will continue to be disrupted by new technologies in future years. The multinational technology sector with large profits and low effective corporate tax rates will be favorite candidates for taxation, such as recently proposed digital taxes on sales, as a presumptive corporate income tax, an expansion of VATs, or both.
- Some sectors were not much affected during the recession or will recover within a shorter period, such as utilities, healthcare and social assistance, education, transportation and logistics, finance and insurance, manufacturing, fishing, forestry, construction, mining, and public administration. Several sectors such as health, transportation, and manufacturing will be strategic to growth and safety.
- Some businesses were severely affected by the pandemic and could take several years to recover, if at all. These include accommodation and food services, tourism, airlines, retail trade, wholesale trade, commercial real estate, and certain household and business services that relied on person-to-person contact. Petroleum, affected by falling demand, inventory accumulation, and international price wars, is expected to take longer to recover. Some sectors with significant costs to comply with health restrictions will look for tax relief or grants.

Employment: Governments will be looking at various labor market policies to help those workers who cannot return to former employers. Corporate tax policies such as new hire tax credits could be an option to help drive employment demand, especially for certain labor demographics. Many workers may also find that they need to rebuild careers, thereby increasing demand for training programs. While most training is done through education systems, training tax credits could be used to encourage businesses to hire students, train apprentices, or fund internal training programs. The latter can be problematical since some costs might be easy to categorize as training even though they would have been done anyway as part of management programs.

Workers and businesses in larger urban centers are already looking at more flexible working hours to improve productivity and lifestyles now that they learned it is possible to

[11]Substantial work has been done on international profit shifting to estimate the impact of corporate income tax rate increases or decreases on corporate tax revenues. In one meta-analysis incorporating a wide range of studies, it is estimated that a one-point reduction in the corporate income tax rate results in an increase in reported pretax profits of 1.55 percent. *See* Jost H. Heckemeyer and Michael Overesch, "Multinationals' Profit Response to Tax Differentials: Effect Size and Shifting Channels," 50 *Can. J. Econ.* 965 (2017). Isolating tax-planning shifts from economic changes, the authors suggest that a one-point reduction in the corporate income tax rate increases profits by 0.8 percent. In a more recent meta-analysis, the authors find a larger response in later years especially: A one-point increase in the corporate tax rate causes pretax profits to fall by one percent. *See* Sebastian Beer, Ruud A. de Mooij, and Li Liu, "International Corporate Tax Avoidance: A Review of the Channels, Magnitudes, and Blind Spots," 34 *J. Econ. Surveys* 660 (Jan. 2019).

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work successfully at home.[12] The workplace is typically required in goods and certain service industries like salons and medical offices. Some workers find it difficult to work at home for privacy and other reasons. Nonetheless, it is already expected that many companies will be looking at part-time or full-time arrangements for employees to work at home.

The new work environment could affect urban planning, business travel, and municipal taxation. It enables companies to spread out their work force to hire talent working at home in various jurisdictions. Labor markets could become more competitive as companies hire workers from anywhere in the world, giving a distinct advantage to low-wage economies. The new workplace could also affect corporate residency requirements since management could, for example, live in a country like the Bahamas to control a company operating in the United States.

Deleveraging: As economies recover, they will need to deleverage, as household, business, and government debt has soared. Consumption will not return as quickly, and businesses will be cash-constrained to invest in capital and new technologies. The corporate tax, which falls on profits, makes deleveraging more difficult. On the other hand, governments may relax debt interest limitations (such as deductibility of net interest expense to be no more than 30 percent of earnings before the deduction of interest, taxes, depreciation, and amortization), since they hurt cash-constrained businesses most, deterring their investments. The United States has relaxed its interest limitation rule that was originally adopted in 2018 from 30 percent to 50 percent of adjusted earnings for 2019 and 2020.

Trade and Tax Competitiveness: A desire for secure supplies, shortening of supply chains, and increased nationalistic policies could reduce global trade. However, given that countries have prospered from trade and cheaper consumer goods, it is quite unclear how much trade will be affected in the long run. Smaller countries will seek trade since they cannot provide all the goods and services themselves. Global supply chains might shorten if national security needs to be protected. Those governments that care less about foreign supply and export-led growth will likely view tax competitiveness as less important.

Climate Change and Corporate Taxation: Countries will likely continue to resort to climate change policies to reduce greenhouse gas emissions. Carbon policies that result in higher direct and indirect energy costs for businesses will deter investment. If governments use carbon levies, they have a source of revenue that could be used to improve productivity and competitiveness to offset the harmful impact of carbon policies on investment. As argued in the past, a "double dividend" is possible by substituting environmental taxes for corporate income taxes (given the latter imposes the highest economic costs).[13]

Investment, Technological Adoption, and Corporate Taxation: Investment is key to growth. It allows companies to adopt the latest technologies to improve cost competitiveness, as well as grow new markets. The adoption of digital, robotic, artificial intelligence, and other new technologies in business practices has been in corporate plans this decade that would drive labor productivity gains.

It has been argued that labor displacement from digitalization and robotics would particularly affect the service sector, leading to large losses in employment. Even so, the story is more complicated. As with any new technology, firms become more cost competitive. New products or services are offered to satisfy growing market demand. Overall, technological adoption leads to more employment, despite the initial effect on industries where displacement takes place.[14]

[12]Technology firms such as Google, Facebook, OpenText, and Twitter have already made such announcements. In the work I am doing as chair of the Alberta Premier's Economic Recovery Council, I have learned from my discussions with sector roundtables that many companies are now looking at more flexible working relationships for the long run. Some workers may work at home altogether or part time in an office. Workers living further from the city could also be hired. One estimate has been made that roughly 15 to 20 percent of working hours will be spent at home and not at the workplace. In large urban centers with long commutes, the advantages of working at home will be more apparent.

[13]Lawrence H. Goulder, "Environmental Taxation and the Double Dividend: A Reader's Guide," 2 *Int'l Tax & Public Fin.* 157 (1995).

[14]David Autor and Anna Salomons, "Is Automation Labor Share-Displacing: Productivity, Growth and the Labor Share," Brookings Institution, Washington, D.C. (2018) 1-60.

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In the years following the COVID recession, businesses could be incented to find or adopt new technologies to reduce labor costs, especially if health restrictions remain in place for a lengthy period. However, business balance sheets have been damaged, which potentially postpones the adoption of new technologies (this will not be the case for technology and those companies that have done well during the crisis).

Some policies, such as partial refundable investment tax credits or allowances, could provide cash up front for struggling businesses. Exchanging tax loss pools for reductions in other taxes paid by businesses might help initially with business cash flows.[15] Or corporate taxes could simply be reduced to encourage investment in profitable projects, which should be an objective for growth-oriented tax reform.

Corporate tax reform could also be a relatively low-revenue-cost policy to encourage investment. Obviously, taxes are not the only factor that influences capital formation. Demand for business products, interest rates, infrastructure, political stability, and regulations also affect how much investment takes place. A proper analysis looks at competing factors affecting investment, including taxation. In addition to aggregate demand, financing costs, transparency, and inflation, economic studies have shown that private investment is sensitive to taxation — conservative estimate is that a 10 percent increase in cost of capital (adjusted for the METR, which adds to the cost of capital) causes a decline of 7 percent in capital stock. Other studies focused on foreign direct investment show a higher impact — foreign direct investment flows would rise as much as 25 percent with a one-point reduction in the corporate income tax rate.[16]

[15] These policies, however, may be less efficient than government loans and grants that could be aimed at firms more likely to survive.

[16] A specific study examining phased-in corporate tax reductions in Canada from 2001-2004 resulted in a 7 percent increase in capital stock with a 10 percent reduction in the user cost of capital. *See* Mark Parsons, "The Effect of Corporate Taxes on Canadian Investment: An Empirical Investigation," Finance Canada Working Paper 2008-01 (2008). See similar results in a meta-study by de Mooij and Sjef Ederveen, "Corporate Tax Elasticities: A Reader's Guide to Empirical Findings," 24 *Oxford Rev. Econ. Pol'y* 690 (2008). A recent meta-analysis survey estimated that a one-point reduction in the corporate income tax rate results in an increase in foreign direct investment by 2.49 percent. *See* Lars P. Feld and Heckemeyer, "FDI and Taxation: A Meta-Study," 25 *J. Econ. Surveys* 233 (2011).

Corporate Tax and Inequality: The effect of the pandemic and economic relief programs has led to a sharp increase in unemployment more heavily weighted toward less-skilled and less-paid workers. This is seen by the increase in the hourly wage rate during the pandemic, as layoffs were preponderantly more among lower-wage workers. This would suggest an increase in inequality in the coming years as it will take time to reemploy workers. However, it is not clear that inequality will rise, keeping in mind the impact of the pandemic on returns to investment. Capital income has also fallen as business profitability declines. Household and business bankruptcies have increased. Housing and other asset values have eroded, affecting household wealth. Without further analysis of the proportionate losses to labor and capital, we cannot say much about inequality. However, we do know that poverty in many countries will increase as some permanently lose jobs, homes, or savings.

As discussed above, the concern over inequality could push some governments to raise corporate taxes for political reasons, contrary to the 2010-2019 experience. While the legal incidence of the corporate tax surely falls on the corporation, its economic incidence is another matter since a corporation itself is not an economic person. People ultimately pay corporate taxes through higher consumer prices, lower wages or dividends, capital gains, and other capital income accruing to owners.

In small open economies, corporate taxes cannot be easily shifted back to domestic or nonresident owners of capital. If corporations reduce rates of return on capital, investors will shift their capital to other opportunities in international markets where returns are higher. The tax tends to be recovered by raising prices on consumers or by reducing payments to immobile factors of production: wage payments to labor, including layoffs, or rents paid to landowners.

In larger economies or those with financial markets less integrated with world markets (such as due to capital controls), the corporate tax would fall in part on capital owners. Even then, capital is owned not just directly by individuals (who tend to be wealthier) but also indirectly through pension plans and other financial intermediaries. With the corporate tax falling

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partially on labor and consumers, as well as some lower income investors, the corporate tax incidence could therefore be regressive rather than progressive, making inequality worse.

Smaller corporations that do not have access to international markets are owned by individuals for legal (i.e., limited liability) and tax reasons. Owners have a choice of organizing their business affairs as an unincorporated business (sole proprietorship or partnership) or corporation. All else equal, they prefer a corporation if corporate profits tax and personal income tax on distributed earnings and (accrual-equivalent) capital gains are less than personal taxes on unincorporated business income. Thus, an increase in corporate tax on small companies may be primarily shifted to the owners who have different incomes.

The public may view that taxing corporations improves fairness by making the rich pay more, but empirical analysis confirms that this is not entirely the case. A recent study found that 31 percent of the U.S. corporate tax is shifted forward into higher consumer prices, making the corporate tax regressive to a certain extent.[17] A Canadian study found that an additional dollar of corporate tax payments results in a loss of wages to the order of $1 to $3.85 depending on the province, given the lack of mobility of labor internationally and productivity effects on labor incomes.[18] These results are consistent with much of the literature that suggest that the company tax, especially on large multinationals, may fall from 30 to 70 percent on real wages.[19] For small open economies, the corporate tax is more likely regressive.

Corporate Tax Rate Reductions vs. Accelerated Depreciation: Governments have provided tax relief to business by reducing corporate income tax rates (generally or for certain activities like patent boxes) or providing accelerated depreciation. The advantage of accelerated depreciation is that the company must carry out new investment activity to reduce corporate tax payments, unlike a corporate tax rate cut that reduces profits on old and new capital. However, accelerated depreciation is distortive by favoring assets that have shorter lives, while corporate tax rate reductions are more neutral across business activities and industries. Corporate tax rate reductions also enable a country to attract investments with high yields (economic rents) and profits shifted from other jurisdictions (such as through transfer pricing and financial structures). With post-COVID governments short of cash, accelerated depreciation might be preferable for revenue reasons but it provides little cash flow to companies needing help. To attract high-profit investment, corporate tax rate reductions would be preferable.

Much of the literature treats corporate taxes as a whole even though effective tax rates can vary across industries and assets. Less understood, therefore, is how different corporate tax policies might affect inequality. For example, accelerated depreciation that favors short-lived assets favors the hiring of skilled over unskilled labor, resulting in a worsening of inequality.[20] On the other hand, a corporate tax rate reduction is more neutral and therefore has less impact on inequality.

Conclusion

It is far from clear that governments will use corporate taxes to raise revenues given debt accumulation, as well as concerns about growth, productivity, and getting people back to work. That certainly seemed to be the experience of the post-financial crisis era during which government deficits and debt grew while economies had a long recovery period. Yet this recession is so deep and potentially enduring that governments may look to raise corporate taxes to contribute to their budgets.

Even if corporate taxes are not increased (and even potentially reduced), it is unlikely tax policy will remain the same. Governments might initiate

[17] Scott R. Baker, Stephen Teng Sun, and Constantine Yannelis, Corporate Taxes and Retail Prices, NBER Working Paper No. w27058 (Apr. 2020).

[18] Kenneth J. McKenzie and Ergete Ferede, "Who Pays the Corporate Tax?: Insights from the Literature and Evidence for Canadian Provinces" SPP Research Papers 10(6), University of Calgary School of Public Policy (2017).

[19] Anna Milanez, "Legal Tax Liability, Legal Remittance Responsibility and Tax Incidence: Three Dimensions of Business Taxation," OECD Taxation Working Papers No. 32 (2017).

[20] Ctirad Slavík and Hakki Yazici, "On the Consequences of Eliminating Capital Tax Differentials," 52 *Can. J. Econ.* 225 (Feb. 2019).

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new tax preferences for investment, innovation, new hires, and training rather than reduce corporate income tax rates. Or, as discussed above, they might wish to reform altogether their corporate taxes, such as by adopting a rent tax or an Estonian profit distribution tax that exempts reinvested earnings from corporate income tax. If they lose revenues with some reforms, they may raise revenues by broadening tax bases by scaling back preferences or imposing new taxes, such as on multinational technology companies.

Too much is uncertain now to even make any predictions — our only guide being the last economic recovery. But if growth is the overriding concern, governments will lever corporate taxes to achieve it. ■

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Global Tax Policy Challenges After COVID-19: Transfer Pricing And Withholding Tax Aspects

by Hafiz Choudhury and Peter Hann

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Global Tax Policy Challenges After COVID-19: Transfer Pricing and Withholding Tax Aspects

by Hafiz Choudhury and Peter Hann

This article is part of the series, "Post-COVID-19: How Governments Should Respond to Fiscal Challenges to Spur Economic Recovery," coordinated by the International Tax and Investment Center (ITIC) to offer tax policy guidance to developing countries during the post-pandemic recovery phase.

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In this installment, the authors consider how governments can increase tax compliance during the COVID-19 crisis through more efficient enforcement of existing legislation in areas such as transfer pricing and the effective use of withholding mechanisms without discouraging businesses from restructuring or protecting supply chains.

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Introduction

Economic Challenges After the COVID-19 Crisis

Restrictions arising from the COVID-19 crisis have led to serious declines in economic activity. Governments worldwide have had to find additional resources for their healthcare efforts. In many countries, financial support has also been provided where possible for individuals and businesses hit by the consequences of social distancing, lockdowns, and closures.

The fiscal effect has thus been twofold. On the one hand there has been an increase in government spending and borrowing; on the other, the crisis has resulted in reductions in tax collection as incomes and profits fall and tax relief is provided to aid recovery efforts.[1] Looking beyond the current situation as at the start of June, governments will next be called upon to further increase spending to promote a revival of their economies.

Emerging economies will be facing the economic consequences of the COVID-19 crisis with very little fiscal capacity to introduce appropriate stimulus measures, as they have already been borrowing to offset the effects of the health crisis. Emerging markets generally rely on foreign capital inflows, but some outflows of foreign capital have occurred during the health crisis. They face higher borrowing costs, a squeeze on liquidity, and weaker economic growth.[2]

Governments worldwide will thus be under pressure to collect more tax to put public finances in order. In the case of developing countries with scarce resources, this involves the use of the existing legal and administrative resources to target areas where additional tax can most easily be assessed and collected. Developing countries will be particularly pressured to make revisions to the tax rules and regulations to improve collections from international transactions, such as those to facilitate transfer pricing audits and improve withholding taxes assessment and collection. These governments have to balance the need raise taxes to restore public finances and the need to take tax measures, including lowering tax rates to stimulate their economies, attracting new

[1] For a comprehensive and regularly updated table of C19 related measures, see RegFollower, "COVID-19: Tax Relief Measures Around the World" (July 21, 2020).

[2] *See* Oxford Economics, "Coronavirus — Fiscal Challenges for Emerging Markets," *Tax Notes Int'l*, Sept. 7, 2020, p. 1359.

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investment, and creating employment opportunities for their people.

Multinational Supply Chains

The crisis has also exposed some of the difficulties of globalized, fragmented supply chains. Following the lessons learned from the crisis, many multinational enterprises are concerned about the security of their supply chains. This will lead to more analysis of the potential risks to supplies in their home countries and more research into the security of the independent suppliers selling to related-party suppliers and their vulnerability in similar future crises.

Some groups may take the decision to move certain functions from one country to another to improve security. Some of these functions may be transferred from one developing country to another, while others may transfer functions to an industrialized country where the suppliers are considered to be more secure. Some groups may even decide to bring some functions back to the home country; this process may be accelerated by measures in developed countries that for political or economic policy reasons wish to "reshore" manufacturing industries or secure access to strategically important goods. As a result of these considerations, the number of business restructurings within multinational groups may increase after the initial health crisis is over.

Growth-Friendly Tax Policy

Many countries will have taken on further debt in their efforts to mitigate the effects on their citizens of the measures taken to combat the coronavirus. After the immediate crisis is over, they will need to raise more revenue, but at the same time they will need to take stimulus measures to revive their economies following the severe effects that lockdowns and other emergency measures will have had on their economies. Governments must bear in mind the need for a balanced approach to work out how to increase tax revenue without damaging or jeopardizing economic recovery. The ITIC's "Principles for Developing Country Hydrocarbon Investment Policies" provide guidelines to consider in this context.

For developing countries, it would be wise to make use of existing tax legislation and administrative provisions to look for areas where their laws and guidelines are not being put to optimum use to collect the right amount of tax. A key consideration in this process must be to have a transparent process that recognizes that there are good and valid reasons for shifting of functions, assets, and risks by an MNE. Where practicable, this should entail input from the industries affected. Some of these shifts may simply arise for the supply chain considerations mentioned above. There is often pressure on tax administrations in developing countries to consider whether certain MNE activities might be deemed to be abusive transfer pricing — that is, to enable profit shifting to take place. Tax administrations in developing countries should bear in mind the need to maintain growth-friendly tax policies in their efforts to ensure that the correct amount of tax is being collected.

Post-Pandemic Transfer Pricing Administration

Capacity in the Tax Administration

The first step should be to assess current levels of knowledge and experience of transfer pricing within the tax administration, and to look at how these resources are currently used. In the medium-term, administrations may wish to bring together their transfer pricing expertise into a separate specialized unit within the organization. This unit can build up its specialist knowledge through training courses and capacity building programs, either in-house or with the assistance of outside expertise from regional and international bodies. Input from industry bodies might also be provided to gain an understanding of this perspective, since any practice or reporting revisions must be workable — and not serve as a deterrent to economic activity. A review could also be done of other types of transfer pricing resources within the administration, such as the access to information and the availability of information technology systems that can support tax compliance, save time, and back up audit strategies and tax collection.

Making Use of Existing Forms and Returns

The OECD's base erosion and profit shifting action 13 report notes that documentation is

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required to make sure that taxpayers pay sufficient attention to ensure that their transfer pricing is in line with the arm's-length principle, provide information to enable the tax administration to perform a transfer pricing risk assessment and select taxpayers for audit, and provide information necessary to perform an audit of transfer pricing issues.

The tax administration must make sure that it makes full use of the information already collected through the CbC reports and other documentation. This can be done by making the information available to staff with the appropriate specialism and qualifications and by ensuring the information is used in preparing risk assessments, audits, and tax assessment. Information from different returns or different sources should be collated efficiently so information is not lost.

Examining Transfer Pricing Documentation

Before looking for information further afield, the tax administration should make sure that it is using the information supplied to it by the local taxpayer in its tax return, transfer pricing information return (if any), and transfer pricing documentation. If taxpayers submit an annual transfer pricing information return, this can be used to gain an overview of group activities and the role of the local taxpayer in the enterprise group. This will give some idea of the amount of related-party transactions and their size, and this information can be used in transfer pricing risk assessment and audit planning.

Another way to collect information might be the use of targeted transfer pricing questionnaires. These could be used to gather information from certain groups of taxpayers or industrial sectors or to gain further information on certain areas of transfer pricing that are not currently sufficiently covered in the annual tax return or transfer pricing information return.[3] These questionnaires could also be used as part of the risk assessment for selecting taxpayers for audit by pinpointing areas of weakness in the transfer pricing position; or they could be used to collect further information during an audit, in addition to the normal ad hoc requests for further information that may be made by the tax auditor.

The risk assessment can be used in selecting taxpayers for audit and more closely inspecting their transfer pricing documentation to identify high-risk transactions or areas where the documentation is weak. The audit can then be targeted toward the highest risk issues or transactions, with a recognition that certain sectors bear inherently less transfer pricing risk; for example, where prices are public or there are existing means of independent cost oversight — that is, via joint venture partners. Where such additional information is available (posted prices or audits conducted by partners in a JV structure) that should also be taken into account.

The tax administration should request all information necessary to complete a risk assessment, including information that is held by foreign related parties where the local entity can reasonably be expected to obtain the information. In the case of information that is not available to the local taxpayer, the tax administration can use provisions in exchange of information agreements to obtain this from other tax authorities. The tax administration should always take into account the need to balance the need for the information with the compliance costs for the taxpayer.

Finding Comparable Companies and Transactions

Employment of accepted transfer pricing methods — the comparable uncontrolled price (CUP) method, the resale price method, the cost-plus method, and the transactional net margin method — requires the use of comparable transactions or margins. In practice it may be difficult for developing country tax administrations to obtain information on comparable transactions or margins that is sufficient to apply the arm's-length principle in a particular situation. However, in the context of the hydrocarbons sector, the availability of published index prices as CUPs and their worldwide acceptance provide robust determinations of arm's-length value.

There may be fewer businesses operating in a developing economy in a particular sector, and the information available on a particular business

[3] *See* Platform for Collaboration on Tax, "Practical Toolkit to Support the Successful Implementation by Developing Countries of Effective Transfer Pricing Documentation Requirements," consultation draft (Sept. 27, 2019).

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may not be complete or available at all. The available databases tend to concentrate on data from developed countries and those data are potentially less likely to be suitable in analyzing transactions in developing economies. The toolkit on the use of comparables issued by the Platform on Collaboration for Tax concludes that strategies to help developing country tax administrations deal with issues relating to comparable transactions could include: (1) the use of safe harbors; (2) making better use of the available data while protecting taxpayer confidentiality; and (3) devising a framework that allows the application of the most suitable transfer pricing method.[4]

For analysis of transactions taking place within an MNE, for example, within the digital sector, a profit-split method may be the appropriate method. In that case, data on comparable transactions would not be needed. In other situations where data are not available or the resources are not sufficient to apply another transfer pricing method, a developing country could consider an antiavoidance measure — for example, a restriction on the tax deduction for net interest expenses (again bearing in mind the potential deterrent to prospective capital investment).

International Exchange of Information

Owing to the scarcity of resources available, many developing country tax administrations often find themselves at a disadvantage when dealing with MNEs. Developing countries must take advantage of all opportunities to obtain information on multinational groups operating in their territory. In some cases, information may be obtained through using the provisions for exchange of information in relevant agreements including double tax treaties.

In the past few years, countries have been introducing a requirement for country-by-country reporting as recommended in the OECD report on BEPS action 13. The CbC reports are exchanged between tax administrations and provide an opportunity to gain an overview of the activities of MNEs across the countries in which they operate. Developing country tax administrations can therefore use these reports to identify the strategy of the groups operating in their country and help clarify the functions of the entities located in their jurisdiction in the context of wider group operations.

Business Restructurings

Post-Crisis Restructurings

MNE reorganizations following the COVID-19 crisis could include moving manufacturing subsidiaries from one developing country to another, removing functions or risks from a local entity, setting up a regional holding company or intellectual property holding company, or moving some functions back to the home country. The reorganization may involve transfers relating to the ownership and management of intellectual property rights or marketing intangibles.

Correct Delineation of Transactions

Transfer pricing rules may be difficult to apply owing to the high degree of integration among the entities that are part of MNEs and the complexity of intragroup transactions involving intangibles or services. MNEs may also use complex financing arrangements that present a challenge to the capacity of developing country tax administrations. It is necessary to perform a functional analysis and accurately delineate the transactions taking place. The tax administration needs to understand the structure before and after the restructuring and look closely at how income flows have changed and what functions and risks have been transferred. This process needs to take into account the supply chain considerations mentioned above and be understood from a purely technical perspective.

Location-Specific Advantages

Location-specific advantages (LSAs) are cost savings resulting from operating in a particular location. They may be the result of government grants, incentives, or other industrial policies in the host location. The availability of well-educated low-cost labor in the host location and the presence of relevant raw materials and a

[4] *See* Platform for Collaboration on Tax, "Addressing Difficulties in Accessing Comparables Data for Transfer Pricing Analyses" (Sept. 1, 2017).

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network of suppliers in the local area or proximity to customers and markets may also be considered to be LSAs. There are often savings that would normally, though not always, arise in developing economies rather than in developed countries.

When a multinational group relocates a part of its business to a low-cost economy, the group can achieve net cost savings as a result of lower expenditure on raw materials, labor, rent, transportation, and infrastructure after allowing for additional costs, such as training expenses for new staff, that may arise from the relocation.[5] An important factor in post-COVID-19 business restructurings will be consideration of LSAs that may have been a factor in the analysis in the past.

Accurate delineation of the transaction is a priority. An industry analysis and a quantitative analysis are necessary as part of the transfer pricing analysis. The analysis would look at the factors in the local market that tend to reduce costs or increase sales for the multinational group, arising from unique features of the local economy. Any increases in costs should also be taken into account. The LSAs can be identified, and the most appropriate transfer pricing method should then be applied to establish the amount of the LSAs that should be allocated to the local entity.

Intangibles

Identifying Intangibles

Intangible assets are increasingly important as a driver of profits within MNEs. Identification and valuation of intangibles is therefore an important part of the transfer pricing analysis by the tax administration. It is important for developing country tax administrations to identify particular intangibles, establish the ownership of the intangibles and look at how they are valued, assess the contribution of the intangibles to value creation within the MNE group, and decide which group members contributed to the value of the intangible.[6] The appropriate transfer pricing method should then be established to allocate the profit between the related parties.

Valuing Intangibles

There is concern in many tax administrations about profits being shifted by means of the transfer of an intangible at an undervaluation. The valuation of the intangible should be examined carefully in line with global standards as outlined in the U.N. Practical Manual on Transfer Pricing and in the OECD guidelines. An important consideration for developing countries is that the concept of an intangible is wider than just patents, copyrights, and trademarks, and could include wide categories such as available human capital, network effects, best practices, or noncontractual relations with the suppliers or with the customers. Although these types of intangible asset are not necessarily defined in law, they may have a value that should be compensated for at arm's length. The comparability analysis could therefore take these intangibles into account as part of the economic characteristics. The relative value of intangibles after the crisis should also be taken into account in any transaction involving transfers of intangibles.

Marketing Intangibles — Local Input

Marketing intangibles such as trademarks, trade names, or customer lists can be created by marketing activities and boost the sales of a product or a service. The local distributor of an MNE may benefit from central marketing activities within the group and may make a payment to a foreign related party in relation to use of the brand. Such activities are not relevant to commodity-based enterprises.

Tax authorities look at any payments made by the local entity to the parent company for the use of the brand and consider the relevance of that global brand in the local context. In a post-crisis environment, the relative value of marketing intangibles in relation to the overall performance of the local economy should be taken into consideration.

The local marketing activities may be similar to those of independent comparable companies, but in some cases the local enterprise may be carrying out wider marketing activities than those of independent distributors, developing its own

[5] *See* U.N. Practical Manual on Transfer Pricing for Developing Countries (2017), section B.2.3.2.51.

[6] *Id.* at section B.5.2.

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marketing campaigns, expanding its offering further than the group's central guidelines, and spending more on its marketing activities than comparable independent distributors.[7] The tax authority could in this case consider the possibility that a local marketing intangible is being developed. The excess marketing activities may have been compensated for with a greater return than that for marketing activities of independent comparable firms. However, in a post-crisis environment, the market realities may have changed significantly, and this reality needs to be taken into account.

Financial Transactions

General

On February 11 the OECD released a report entitled "Transfer Pricing Guidance on Financial Transactions: Inclusive Framework on BEPS: Actions 4, 8-10." The guidance follows the BEPS approach of accurate delineation of the actual transaction to arrive at the amount of debt to be priced. The report looks at the economic characteristics that are relevant in the analysis of the terms and conditions of financial transactions, including the industry in which the multinational group is operating. The guidance recognizes that in order to counter base erosion effect of debt financing, some countries have made the tax policy choice to introduce in their domestic tax laws measures aimed at either reducing the advantage of debt financing or increasing the advantages of equity financing. Such measures could include general antiavoidance rules, specific antiavoidance rules (SAARs), or application of arm's-length pricing. The OECD guidance recognizes that in a cross-border scenario, the transfer pricing provision in treaties is relevant but domestic law has priority, except in cases of discrimination.

The U.N. Practical Manual on Transfer Pricing is also developing guidance on the transfer pricing treatment of financial transactions. U.N. guidance will look at OECD analyses, but will express itself independently with a focus on developing country issues and priorities. It emphasizes that an intercompany financial transaction should be considered from the perspective of both parties to the transaction. The transfer pricing analysis should look at the transaction actually undertaken by the associated enterprises as they have structured it, and the tax administration should base its analysis on the actual conduct of the parties.

In the post-crisis period, especially in an era of historically low interest rates and increased financial risks, it can be assumed that many corporate treasurers will seek to restructure financing arrangements in line with the revised level of risk the MNE wishes to assume. As a general principle, the transfer pricing analysis must take into account the point in the economic, business, or product cycle where the transaction is taking place. MNE groups operating in different sectors may need different amounts or types of financing as the capital intensity levels differ between industries. Tax administrations in developing countries would need to understand the broader trends in the economy in looking at the transfer pricing aspects of financing and refinancing transactions — with a view to encouraging investment and economic growth.

Guidance and Post-Crisis Implications

Key areas of guidance include treasury functions, intragroup loans, guarantees, and implicit support (for example, the guidance on treasury functions states that the taxpayer must first delineate the actual transactions and determine exactly which treasury functions are carried on by the entity). The treasury function will usually be a support service to the main value-creating operation. In some cases, the activities may be services, depending on the facts and circumstances, and pricing will follow the OECD guidance on intragroup services. Regarding the identification and allocation of economically significant risks, the approach of the treasury function to risk will depend on the multinational group's policy, which may set out certain objectives, such as targeted investment returns, reduction of cash flow volatility, or specified balance sheet ratios. The U.N. guidance being developed is broadly similar.

In considering the transfer pricing consequences of a financial guarantee, the

[7] *Id.* at section B.5.2.13.

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taxpayer must understand the nature and extent of the obligations guaranteed and the consequences for the parties to the transaction, accurately delineating the actual transaction. In considering implicit support/effect of group membership, if there is no explicit guarantee, any expectation that other group members will provide support to an associated enterprise in relation to borrowings will arise from the borrowing entity's membership status within a group of companies. In considering intragroup loans, the commercial and financial relations between the associated borrower and lender, and the economically relevant characteristics of the transaction, should be taken into account.

This is an evolving area, where both developed and developing countries are devising approaches at the national level. As mentioned above, the post-crisis period is likely to present new transfer pricing challenges, whether through restructuring of supply chains, realignment of financing structures to take advantage of the new environment, or both. Tax administrations in developing countries should consider the guidance in the U.N. Transfer Pricing Manual and from the OECD, as well as input from key industry representatives, in developing a consistent approach based on these principles, rather than adopt ad hoc approaches to specific transactions.

Transfer Pricing Audits

Risk-Based Audit Selection

Efficient tax audits can increase tax revenue for the period under audit, and by encouraging increased tax compliance, can increase tax revenue in the future. Many developing countries have challenges due to limited resources; if they hope to raise more tax revenue by increasing the efficiency of audits they will need to do so with the resources they already have. Greater efficiency can be achieved through risk-based auditing, which ensures that the highest risk sectors, taxpayers, transactions, and tax amounts are selected for audit. This is the optimum strategy for raising the most tax revenue with existing resources.

The method by which risk assessment is carried out depends on the nature of the business activity, as well as availability of information. If the documentation requirements are detailed, this can help risk assessment of taxpayers for audit selection. For purposes of risk assessment, various categories of transactions could be identified, such as profit shifting resulting from business restructuring, from incorrect/incomplete functional analysis, or from use of inappropriate transfer pricing methods. Having reviewed and identified risks, the tax administration should quantify those risks and where necessary, should perform an in-depth review of documentation with a functional analysis to more accurately quantify the risk. The decision to go ahead with an audit should be taken after a review of the potential tax at risk, taking into consideration the resource commitment the audit would entail.

Audit Planning

A plan should be drawn up to identify the transfer pricing issues that are to be examined during the audit with a planned timetable for action. The audit planning should look at the available documentation and determine what further information needs to be collected from the taxpayer, backed up by interviews with company staff. An audit will be more efficient if it focuses on high-risk transactions or issues that have been identified beforehand. A well-planned and coordinated audit process can lead ultimately to a more effective use of resources in tax revenue generation.

Taxation of the Digital Economy

Post-Crisis Scenario

There is currently an international discussion in relation to taxation of the digital economy. The OECD is leading a dialogue on a new profit allocation rule that would apply for taxpayers with highly digital business models and certain other consumer-facing businesses.[8] (The commodities-based and extractive sectors would be exempt from this regime.)

There would be a new taxing right to give jurisdictions a share of deemed residual profit

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[8] *See* OECD, "Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising From the Digitalisation of the Economy" (approved Jan. 29-30, 2020).

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allocated to market jurisdictions using a formula. This residual profit would be the remainder after allocation of the deemed routine profit to the countries where the relevant activities are carried out. Implementation of this proposal could be of advantage to lower-income countries, as they could collect some tax revenue from digital companies whose users are located within their jurisdiction. The proposals are still under consideration by the OECD's inclusive framework.

The U.N. tax committee is also considering the provision of guidance on tax treaty issues, domestic law issues, and VAT issues in relation to the tax challenges of the digital economy.[9] There are, however, concerns that new rules for the attribution of taxing rights would not be in the interest of developing countries. Many smaller developing countries that rely on export earnings could be affected by a shift to taxing rights based on demand or destination elements. Lower-income developing countries could benefit if the nexus allowing the host country to tax a company's profits arising in its territory takes into account several factors affecting the value of digital goods or services from which profits are generated.

If tax treaties are amended to allocate new taxing rights, countries would also need to implement domestic law provisions to tax the profits. The U.N. tax committee could therefore also be involved in developing and designing domestic tax measures that would address the challenges of the digital economy. The U.N. guidance could take the OECD consultations into account and look at measures that would benefit low-income developing countries, as well as suggest alternative approaches that are adapted to the concerns of developing countries.

Generally, these rules will not be introduced in the near future and are unlikely to form part of the post-crisis response, even though there might be some temptation to expend energy on this source of revenue as a panacea to the current COVID-19-related revenue challenges. The OECD rules may be agreed in late 2020, but given other preoccupations in the post-crisis period, this does not seem likely. Even if some form of global consensus is achieved, this will need further time to reach agreement on implementation approaches. U.N. guidance is likely to be even further away. For the moment, it may be best for developing countries to concentrate on more immediate tax issues (for example, taxation of the informal economy) rather than devote extra resources to solutions around taxation of the digital economy. For the near term, the priority must be domestic resource mobilization for revenue growth — aligned with sustainable economic recovery.

GLOBE Proposal

Another part of the OECD approach to the tax challenges of the digital economy is the global anti-base erosion (GLOBE) proposal. This aims to develop a coordinated set of rules to ensure that international businesses pay a minimum level of tax. This proposal is still under discussion and may be implemented at a later date. Although it may be useful in the future, this proposal cannot be taken into account in tax policy in the short term.

An analysis presented by the OECD on February 13 of the economic effect of the introduction of pillars 1 and 2 of the proposals on taxation of the digital economy indicates a positive revenue effect that would be broadly similar for high-, middle-, and low-income countries.[10] This is, however, a very high-level preliminary view and needs further analysis. In the present scenario, there is a risk that focus on this will be a distraction in solving the very real revenue challenges from the crisis.

Withholding Tax

Cross-Border Intellectual Property Transactions

Establishing the correct rate for royalties paid for the use of intellectual property held by a foreign related party may be a complex process, especially if suitable comparable transactions are not available. Cross-border payments for the use of IP are thus sometimes considered a method by

[9] See the report of the 19th session of the U.N. Committee of Experts on International Cooperation in Tax Matters (Oct. 15-18, 2019).

[10] See OECD, "Update on Economic Analysis and Impact Assessment," webcast (Feb. 13, 2020).

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which profits may be shifted from an entity in a developing country into a related IP company situated in a low-tax jurisdiction.

Developing country tax administrations with scarce resources often protect their position by imposing a withholding tax on payments for use of IP. The rate of withholding tax is computed by applying an adequate rate to the gross payment. A withholding tax is relatively simple and inexpensive to operate and can be enforced by the imposition of suitable penalties in the case of failure to withhold the appropriate amount. To ensure fairness, the withholding tax can be offset against the corporate income tax liability in relation to the income. The normal transfer pricing rules can also be applied to the payments. Care must be taken to ensure the withholding tax is designed to affect only the intended activities so as not to create a deterrence to prospective capital investment.

Technical Service and Management Fees

Technical service fees are often charged by a foreign company for work such as consultancy or design services. The definition of technical fees that are subject to withholding tax will differ from one country to another. Technical service fees can generally be distinguished from royalties paid for intangibles or know-how because the work is carried out by the service provider, rather than just providing the know-how and letting the customer carry out the work. The distinction is rather blurred in some cases because the customer and the service provider may work together on the technical services, so judgment may be required in distinguishing the two categories of payment for withholding tax purposes. A withholding tax on royalties for technical service fees can be collected and enforced by the tax administration with relatively low compliance time and costs.

A management fee is a charge imposed for the management or administrative services of a foreign parent company or head office. Such fees have often been seen by tax administrations as a vehicle used by MNEs to shift profits out of a jurisdiction. Establishing the correct fee under the transfer pricing rules is a difficult process, and for this reason developing countries may choose simpler methods that are easier to administer. A simple approach is to impose a withholding tax on management fees and possibly make the tax deduction for the fee dependent on the correct deduction and remittance of the withholding tax. A suitable rate for the withholding tax must be found, with adequate enforcement and application of penalties for compliance failures.

Branch Profits Remittance Tax

A withholding tax is sometimes imposed on the remittance of profits by branches of foreign companies. This is charged in addition to the corporate income tax charged on the profits of a permanent establishment. The tax is generally regarded as the equivalent of the dividend withholding tax imposed on remittances by a subsidiary to its foreign parent company.

If the branch profits remittance tax is relatively high, the taxpayer may attempt to remit profits in other forms such as technical service fees or management fees, possibly by overstating the amount of benefit received from related parties in those areas. Attention must therefore be paid to the arm's-length nature of these categories of cross-border payment.

Challenges of Investment Hubs

There is considerable debate around the role of low-tax jurisdictions and their use to shift profits between jurisdictions. To save administrative costs, some countries impose a withholding tax on payments to low-tax jurisdictions as defined in their tax rules. Withholding tax may be an option where investigation of the transfer pricing position would be costly for the tax administration in terms of time and resources. Another method of discouraging profit shifting is to deny a tax deduction for payments to low-tax jurisdictions. These domestic law solutions, combined with other remedies (for example, a thin capitalization rule) might be a simpler approach to addressing any perceived risks from potential abuse, rather than further investment of limited resources in complex global approaches such as the BEPS action plan. As noted previously, the assistance of expertise from regional and international bodies, as well as input from industry groups, might be beneficial in designing a tax revenue strategy that does not deter economic activity.

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Tax Treaties and Withholding Taxes

A double tax treaty may reduce the withholding tax on certain types of income such as dividends, interest, and royalties with provision for relief for double taxation. While in the longer term, developing countries will need to consider carefully before conceding taxing powers over passive income, in the present post-crisis period, withholding tax measures with adequate treaty protection provide a workable solution for the revenue needs of developing countries. The effort in the post-crisis period should thus be on making withholding taxes provisions and relief under treaties more efficient and to reduce compliance costs in this regard. There is always a balance and trade-off between the need to attract foreign investment and the need to increase domestic tax revenue. Developing countries may be helped by the guidance issued by the U.N. on tax treaty negotiation.[11]

Conclusion

Tax administrations in both developed and developing countries face pressures to collect more tax with their existing resources on the basis of current law. This means that more effective use must be made of the information available to them so the current laws can be better applied in the assessment and collection of taxes due. Tax return forms and transfer pricing documentation must be scrutinized carefully to find the areas of high risk of tax revenue leakage; tax audits can then be concentrated on those areas. The emphasis must be on avoiding unnecessary compliance costs and finding a balance between revenue needs and the need for more investment to grow the tax base. In this context, it will also be necessary to examine the range of tax incentives granted and consider if they are still fit for purpose, bearing in mind that such incentives stimulate economies by decreasing barriers to prospective investment.

Withholding taxes are a relatively efficient way of collecting tax, and if these are already included in the local law, they should be enforced effectively. Tax administrations should always ensure that taxpayers are categorizing payments correctly for withholding tax purposes, especially where there are significant differences in withholding tax rates for different categories of income.

Using current law and regulations, tax revenue can be enhanced if appropriate and balanced procedures and approaches are employed. More efficient use of the existing transfer pricing rules can be combined with more training and specialization of tax staff.

Developing countries can collaborate with regional or international organizations, including relevant industry bodies, to promote capacity-building and exchange of practical guidance. By making full use of existing resources, transfer pricing rules, and withholding taxes, tax administrations in developing countries can move swiftly to increase recovery of taxes due to support government finances in a fair and practical manner that does not deter economic growth. ■

[11] See U.N., "Manual for the Negotiation of Bilateral Tax Treaties Between Developed and Developing Countries" (2019).

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VAT in and After the Pandemic

by Richard M. Bird

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VAT in and After the Pandemic

by Richard M. Bird

This article is part of the series, *Post-COVID-19: How Governments Should Respond to Fiscal Challenges to Spur Economic Recovery*, coordinated by the International Tax and Investment Center (ITIC) to offer tax policy guidance to developing countries during the post-pandemic recovery phase.

Richard M. Bird is professor emeritus of economics at the Joseph L. Rotman School of Management at the University of Toronto. He thanks Sijbren Cnossen, Pierre-Pascal Gendron, James Robertson, and Daniel Witt for their comments on an earlier draft of this article.

In this installment, the author considers how countries can use VAT during the COVID-19 pandemic recession to increase revenue without raising rates and make the structural and administrative changes to improve VAT from all perspectives.

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Introduction

The VAT is an important source of revenue in over 160 countries around the world and the mainstay of the revenue system in many countries, particularly in less-developed countries (see Figure 1).

Countries have adopted VATs for many reasons. The principal reason is simply because it is a major revenue producer. Moreover, in contrast to such alternatives as income taxes, import duties, or some excise taxes, a broad-based consumption tax like VAT is a relatively efficient way to raise revenue from an economic perspective because it is less distorting and hence less likely to discourage investment and growth. Finally, because consumption is a more stable revenue source than other tax bases, VAT revenues generally grow more or less at the same rate as the economy as whole, unlike other taxes — notably, those on business income, which usually expand more rapidly when the economy grows but tend to vanish equally rapidly when growth slows down.

Coping With the Pandemic and Lockdowns

The pandemic and the resulting lockdowns implemented in varying degrees in many countries in an attempt to reduce its impact did not change any of the factors mentioned above. As in earlier crises, like that of 2008-2009, government revenues from almost all taxes, including VAT, have declined at the same time, as most governments have expanded expenditures in the attempt to offset the impact of the pandemic lockdown. In the earlier crisis, as in this one, VAT revenues were adversely affected.[1] But the impact this time is likely to be considerably more severe, for several reasons:

- First, unlike in the earlier crisis, the real level of consumption has declined (although the share of consumption in GDP may have increased as investment has likely declined even more).
- Second, because when people reduce consumption they tend to spend relatively more on food and other necessities, which in many countries are more lightly taxed, the

[1]In OECD countries, one study found that the implicit VAT rate on consumption decreased on average in 2008-2009. The real level of consumption was relatively stable, but the decline in investment during the crisis meant the share of consumption in GDP increased. However, because a larger share of consumption consisted of government consumption (taxed only on some inputs) and (often more lightly taxed) necessities, consumption tax revenues declined as a share of GDP. *See* Michelle Harding and Hannah Simon, "What Drives Consumption Tax Revenues? Disentangling Policy and Macroeconomic Drivers," OECD Taxation Working Papers No. 47 (2020).

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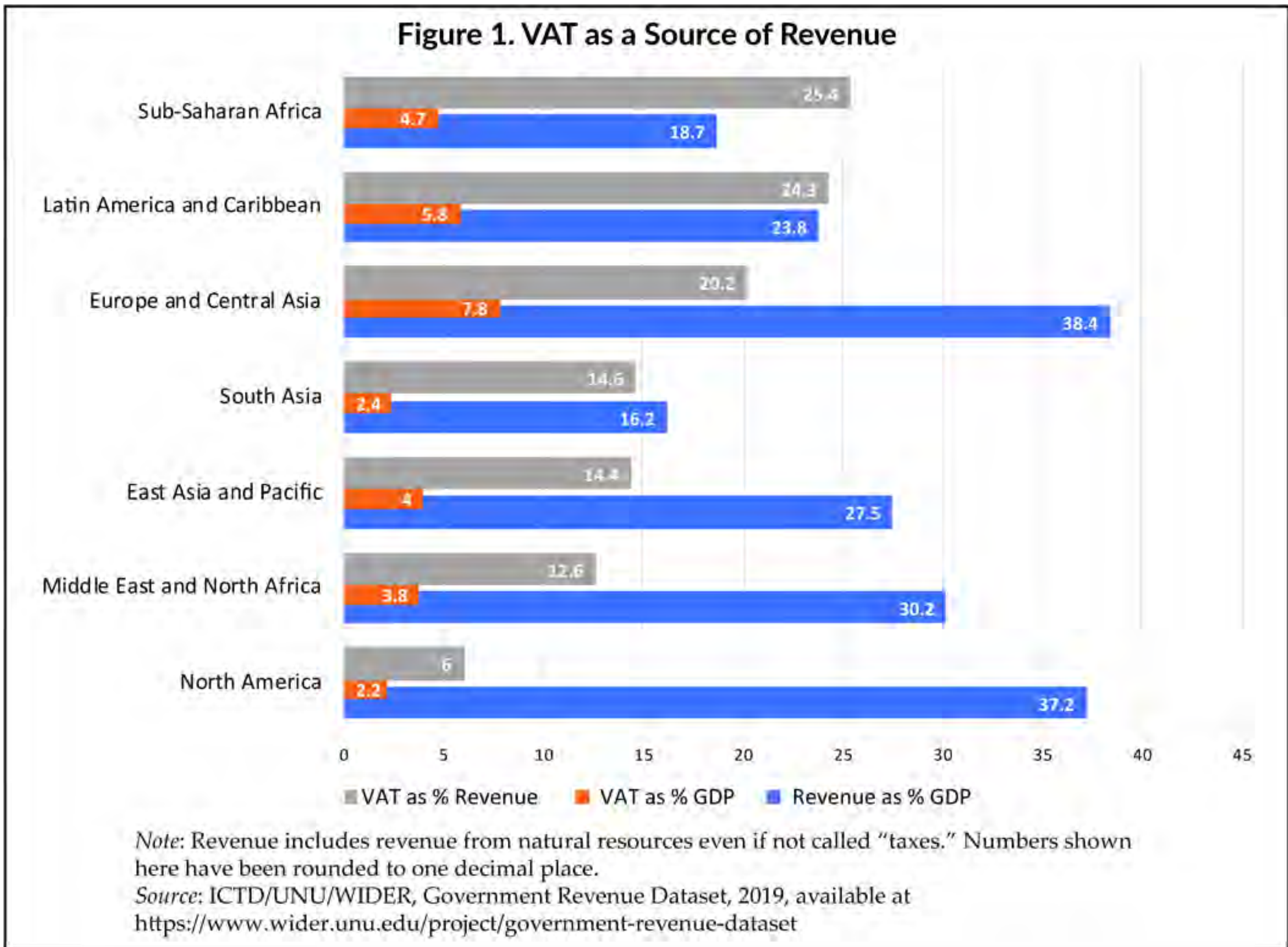

Figure 1. VAT as a Source of Revenue

Note: Revenue includes revenue from natural resources even if not called "taxes." Numbers shown here have been rounded to one decimal place.
Source: ICTD/UNU/WIDER, Government Revenue Dataset, 2019, available at https://www.wider.unu.edu/project/government-revenue-dataset

impact on VAT revenues may be proportionately greater.[2]

- Third, the impact on VAT revenue is especially marked in the many lower-income countries in which a large share of VAT is collected at the border, owing to the sharp fall in trade and especially tourism.[3]
- Finally, quite a few countries have deliberately reduced VAT revenues temporarily as part of their attempts to sustain businesses in the face of the drastic decline in demand.

Even before the pandemic, most governments around the world, especially in low- and middle-income countries, had little "fiscal space" — a term that, while complex to define and measure,[4] means something like room to expand spending or reduce revenues without running into serious debt problems. They now have even less, owing to the direct effect of the virus and the resulting countermeasures on consumption, production, trade, and in many cases also the indirect effect of the related decline in capital inflows from investors and migrant remittances. Moreover, many countries have exacerbated the impact on revenue by deferring and reducing taxes in an attempt to bolster the level of economic activity. Table 1 indicates the sorts of changes in VAT policy and administration that have been

[2] Although the effect on net VAT revenues will be offset to some extent because production and exports (and hence input tax credits) have also declined.

[3] This impact will likely be most marked in small countries (like those in the Caribbean and South Pacific) that are highly dependent on tourism. Cheap international air travel and cruise ships are unlikely to provide much tax base for some time to come.

[4] IMF, "Assessing Fiscal Space: An Update and Stocktaking" (June 2018).

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Table 1. VAT: Changes to Cope With COVID-19

Administration:	1. Deferred or delayed returns — usually combined with delayed payment, often automatic, but sometimes must be applied for [Germany, Czech Republic, Hungary, Japan, Croatia, Netherlands, UK]; sometimes only for small business [Chile, Argentina, South Africa] or imports [Chile] or non-resident businesses [Italy], and sometimes only for specific sectors [e.g. transportation in Colombia]. 2. Deferred or delayed payments — often same as for (1) [Indonesia on imports] 3. Deferred or cancelled interest [New Zealand, Ukraine, Ireland] and penalties [Luxembourg, Finland] — usually part of package with (1) and (2) 4. Speeding up refunds — less widespread than (1)-(3) but sometimes specifically mentioned [Hungary, Latvia, Mexico, Senegal, Uganda, Romania, Australia]; sometimes done by doubling financing for refunds [Georgia]; sometimes for specific sectors [Indonesia] or for small refunds only [Greece] 5. Discounts on VAT payments [France] 6. Loans to cover payments — to small business [Denmark] 7. Audits suspended [Ecuador, Kazakhstan]
Policy:	1. Exemption or zero-rating — usually for pandemic-related supplies [China, Austria, EU, UK] but sometimes for other products [e.g. e-books in UK, food in Kazakhstan] or small business [Korea] 2. Threshold level increased [Austria] 3. Reduced rates [Jamaica, Kenya] — sometimes for small business, sometimes for specific activities such as catering [Greece, Germany], tourism, hospitality [Iceland, Moldova], electricity [Ukraine] or transportation [domestic air travel in Turkey], sometimes in "reduced rate" only [Norway] and in one case on "non-alcoholic beverages" [Austria] 4. Tax holiday for specified period [Estonia]; for tourist sector [Egypt, South Africa] 5. Postponing planned changes — often for administrative changes such as e-invoicing or special cash registers [Czech Republic, Kyrgyzstan, Vietnam], but in other cases delaying proposed rate increase [Italy] or removing special treatment of small business [China]

Note: Most of the examples cited are taken from Richard Asquith, "World Turns to VAT Cuts on Coronavirus COVID-19 Threat," Avalara VATlive (consulted on May 21), supplemented with information from IMF, Fiscal Monitor 2020, on-line Annex 1.1, Fiscal Measures in Selected Economies in Response to COVID-19 Pandemic (as of April 8) and Cristina Enache, Elke Asen, Daniel Bunn, and Justin DeHart, "Tracking Economic Relief Plans Around the World During the Coronavirus Outbreak," Tax Foundation (consulted May 13). These sources differ in some respects and countries mentioned in brackets are only examples, and not necessarily a reflection of current situation. Some have changed treatment several times and may not now be adequately characterized here. Moreover, more countries than those mentioned have changed VAT to some extent, primarily by delaying payment dates, with several extending or, less commonly, reversing earlier measures.

introduced to provide some immediate (cashflow) relief to firms coping with the impact of the pandemic and lockdowns.

Action along some of these lines was viewed favorably by such international organizations as the OECD and the IMF[5] as a way to provide some immediate disaster relief to help business — often especially small business — cope with the sharply diminished cashflow resulting from official lockdowns and related restrictions. Regardless of any changes in the timing of returns and payments, however, the sharp decline in the level of economic activity means that even if all VAT due for the current year is finally collected, VAT revenue, like that from most taxes, will clearly be less than expected. Since government spending will almost certainly be more than expected, the fiscal space available to governments everywhere has shrunk. Although the immediate future is difficult to forecast anywhere, a quick recovery seems most unlikely, given both the expected high failure rate of small businesses with meagre cashflow and the likely slow recovery of trade and economic activity in general. Few countries will be able to restore even their (sometimes precarious) pre-pandemic fiscal position in the near future.

Some countries, even well-off and well-run countries like Norway, reacted to the crisis by

[5] *See* OECD, "Tax and Fiscal Policy in Response to the Coronavirus Crisis: Strengthening Confidence and Resilience" (2020); and IMF Fiscal Affairs, "Tax Issues: An Overview, Special Series on Fiscal Policies to Respond to COVID-19" (2020).

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reducing some VAT rates or creating new categories of exempt (or zero-rated) goods or services. Although understandable in the face of the pandemic, such crisis-induced changes in tax bases or rate structures are seldom a good idea — whether worthy (such as for personal protective equipment)[6] or dubious (such as for transportation or tourist-related activities).[7] It is usually difficult to reverse such concessions once made. Moreover, each additional exceptional treatment for this or that product, activity, or business type makes VAT administration more difficult and reduces the central economic advantage of this broad-based consumption tax — its relatively small distortionary effect. Finally, in a few cases, countries that had been intending to revise administrative procedures (such as by expanding e-invoicing) or to make policy changes that would have made the VAT more efficient and productive have decided to postpone these changes, some of which had been planned for years. Experience suggests that they may often not find it easy to revive and implement such changes.

Recovering From the Crisis

Most countries are still coping with the initial impact of the pandemic, and in some, such emergency measures as deferred tax payments may have to remain in place for some time. But it is not too soon to begin to think about what future fiscal changes may be needed to recover from the pandemic and the measures taken to control it and to moderate their severe economic impact. In the many low- and middle-income countries in which VAT is a mainstay of the domestic revenue system, a well-functioning VAT is an essential component of both their recovery and their future prospects.

Of course, not many developing countries had such a well-functioning VAT before the crisis, so the immediate question facing such countries is whether they should focus primarily on returning to their pre-crisis VAT or whether they should, following the adage that one should never waste a good crisis, seize the occasion to try to make the VAT a better, fairer, and simpler tax than it now is in the many countries in which it is far from the conceptual ideal of a broad-based uniform tax on all final consumption.[8] Many existing VATs are imperfect in two distinct respects: structure and administration.

As a result, in most countries there is a substantial VAT gap in the sense that the revenue from the tax is substantially less than that a uniform tax imposed at the standard rate would yield. This gap has two major components, usually called the policy gap and the compliance gap. The policy gap measures the extent to which VAT revenues are reduced as a result of the design of the tax law, especially by zero-rated exemptions or reduced rates granted to particular activities. The remaining share of the VAT gap — that not explained by explicit policy decisions — is the compliance gap, measuring the extent to which the taxes legally due (under the existing law) are not collected. While neither of these gaps can be measured precisely, substantial evidence suggests that the aggregate gap is considerable in many countries, with the policy gap normally accounting for most of the total in developed countries and the compliance gap being more important in many low- and middle-income countries, although with substantial variation from country to country within both groups.

Technically, the easiest change to make is always in the tax rate. Politically, however, rates are usually difficult to change. The only thing most people know about a tax is its rate. Determining the initial VAT rate (or rates) was a politically controversial issue in many countries, and though rates have sometimes crept up in response to growing revenue needs, few governments are eager to raise the rate. At most

[6] The U.K., for example, zero-rated disposable gloves, plastic aprons and fluid-resistant coveralls or gowns, surgical masks, filtering face piece respirators, and eye and face protection. Such concessions may be rationalized as direct contributions to the task of fighting the infection and are no doubt popular. But they are far from ideal and may prove difficult to reverse.

[7] Unsurprisingly, however, such changes are not only usually welcomed but often urged by business groups, as indicted by press reports from countries as different as Ireland (hotels — see "Hoteliers Call for Scrapping of Tourism VAT for 12 Months During Pandemic," *Irish Examiner*, May 3, 2020) and Vietnam (tourism and construction — "Businesses Seek Tax Reduction to Foster Recovery After Pandemic," *Vietnam Net Global*, May 12, 2020).

[8] Some might prefer to use the crisis to achieve such broader objectives as strengthening taxes (such as on income and property) that impact more heavily on the richer segment of society or by increasing taxes on such "bads" as fossil fuels and tobacco; these topics are largely beyond the scope of this paper.

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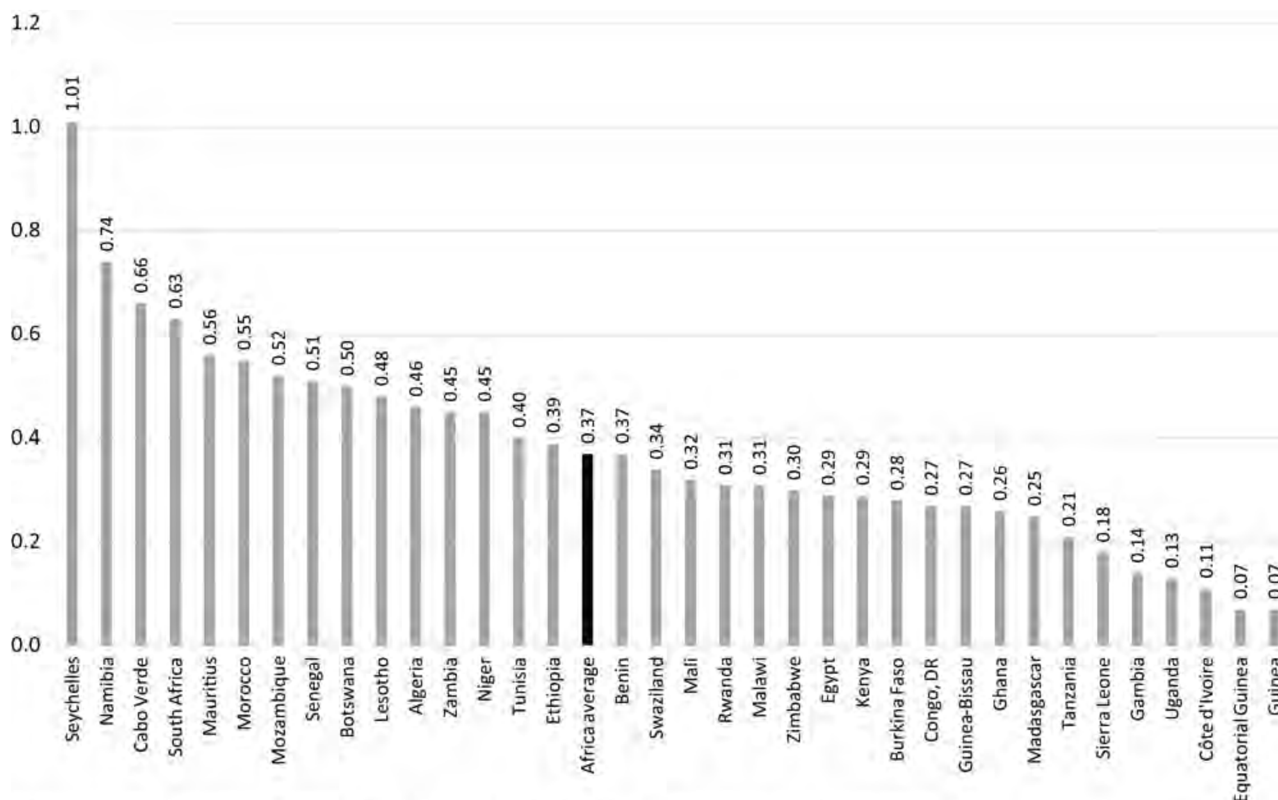
Table 2. Imperfect VATs: The VAT Gap[a]

European Union	11% (range from 7% to 35.5%)
Latin America	43% (range from 9% to 67%)
Africa	average 37% (range from 7% to 74%)



Note: Figure 6.1, "Africa: C-efficiencies, 2015," from Sijbren Cnossen, *Modernizing VATs in Africa* (2019).

[a]The VAT gap measures the difference between potential VAT revenue — the amount that would be yielded if the standard tax rate applied to all final consumption by households, governments, and non-profit organizations and actual VAT revenue as a share of the potential revenue. Alternatively, if actual revenue is divided by potential revenue, the result is a measure of "c-efficiency." Data for EU are for 2017 (Grzegorz Poniatowski et al., "Study and Reports on the VAT Gap in the EU-28 Member States: 2019 Final Report," CASE Reports No. 500 (2019)); for Latin America for 2015 (CIAT, "Value Added Tax: Revenue, Efficiency, Tax Expenditure and Inefficiencies in Latin America," Working Paper 5 (Nov. 2017)); and for Africa for 2015 (Sijbren Cnossen, *Modernizing VATs in Africa* (2019)). The range shown for Africa omits Seychelles, where the calculated yield of the tax slightly exceeds the estimated potential, perhaps because of importance of (nonrefunded) taxes on tourists or simply because of problems with the national accounts data.

one or two countries may perhaps have reached the revenue-maximizing VAT rate — the level beyond which further increases may discourage economic activity (or encourage evasion) to such an extent that revenues will decline rather than increase.[9] In principle, therefore, if a country wants more revenue from a VAT for any reason, it could simply raise the rate. However, few, if any, countries could or should emulate Saudi Arabia, which earlier this year tripled the rate of its new VAT from 5 percent to 15 percent to offset the combined effects of the pandemic and the decline in oil prices on government revenues.[10] In practice, the best way in economic terms for most countries

[9]Richard Bird and Sally Wallace, "Revenue-Maximizing Tax Rates," in *The Encyclopedia of Taxation and Tax Policy* 347-349 (2005).

[10]Marwa Rashad and Davide Barbuscia, "Saudi Triples VAT Rate in Austerity Push to Counter Oil Slump, Virus," Reuters, May 10, 2020.

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to raise more revenue from VAT if they wish to do so is instead to focus on reducing the policy gap, the compliance gap, or both.

Technically, the simplest way to improve the performance of a VAT in any country is to simplify and expand the tax base by removing exemptions and concessions that not only reduce revenues and reduce the economic efficiency of the tax, thus hampering economic growth, but also by making it more difficult and complex to administer the VAT, contributing to the compliance gap.

In the European Union, for example, policy decisions accounted for 44.5 percent of the total VAT gap in 2017, although less than a third of this policy gap (13 percent of the total) was labeled as "actionable" in the sense of being attributable to specific policy decisions about rates and exemptions. About one-third of the EU VAT gap is attributable to the exclusions or standard exemptions set out in the original VAT directive, a bit more than half to compliance issues, and the balance to deliberate policy decisions to provide lower rates or exemptions for particular activities.[11]

- The range of the actionable policy gap varies widely from country to country, from a low of less than 1 percent (Bulgaria) to a high of 27 percent (Estonia). The much larger non-actionable share reflects the substantial amount of consumption — such as the imputed rent of owner-occupied residences,[12] financial services, and most importantly, the goods and services provided by the public sector — that is explicitly excluded (or exempted) under the standard EU VAT. Unsurprisingly, this non-actionable share is generally larger in the (usually richer) countries with larger public sectors, such as Sweden and the Netherlands.

- The remaining components of the policy gap are the rate gap (from less than standard rates), which accounts for 9.6 percent of the VAT gap, and the actionable exemption gap, which for the EU as a whole accounts for only 3.4 percent of the gap — though again with very wide variations in different countries (including a few in which, owing to the continuing taxation of some intermediate goods, it is negative).

The broad picture in Latin America is not that different, with one estimate being that about 46 percent of the VAT gap in the region is accounted for by policy choices and 54 percent by compliance problem.[13] As usual, variations within countries and in some cases, over time, are large. A study in Costa Rica, for example, found a policy gap of about 40 percent and a compliance gap of 30 percent.[14] In contrast, a study of Bolivia found a compliance gap of only 9 percent in 2012 (compared to one close to 50 percent a decade earlier) and a policy gap of only 12 percent.[15]

Fewer studies have focused on Africa, but again the results clearly vary sharply from country to country. South Africa, for example, where the VAT is likely closer to a model VAT than in any other developing country, had a compliance gap in 2012 of less than 10 percent, compared to the average of over 20 percent in the EU, and a policy gap of only about 30 percent, according to the IMF,[16] compared to the European average of over 40 percent. On the other hand, a study of Benin and Burkina Faso reported very different results, with Benin having a total gap of close to 50 percent, with about 80 percent of this total due to compliance issues, while Burkina Faso had a gap of about 60 percent, but with only 70 percent of the total attributable to

[11] Grzegorz Poniatowski et al., "Study and Reports on the VAT Gap in the EU-28 Member States: 2019 Final Report," CASE Reports No. 500 (2019).

[12] Often, newly built residential property is subject to VAT, which may be considered a proxy for VAT on future rentals.

[13] CIAT, "Value Added Tax: Revenue, Efficiency, Tax Expenditure and Inefficiencies in Latin America," Working Paper 5 (Nov. 2017).

[14] IMF, "Costa Rica: Technical Assistance Report — Revenue Administration Gap Analysis Program — Tax Gap Analysis for General Sales Tax and Corporate Income Tax," Country Report No. 18/174 (May 2018).

[15] Mattéo Godin, Romain Houssa, and Kelbesa Megersa, "The Performance of VAT in DGD-Partner Countries," Belgian Policy Research Group on Financing for Development Working Paper 16 (Feb. 2017). This result may be a bit surprising to some, but the quite different analysis in CIAT, "Value Added Tax: Revenue, Efficiency, Tax Expenditure and Inefficiencies in Latin America," Working Paper 5 (Nov. 2017), also shows that Bolivia's VAT performance, in terms of both its structure (policy gap) and its administration (compliance gap), is one of the best in Latin America.

[16] IMF, "South Africa: Technical Assistance Report — Revenue Administration Gap Analysis Program — The Value-Added Tax Gap," Country Report No. 15/180 (July 2015).

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noncompliance.[17] In contrast, in Uganda, one study reported a compliance gap of about 30 percent, or only about twice the size of the policy gap.[18] As always, of course, the gaps measured often vary from year to year, as well as from country to country, reflecting both changing conditions and the data and assumptions used to calculate them.

Since most VATs in both Latin America and Africa are modeled to a considerable extent on those in the EU, it seems likely that, as in the EU case, much of the untaxed potential consumption falls in the same categories — imputed rent, financial services, and public sector — as those in Europe, although the smaller public (and financial) sectors in most middle- and lower-income countries suggest that the actionable part — sometimes called "tax expenditures" or "nonstandard" exemptions — may be relatively more important than in the EU case.

Table 3. The Structure of VAT: Room for Improvement

- Reduce exemptions and reduced or zero rating to as few items as possible e.g. enumerated unprocessed foodstuffs, public transit, a few inputs solely for agricultural use (e.g. fertilizer, pesticide).
- If health, education, social services exempt, then also refund taxes on inputs (if they can be properly managed). Impose tax on petroleum products, electricity, water services, etc.
- Tax fee-based financial services (zero-rating B2B services) as well as property and casualty insurance and perhaps also gambling and lotteries.
- Exempt small businesses (say, under $(US)100,000 in gross sales).
- If bringing new sectors e.g. financial services into VAT base, eliminate such redundant and often troublesome levies as separate taxes on banks, stamp and transfer taxes on real property (if already subjected to VAT), and presumptive taxes (and license fees) on small businesses.

Note: This table and the next draw in part of the recent work of Sijbren Cnossen, *Modernizing VATs in Africa* (2019); and "Modernizing the European VAT," CESifo Working Papers 8279 (May 2020).

Recommendations similar to those in Table 3 have of course been made by many in many countries, for example, by the IMF and other international agencies. So far, however, few have listened to the experts on this issue. The main obstacle to such reforms in most countries is simple: People do not like taxes; they do not like changes that increase (or at least appear to increase) taxes; and most of them do not like taxes like VAT that (arguably) seem likely to increase more the tax burden of the poor rather than the rich. Although most countries have managed, often only after considerable political discussion, to put a VAT in place, the combination of the common perception by many politically aware people that VAT taxes the poor (relatively) more than the rich — though not always true — and the reality that it places a relatively heavier compliance burden on smaller businesses makes structural reform difficult. As in the EU,[19] countries everywhere find it difficult to alter the initial tax structure, no matter how imperfect it may have become in the political process leading to its adoption.

This rigidity is unfortunate because, while closing the compliance gap seems to be almost everyone's preferred way to strengthen any VAT, it is considerably more difficult in terms of resources and time to improve the administration of a VAT than to improve its design. One reason is because what is called the compliance gap (which is sometimes defined simply as a residual — what is left over after the policy gap is measured) is a complex multidimensional concept consisting of a number of different components. Although the popular perception may sometimes be that noncompliance is simply a fancy way to say tax evasion, and evasion is indeed often a significant component of the compliance gap, there is more to reducing the compliance gap than simply catching tax cheats — not that many developing countries have proved very successful at this difficult task.

The IMF, for example, reported that the average compliance gap in the EU in 2012 was about 16 percent of potential revenue, and that in

[17] Houssa, Megersa, and Roukiatou Nikiema, "The Sources of VAT Gaps in WAEMU: Case Studies on Benin and Burkina Faso," Belgian Policy Research Group on Financing for Development Working Paper 22 (Oct. 2017).

[18] Corti Paul Lakuma and Brian Sserunjogi, "The Value Added Tax (VAT) Gap Analysis for Uganda," Economic Policy Research Centre Research Series No. 145 (Oct. 2018).

[19] Cnossen, "Modernizing the European VAT," CESifo Working Papers 8279 (May 2020).

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Latin America was 27 percent.[20] Studies in four EU countries estimated compliance gaps from less than 10 percent (in Denmark and Finland) to about 20 percent in Poland, with Estonia coming in between with a gap of about 15 percent.[21] Finally, a study of Turkey using a different methodology found the policy gap to be twice as large as the compliance gap.[22]

Some of the studies mentioned, like those by the IMF, attempt to decompose the gap in ways that help one understand the source of the problem. There are many possible explanations:

- nonregistration — that is, failure to have 100 percent coverage of all businesses that should be charging VAT;
- nonfiling — that is, the failure of registered firms to file on time or perhaps ever;
- nonpayment — that is, the failure of firms to pay the taxes they owe;
- improper returns — that is, the failure to report sales and purchases properly;
- inadequate monitoring of filing and returns;
- inadequate auditing and application of penalties and interest; and
- inability to prevail in appeal and judicial proceedings.

All these matters are often more complicated than they might seem at first glance because there is almost always a margin of arguable doubt about the extent of legal liabilities. Taxpayers may, understandably, tend to interpret provisions in ways favorable to them. If governments do not agree, the resulting appeals and judicial proceedings may often take years to determine whether such actions are legal (avoidance) or illegal (evasion). The scale and nature of the compliance problem may also differ substantially from country to country and time to time. Certain industries — for instance, transportation, construction, agriculture, and professional services — often give rise to much greater problems than others. In many developing countries, half or even more VAT may be collected at the border, and many countries have difficulties in enforcing the rules on cross-border trade. Such problems not only reduce VAT collected at the border but make it more complex to allow VAT credits on imported inputs, such as machinery and equipment.

One form of noncompliance which is peculiar to VAT — improperly claiming refunds for VAT on inputs which has not in fact been paid — has been a particular problem with respect to cross-border trade because exports are zero-rated but many inputs used to produce them are taxed. Improper claims for credits are of course most obviously seen as a problem when they result in actual refunds, but they are equally costly in revenue terms even if they simply reduce the net amount of VAT collected on sales. Owing to the high visibility of VAT refunds, countries in difficult fiscal circumstances have sometimes solved their problems by not paying legal VAT refunds in a timely fashion, in part perhaps because they have difficulty in assessing the validity of the claim and in part simply because they are short of funds.[23] Whatever the rationale, the result of such policies is to impose a substantial VAT burden on exports in some countries[24] and to complicate the administration of the tax substantially in most.

Everything just mentioned is of course well known to those charged with tax administration in most countries, and, as with the problems with the structure of the VAT, many reports and studies have discussed these problems, often producing recommendations along the lines of those set out in Table 4.

[20] IMF, "South Africa. Technical Assistance Report — Revenue Administration Gap Analysis Program — The Value-Added Tax Gap," IMF Country Report No. 15/180 (July 2015).

[21] These results are comparable because all followed the same methodology. *See* IMF, "Republic of Estonia: Technical Assistance Report — Revenue Administration Gap Analysis Program — The Value-Added Tax Gap," Country Report No. 14/133 (May 2014); "Denmark: Technical Assistance Report — Revenue Administration Gap Analysis Program — The Value-Added Tax Gap," Country Report No. 16/59 (Feb. 2016); " Finland: Technical Assistance Report — Revenue Administration Gap Analysis Program — The Value-Added Tax Gap," Country Report No. 16/60 (Feb. 2016); and "Poland: Technical Assistance Report — Revenue Administration Gap Analysis Program — The Value-Added Tax Gap," Country Report No. 18/357 (Dec. 2018).

[22] Ebru Canikalp, Ilter Unlukaplan, and Muhammed Celik, "Estimating Value Added Tax Gap in Turkey," 3(2) *Int'l J. Innovation & Econ. Dev.* 18 (2016).

[23] Such behavior may perhaps be more likely if such refunds are shown as expenditure items in the budget rather than — like other credits — simply netted out when reporting tax revenues.

[24] Rishi Sharma, "Does the VAT Tax Exports?" 58 *Econ. Inquiry* 225 (2020).

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Table 4. VAT Administration: Room for Improvement

- Clean up VAT register: deregister non-credible firms, unify business identification systems, enable fast and simple registration.
- Keep on top of changing reality: follow up non-filing quickly, audit and apply penalties properly, pursue appropriate legal action on non-compliers. Establish good training and internal monitoring system.
- Reverse-charge industrial capital goods at import to reduce cash-flow problems. (The purchasers of the imported good are required to account for VAT paid at border, while simultaneously claiming credit for it so that both transactions show up clearly in the firm's tax accounts.)
- Refund VAT promptly on exports, and pay appropriate interest on delayed refunds.
- Move as fully and quickly to e-invoicing as possible, perhaps beginning with VAT treatment of cross-border trade.
- Move as fully and completely to on-line (digital) operation as possible.
- Strengthen data and analytical components of administration including linkages within the administration, with other departments, and with other governments and financial sector and major third-party information sources.

Again, however, few countries seem to have heeded such advice, although there are, as always, some exceptions. Two reasons seem to explain this outcome. The first is a variant of the argument made earlier with respect to structural reform. Since most people neither know nor care how business taxes like VAT are administered, what matters here is less popular perception than the strong and usually adverse reactions of VAT taxpayers (businesses) to any changes in tax procedures. This reaction is especially understandable in the case of small businesses, where the relative cost of compliance is much higher than for large businesses. In many countries, the best way to deal with this problem is probably to leave most smaller businesses outside the scope of the VAT completely or at least to simplify the administration of the tax for them. Relatively small and simple policy changes along these lines can make life much easier for taxpayers and governments alike, with little if any adverse effect on revenue, since often 80 percent or more of revenue comes from the largest 10 percent of taxpaying firms. Administrative resources are scarce in most developing countries, and what little they have is likely to be required simply to get VAT (and other major taxes) functioning properly during what may prove to be the lengthy post-pandemic recovery period. Using scarce resources to police a large number of small VAT registrants who produce a relatively small share of the revenue is seldom sensible. Countries that have not already simplified VAT for small businesses by introducing an appropriately high threshold and simplifying registration and filing requirements should definitely consider doing so.[25]

One reason to do so is simply because countries must also deal with the second reason that so little has been done to deal with the compliance gap: the lack of resources. Most countries should invest more resources in hiring, training, and retaining highly qualified staff, as well as in recasting — simplifying and strengthening — the business processes of the tax administration as a whole. Of course, no votes and little popular support is to be found in spending the time and resources needed to improve VAT administration significantly. It is much easier for politicians, like others, to complain about taxes and their administration than to deal with the underlying problems. All too often all that results is something highly visible, like sweeping still more small businesses into the VAT net with little if any gain in net revenue, rather than tackling the much more difficult task of policing more carefully the often much more important — though of course less obvious — noncompliant behavior of larger firms. Those whose interests may be hurt by really trying to fix the problem will of course complain while those who may benefit — the population as a whole — are unlikely to notice, let alone support, such efforts. Selling increased investment in tax administration as good, let alone necessary, is seldom any easier than selling increased taxes.

Conclusion

Politics makes it hard for countries to reform either VAT structure or VAT administration even when times are good. When times are bad, it may

[25] It may also be desirable to permit qualifying firms below the threshold to register voluntarily, provided there is also an established procedure for keeping the tax register up to date by purging nonactive firms.

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seem even more difficult to do so. Still, within the next year or two many countries will face the difficult need to secure more revenue without hampering reviving economic activity unduly, so some changes will be needed. The VAT is already a major revenue source in many countries. It is also often the most economically — if not always politically — best way to achieve revenue and growth simultaneously, though to do so will usually require improving the structure and administration of the VAT along some of the lines suggested above. In many countries, strengthening VAT in any way may be acceptable only if accompanied by even stronger and more visible efforts to strengthen and increase more progressive sources of revenue such as taxes on property and incomes. As many have suggested, reforms to wealth and income taxes may indeed be a necessary and important component of rebuilding revenue systems countries in which the pandemic has underlined the devastating effects of basic social and economic inequality. Strengthening VAT is much less likely to be widely supported. Nonetheless, because VAT is both a mainstay of government revenues around the world and one of the economically most sensible taxes available, a better VAT remains an important and necessary component of the fiscal solution for countries that face the complex task of building a stronger and more resilient revenue structure without unduly hampering the task of restoring the level of economic activity. ■

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Using Excise Taxes to Increase Government Revenue Post-COVID-19

by Elizabeth Allen

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Using Excise Taxes to Increase Government Revenue Post-COVID-19

by Elizabeth Allen

This article is part of the series, "Post-COVID-19: How Governments Should Respond to Fiscal Challenges to Spur Economic Recovery," coordinated by the International Tax and Investment Center (ITIC) to offer tax policy guidance to developing countries during the post-pandemic recovery phase.

Elizabeth Allen is a former head of a VAT Division (HM Customs & Excise) and of an Excise Division (HM Revenue & Customs).

In this installment, the author considers how governments can increase their tax revenues during the coronavirus pandemic through existing or new excise taxes.

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Introduction

Whilst the reaction to COVID-19 has differed in each country, all countries where lockdowns have been imposed have suffered large drops in output, huge national budget deficits and increased national debt. Poorer countries already had narrow tax bases and tax revenue insufficient to finance basic education and healthcare provision let alone to compensate businesses and workers for loss of earnings as a result of the virus.

Governments around the world are now considering how best to increase tax revenues whilst trying to encourage an economic recovery. Of all the direct and indirect tax options, excise taxes (provided they are implemented correctly) should be the easiest source since they are comparatively cheap to collect and usually bear on products and services that are the subject of discretionary expenditure and can be considered "non-essential" or even "unwelcome" or "harmful." With judicious use, new or increased rates of excise taxes can help raise much needed revenue without harming the investment climate or alienating citizens by increasing taxes on income or on essentials whilst people are focusing their funds on ensuring they can maintain their homes and feed and clothe their families.

This paper considers the pros and cons of different excise taxes in order to give revenue authorities — and particularly those in developing countries — a menu of options that should help them increase revenue collected at the lowest possible economic and social costs. In particular, this paper looks at taxes that can raise more revenue and contribute to a country's economic and social goals at the lowest cost and with manageable risks (e.g., of increasing illicit trade or harming the investment climate).

For the purposes of this paper, the definition of excise duties is broad and follows the Organization for Economic Co-operation and Development (OECD) definition,[1] which defines excise taxes as "all selective taxes on the production, sale, transfer, leasing and delivery of goods and the rendering of services as well as all selective taxes on the use of goods, or on the permission to use goods or perform activities, other than general taxes on goods and services." This includes taxes on tobacco products, alcoholic beverages and hydrocarbon oils, on luxuries, sugar sweetened products and some services where the key aim is to influence behaviours.

Why Excise Duties?

Excise duties are extremely revenue efficient, easy to collect[2] and can be justified not only for

[1] OECD (2019), *Revenue Statistics 2019*, OECD Publishing, Paris.

[2] International Monetary Fund (2011), Revenue Mobilization in Developing Countries.

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economic reasons but also on social, environmental and health grounds. Experience indicates that increasing excises does not have a negative impact on a country's investment climate, provided they are implemented effectively.

In the past, most excises were enacted for revenue purposes, the main consideration being that they could be administered more easily than other taxes. Excise duties on tobacco, alcohol, hydrocarbon oils and motor vehicles are good potential sources of revenue because the products are easy to identify, the total volume of sales is high and there are few producers (wine, cider and beer excepted). This simplifies administration. There are few substitutes that consumers would find equally satisfactory so that consumption and, thus, revenue remain high despite excise-prompted price rises. Politically, it has proved more acceptable to increase the traditional "sin" taxes on tobacco products, alcoholic beverages, and gambling than to increase direct taxes.

Whilst economists argue in favour of excise taxes that charge consumers for external costs (e.g., healthcare, pollution, etc.), excises are also designed to nudge consumers to change their behaviours. Hence, we now see excise taxes designed to protect the environment (e.g., tax on motor vehicles, plastics, landfill, air travel, etc.) or to encourage consumers to switch from harmful to less harmful products. Historically, excise taxes have been understood to be regressive in that they bear more heavily on the poorest in society. Recently it has been pointed out that people on lower incomes will benefit relatively more from better health if the excise tax rate deters them from consuming the goods subject to excise tax or incentivises switching to less harmful options, which incur lower or no excise tax.

Some countries have also introduced excise taxes on luxury items such as yachts, private planes, top range cars, gold, land and property transactions, financial transactions, insurance and beauty products in order to achieve some progressivity in taxation. Recently, governments keen to reverse the growing trend of obesity in many countries have introduced taxes on certain food and beverage items in order to nudge consumers towards products considered less likely to result in obesity. Some governments have introduced a tax on telecommunications services trying to profit from the proliferation of mobile phone usage but without, perhaps, understanding the positive role that telecommunications can play in developing economies.

Despite excise taxes being easy to collect and revenue efficient, excise tax receipts in most emerging economies account for only about 10 percent of total tax revenues or 1.5-2 percent of GDP,[3] so there should be scope to increase existing excise taxes and/or to introduce other excise taxes from the range described in this paper. If governments decide to increase excise taxes on goods that can be addictive or are otherwise indispensable (e.g., motor fuel) it is important to avoid shocking consumers into buying from illicit sources. To avoid such unintended consequences a gradual increase in tax rates over several years is recommended. Alternatively, fiscal policies can be used to encourage both manufacturers and consumers to produce and consume less harmful alternatives, which has been the case, for example, with solar panels and electric vehicles, and more recently with e-cigarettes, heated tobacco and other non-combustible nicotine products, as alternatives to smoking.

Another area to consider is the scope for improving compliance with existing excise taxes. Some countries estimate compliance using "tax gap analyses" which allow governments to identify the taxes where compliance is poor and to measure year-on-year changes.[4] Analyses of "tax gap" estimates can enhance knowledge about behaviours by segmented customer groups and by type of tax. The behaviours identified include criminal attacks, non-payment, errors, hidden or informal economy, and avoidance. Whilst easier said than done, the answer lies in both reducing the supply of illicit goods through effective administration and enforcement combined with reducing demand through continuous public education and awareness campaigns including through the education and health and social services sectors.

Countries without sufficient expertise in statistical analysis should consider

[3] International Monetary Fund, Government Finance Statistics.

[4] For details of the U.K.'s "tax gap analyses," see HMRC, "Measuring Tax Gaps" (2020 edition).

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commissioning a research grant to the economics or government/business administration department at a reputable university to carry out this work. This is a comparatively inexpensive way of obtaining benchmark and subsequent annual data whilst supporting local academic research.

Goods and Services Subject to Excise Taxation

Tobacco Products[5]

Throughout the world, cigarettes are among the most heavily taxed consumer goods. The desirability of taxing cigarettes and setting high tax rates depends on several competing concerns. Tobacco taxes raise considerable amounts of revenue and may discourage cigarette smoking. According to the IMF, "*Tobacco excise receipts vary across countries, but have proved to be a significant and stable source of revenue for many.*"[6] As a result of the very high tax rates on tobacco products, especially cigarettes, the disparity between the pre-tax cost of production and the legal retail price has led to substantial smuggling and fraud. Governments should, therefore, develop long-term plans to raise taxes with regular modest tax increases, rather than one-off tax shocks in order to prevent or minimise illicit trade.

Determining the appropriate level of cigarette taxes is a debate between the health and taxation policy makers and tax administrators. If the goal is maximising tax revenues, higher tax rates do not necessarily boost tax revenue because the quantity of tax paid on products declines where committed smokers switch to illicit trade or, where high ad valorem or multi-tier excise rates apply, to lower taxed cigarettes thus undermining government tax revenue and health objectives. Many factors should be considered in setting tobacco tax levels such as income levels and the ensuing affordability of tobacco products, as well as tax levels in neighbouring jurisdictions and revenue administration capabilities of the relevant authorities. Taxation should not be the only policy instrument used to achieve a health policy objective of reducing smoking. In most countries, cigarette taxes are regressive, bearing most heavily on those who are the poorest members of society. Research has shown that the prevalence of smoking is 8 times greater among the poorest people than among the wealthiest, especially if they believe they can buy the products they want cheaply without incurring any penalties. Smoking is addictive and while quitting smoking is the best option for smokers, for those who cannot quit, less harmful alternatives should be available and taxed at a level that can encourage those smokers who cannot quit to switch instead of turning to illicit products.

Having the correct excise tax structure in place is imperative in order to optimise tax revenue collection. As stated by Chaloupka et al. (2018), "*Revenue from ad valorem excises is dependent on prices and may vary over time depending on the consumer behavior and manufacturer strategies. . . . Tax structures are key in raising tobacco taxes and revenues.*"[7] Before embarking on significant tax increases, governments should reduce any dependency on ad-valorem tax in favour of specific excise tax and eliminate multi-tier excise systems. The advice from international financial organisations such the IMF and the World Bank and from leading health economists, is that countries should apply specific or predominantly specific excise tax systems to optimise tax revenue collections and help achieve effective excise tax increases and health outcomes.

Technological and scientific developments in the last decade will enable governments to increase cigarette excise taxes more given the availability of non-combusted alternatives such as heated tobacco products, e-cigarettes and oral products. In a research paper published by the WHO International Agency for Research on Cancer (IARC) in 2019, regarding similar tax treatment of all tobacco products that, the authors stated, "*[. . .] in the case where products have similar levels of harm, this is an appropriate strategy. However, as less harmful products have become more prevalent,*

[5]This section has been written primarily from a revenue perspective. For an economic analysis of tobacco taxation, see: Sijbren Cnossen et al. "Chapter 2: Taxation of Tobacco." *Theory and Practice of Excise Taxation: Smoking, Drinking, Gambling, Polluting, and Driving*, edited by Sijbren Cnossen, Oxford University Press, 2005, pp. 20–55.

[6]IMF, "Fiscal Policy: How to Design and Enforce Tobacco Taxes?" How To Notes 3 (Nov. 2016).

[7]Chaloupka et al. (2018), *Tax structures are key in raising tobacco taxes and revenues*.

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and a continuum of risk or harm is present, it is appropriate to differentiate taxes according to relative risks (Chaloupka et al., 2015)."[8]

In summary, there is now an opportunity for governments to increase the excise tax on cigarettes and other combusted products to raise much needed tax revenues, while taxing combusted products much higher than non-combusted alternatives to nudge consumer behaviour towards better alternatives or quitting smoking.

Alcoholic Beverages[9]

There are three main policy functions in alcohol taxation — revenue raising, correcting for costs to society of excessive alcohol consumption and influencing the behaviour of consumers. Excise tax on alcoholic beverages can be thought of as "user fees" to ensure that the social cost of excessive drinking is paid mainly by consumers. Many public health advocates encourage governments to increase tax rates on alcohol in an effort to reduce the overall amount of alcohol consumed by the population.

There is no consensus in academic literature about the effectiveness of tax increases as a measure to reduce alcohol-related harm and crime. Tax increases tend to encourage consumers to seek lower priced substitutes rather than to reduce the overall amount of alcohol they consume. Multiple studies have shown that increasing taxes to reduce consumption is ineffective because consumers tend to trade down or change their consumption patterns within their budget. Heavy drinkers are not influenced by price to reduce their overall consumption. As with tobacco products, there is a thriving global market in illicit alcohol products — some are genuine products smuggled into the country and others may be diluted, "stretched," counterfeit or traditional local products (not licensed or quality controlled). Consumption of some of the illegal alcohol products has resulted in deaths, notably in India, the Czech Republic, Libya and Kenya.[10]

In 2004, Kenya took the unusual step of foregoing tax on a legitimate beer product to try to reduce the incidence of alcohol poisoning caused by consumption of illicit alcohol (traditional beer with added battery acid). After some market research, an alcoholic beverage manufacturer established that there was potential to sell a legitimate low-cost lager product to the consumers of traditional beers and thus reduce the health risks to the poorer consumers of alcoholic beverages. The manufacturer conducted pilots among the lower income consumers, reformulated the product and designed a new route to market. The producer then convinced the Kenyan government to allow the product, marketed as "Senator Keg," to be subject to 30 percent tax remission. The new product was an immediate success, attributed by the manufacturer to understanding that lower-income consumers felt a sense of dignity in drinking branded beer in legal establishments rather than being always on the lookout for the authorities when they drank illicit products in an unlawful establishment. This strategy attracted many more consumers to choose legitimate quality-controlled products and many of the previously illicit drinking outlets to join the formal sector. The successful market innovation has been described in detail in a case study by Harvard Business School.[11]

The source of the illegal alcohol (leaked from domestic production/smuggled genuine or counterfeit, traditional beer with additions, etc.) varies from country to country. Whilst more than 84 percent of the world ethanol production is used as fuel, it is also used in paint, in pharmaceuticals, in perfumes and cosmetics, as an antiseptic, a solvent and, of course, it can be used to manufacture illicit alcoholic beverages, so it should be subject to stringent excise revenue controls. As with tobacco taxes, it is best to raise

[8] WHO International Agency for Research on Cancer, Reducing Social Inequalities in Cancer: Evidence and Priorities for Research, IARC Scientific Publication No. 168, 2019.

[9] For a detailed description and economic analysis of alcohol taxes, see: Stephen Smith, "Chapter 3: Economic Issues in Alcohol Taxation." *Theory and Practice of Excise Taxation: Smoking, Drinking, Gambling, Polluting, and Driving*, edited by Sijbren Cnossen, Oxford University Press, 2005, pp. 56-83.

[10] Sijbren Cnossen, editor. *Theory and Practice of Excise Taxation: Smoking, Drinking, Gambling, Polluting and Driving*. Oxford University Press, 2005.

[11] Rosabeth Moss Kanter and Matthew Bird, "Diageo and East African Breweries Ltd.: Tapping New Markets for Social Good," Harvard Business Review (July 2019).

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alcohol taxes gradually and as part of an overall education and support strategy.

Hydrocarbon Oils, Motor Vehicles, and Electric Vehicles

Excise taxes are levied on motor fuels in many countries, but tax rates vary considerably. In many cases, motor fuel taxes act as a sort of "user fee" to finance the construction and maintenance of roads. Experience suggests the behavioural impact of motor fuel excises is likely to be small.[12] In some countries, gasoline contains some ethanol. Biodiesel is conventional diesel fuel, blended with animal and/or vegetable fats or oils with, normally, the addition of ethanol. Ethanol used in road fuels will usually be taxed as such. Since this is usually at a much lower rate than the excise duty applicable to ethanol, there is a high risk of false or inflated claims for tax refunds. The substitution of ethanol intended for blending with gasoline purchased separately is an obvious way for the fraudster to obtain ethanol for use in production of illicit alcoholic beverages. For this reason, countries should require ethanol to be denatured before it leaves the distillery.

In response to the growing global drive to reduce pollution, many countries levy taxes on motor vehicles. For example, the United Kingdom taxes the sale of new cars with VAT so that luxury cars are taxed proportionately more than family cars since the tax is levied ad valorem on the purchase price. In addition, there is an annual vehicle excise duty tax based entirely on the size of the engine.[13] The United Kingdom also has an excise tax on road fuel — both unleaded gasoline and diesel.

Australia has a luxury car tax on top of the GST tax. The luxury tax differentiates between cars that are fuel-efficient and those that are not.[14] Additionally, there is an excise stamp duty charged by individual states on purchases of new cars. This varies according to state. Russia also levies a tax on motor vehicles where the rate varies according to the age of the vehicle.[15]

In the United States, car tax is levied by the states, not by the federal government. All but a handful of states have a sales tax, ranging from around 3 percent to more than 10 percent.

Governments around the world are now recognising the environmental benefit of electric vehicles and are adopting fiscal measure to encourage both manufacturers and consumers to switch away from internal combustions engines to electric vehicles. Electric vehicles do not produce greenhouse emissions during use and they are, therefore, considered to be environmentally friendly substitutes to traditionally fuelled cars. As electric cars do not require traditional fuels, using electric cars can also assist countries in reducing their dependency on oil. So, the use of electric cars is on the increase throughout the world with Governments incentivising the use of electric cars through various fiscal policies.

Norway is a world leader in this domain, where battery electric vehicles (EV) sales accounted for 42 percent of the market there in 2019. The Norwegian government has provided strong fiscal support to help achieve this fundamental change to the car market, including no annual road tax on EVs, exemption from 25 percent VAT on purchase, a maximum charge of 50 percent of the total amount on ferry fares for EVs and parking fees for EVs with an upper limit of a maximum 50 percent of the full price.

This is one of the clearest examples that fiscal policies can be used to change consumer behaviour, and fundamentally change a market for the betterment of society as a whole.

[12] Examples include: (i) Swati Gupta, Jack Guy and Hira Humayun, "Toxic moonshine kills 154 people and leaves hundreds hospitalized in India," CNN, Feb. 25, 2019; (ii) "Czechs ban spirits after bootleg alcohol poisoning," BBC, Sept. 15, 2012; and (iii) "The Methanol Poisoning Outbreaks in Libya 2013 and Kenya 2014," PLos One, Mar. 31, 2016.

[13] U.K. Office for Budget Responsibility, "Vehicle excise duty."

[14] Australian Tax Office, "Luxury car tax rate and thresholds."

[15] Dmitry Sudakov, "Does Russia need luxury tax?" Pravda, July 3, 2017.

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Environmental Excises[16]

The rationale for the comparatively recent growth in environmental taxes is that the polluter should compensate society for the damage consumption of particular goods or services causes to the environment. Environmental taxes/levies are intended to prompt consumers to change their behaviours in addition to generating useful revenue. For countries that lack a comprehensive carbon tax regime, an excise tax on fuel can be a way of achieving the environmental policy aims for an important category of carbon emissions. In countries where motor vehicle ownership is low among the poor, a tax on motor fuels can add progressivity to the tax system as can an emissions tax on new cars according to engine size or selling price. Similarly, as air travel is mainly for the wealthy and middle classes in society, a tax on airports or air passengers can add progressivity as well as contribute to environmental goals. Excise tax on fuel and on airports or air passengers are among the easiest and most efficient taxes to administer as there are few taxpayers to control and they are comparatively easy to monitor. Environmental taxes are becoming more and more popular in developed countries and there is an increasing range of them developing around the world including taxes on: (1) hydrocarbon oils; (2) carbon emissions; (3) congestion in city centres; (4) motor vehicles; and (5) road use.

The rationale for these taxes includes compensating society for:

- Environmental costs, including global and local air pollution (greenhouse gases, nitrogen oxides which contribute to acid rain which can cause health problems). Noise pollution and landscape degradation also fall under this heading;
- Consumption of road infrastructure in the form of road repair costs through the physical wear and tear caused by vehicles using the road system;
- Congestion costs such as extra journey time that road users impose on one another; and,
- Accident costs such as the costs of health care in respect of injuries and the social and economic costs of fatalities caused to pedestrians and other road users.

Growing awareness of the impact of a number of everyday products and services on the environment has led to other environmental taxes, for example: (1) plastic bags; (2) landfill; (3) electricity; (4) aggregates; (5) air passengers/airports; and (6) pesticides.

In several countries, there are pressures on governments to introduce more environmental taxes such as a single-use plastics tax.

Gambling Taxes[17]

For many countries, gambling taxes are an important source of government revenue and are also seen as a mechanism to correct for externalities caused by problem gambling. Countries can have several different forms of gambling tax (e.g., the United Kingdom has bingo duty, gaming duty, lottery duty, machine games duty, general betting duty, pool betting duty and remote gaming duty). A tax on gambling is usually based on monetary amounts and so, by definition, will be ad valorem. Some gambling activities such as slot machines can be taxed on a per-item basis. Some countries levy a tax on the profits of gambling activities instead of an ad valorem tax on takings. Some countries levy a tax on winnings; others do not. Where countries operate a VAT, gambling is usually exempt. Online gambling that has developed over recent decades and is, usually, not specifically mentioned in the VAT legislation and so escapes taxation.

Whilst gambling taxation can be a mechanism to correct for the social costs of problem gambling, there is no evidence that problem gamblers

[16] For an economic analysis of environmental taxes, see the chapters on "Environmental Levies" by Jean-Philippe Barde and Nils Axel Braathen of the OECD, "An Excise Tax on Municipal Solid Waste" by Don Fullerton, University of Texas at Austin, and "Road User and Congestion Charges" by David Michael Newbery of the University of Cambridge in *Theory and Practice of Excise Taxation: Smoking, Drinking, Gambling, Polluting, and Driving*, edited by Sijbren Cnossen, Oxford University Press, 2005.

[17] For more information on gambling regimes and an economic analysis of taxes on them, see: Charles T. Clotfelter, "Chapter 4: Gambling Taxes." *Theory and Practice of Excise Taxation: Smoking, Drinking, Gambling, Polluting, and Driving*, edited by Sijbren Cnossen, Oxford University Press, 2005, pp. 84-119.

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reduce the amount they lose as a result of higher taxes on gambling.

Around the world there are large differences both in what is taxed, the type of tax involved (income tax or profit tax) and the tax rate. Gambling winnings are taxable with Income Tax in the United States but not taxable in the United Kingdom. Casino gambling[18] is charged at 90 percent of turnover in Germany but as low as 0 percent in Italy and in Russia (though Russia levies tax according to the number of gaming tables used rather than on the turnover, profits or amount wagered.)

Luxury Goods

Many emerging economies also use excise taxes to collect revenue on luxury goods. The general reduction in use of import duties combined with weak domestic tax bases has driven many emerging economies to tax luxuries as another source of revenue. Developed economies have tended to tax luxury items through VAT (and sometimes a higher rate of VAT) or sales tax.

These taxes are easy to collect from a small number of producers/importers. Taxing luxury goods highly can be seen as progressive in that only the wealthy will be able to afford them. High taxation is part of the price charged for desirable luxury items (designer handbags, watches, perfumes and even sneakers with well-known branding). This has contributed to a growing market for counterfeit products where brand owners and the State lose out.

Certain Food and Beverage Products

Recently, because of health concerns about what is called the "obesity epidemic" and the link between obesity and non-communicable diseases (NCDs), which are now the most common cause of death around the world, a number of countries have introduced an excise tax or levy on sugar-sweetened beverages (SSBs). The WHO has identified that the most damage to health is caused by "free sugars" (added sugars). The WHO defines these as including monosaccharides and disaccharides added to food and beverages by the manufacturer, cook or consumer plus sugars naturally present in honey, syrups, fruit juices and fruit juice concentrates.[19] "Free sugars" do not include sugar that is naturally part of the structure of a food or soft drink such as unsweetened milk or 100 percent fruit juice.

Some countries have gone further, with Mexico and Hungary introducing a tax on "junk food" as well as on other products such as sugar-sweetened beverages; and some countries (e.g., Finland and Norway) have included sugar and confectionery in addition to SSBs. The rationale for these new excise taxes is to encourage changes in consumer behaviours and compensate for externalities (medical health care, dental health care and the economic/social losses through fatalities), though it can be argued that, unlike tobacco products and over-indulgence in alcoholic beverages, consumption of food and beverage items with a high calorific value is reflected in mainly internal rather than external costs to society.[20]

For a sugar tax alone, there are many design options, for example:

- *Tax the production and importation of refined sugar*. This is the simplest option from the point of view of ease of administration and it is likely to be the most effective in ensuring that tax is levied in accordance with the proportion of added sugars or "harm" in a product. Only a few countries (Uganda is one) have done this to date perhaps because of the difficulty in equalising the tax burden between finished products containing added sugar manufactured domestically and imported.
- *Tax only food and drink products containing "excessive amounts" of sugar*. A variation of this option has been implemented in Mexico using the threshold of 275 calories per 100 grams. The United Kingdom, South Africa, France and Ireland have a sugar tax/levy on soft drinks that includes a threshold. A

[18] Brokke Keaton, "The Highest And Lowest Gambling Taxes Around The World," Casino.org, June 26, 2020.

[19] World Health Organization, "WHO calls on countries to reduce sugars intake among adults and children" (2015).

[20] R. Bahl and R. Bird (2020), Taxing Sugary Drinks, International Tax and Investment Center.

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threshold-based tax is difficult to enforce without precise labelling requirements supported by consumer protection resources and powers to enforce them.

- *Tax all sugar in soft drinks and in food products*. Taxes on sugar in soft drinks come in several different forms. Some are based on total sugar content including natural sugars. Others apply a different tax rate according to the different type of sugar (natural or "added"). Health experts recommend taxing "added" or "free" sugars rather than naturally occurring sugars such as in fruit. Thresholds based on sugar content can induce manufacturers to reformulate products in order to reduce the "added" sugar content. Some countries have exempted products containing only natural sugars. Many countries in sub-Saharan Africa already have excise taxes on non-alcoholic soft drinks including bottled water. Some have an excise tax on sugar in syrups. In both cases, the objective is revenue raising rather than promoting health.
- *Tax the total sugar content in "Ready to Drink" soft drinks*. This option is dependent on having appropriate labelling requirements in place. It does not distinguish between natural sugars (exempted in many options) and added or "free" sugars.
- *Tax "Ready to Drink" SSBs by volume produced or by value of the Ready to Drink product*. Established good practice in excise taxation suggests that a specific excise tax based on a quantitative measure (e.g., cents per gram) would be both easier to administer and better reflect the "harm" in the product than an "ad valorem" rate based on a percentage of value. To simplify tax calculations, such a tax is likely to be tiered with a zero-rate applying to the lowest threshold and higher rates applicable to other tiers. Such a structure encourages firms to reformulate their products so that they are either not subject to tax or subject only to a lower rate of tax.

There is an expectation that, in countries with a severe obesity problem, current tax thresholds will reduce over time for products so as to gradually accustom consumer palates to less sugary tastes. In addition, there are calls from health experts and lobby groups for sugar/fat/junk food taxes to be developed to cover a much wider range of goods. An easier to administer method of taxing added sugars would be to tax refined sugar (and similar products) at import and production provided that legislation requires labels to detail the contents. To ensure that imported finished products containing sugar are not given an advantage over similar domestic products, imported finished products containing sugar (or added sugar) would need to be taxed on a similar basis.

Other Services

To take advantage of a service used by most of the population and make it a source of revenue, countries have diversified their tax bases by taxing services such as insurance premiums, financial services and telecoms. Services differ from goods in that they are intangible and typically rendered by businesses that cannot be defined as manufacturers or producers. Some services are supplied on a casual basis and some by self-employed operators (e.g., mobile hairdressers). Some services are unsuitable for taxation on social grounds such as educational and medical services.

Taxing insurance premiums has been justified as another way of raising money to compensate for the externalities of road transport accidents. Despite the demonstrated positive externalities of telecoms services, some countries are now taxing telecoms because of the recent exponential growth in the use of mobile (cell) phones. As technological improvements are developing fast this is proving to be an extremely complex subject for taxation.[21] Other public utility services such as supplies of gas and electricity have been taxed according to whether they are supplied for domestic or business use.

For hotel, motel and restaurant services excise tax is usually levied on a percentage basis of the total bill. For tax levied on hotels/motels there needs to be a requirement to record and keep

[21] D. Child and L. Allen, Guidebook: Taxing the Telecommunications Industry, International Tax and Investment Center, 2019.

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details of guests. An excise tax on restaurants is often difficult to assure with cash takings unrecorded, so it may be better to levy instead an annual licence fee according to the status of the restaurant (luxury — with fine wines, silver service and tablecloths, buffet service — with or without tablecloths and workers canteens/take-aways/mobile food vendors).

Some countries levy an excise tax on air travel, especially airport departures. The United Kingdom has an air passenger duty tax levied according to distance from London to the destination's capital city. Duty is charged on each passenger at the rate for their final destination. This is one of the most efficient taxes to adopt as the airlines collect the tax from passengers and pay it to the State, so compliance is extremely high.

Excise taxes are levied on a large variety of entertainment services with rates differentiated on a functional basis (e.g., lower rates levied on soccer matches and films than on cabarets and night clubs). Taxes on clubs are usually levied on a gross receipts basis to include meals, beverages and membership fees. Exemptions for small clubs or charitable organizations can be based on assets, gross receipts or charitable status.

Achieving Health and/or Environmental Outcomes: Monitoring the Excise Impact

Many countries introduced excise taxes to achieve an expected impact in health or environmental benefits in addition to raising revenue. There have been claims based on modelling that suggest that taxation can generate health and environmental improvements through changing consumption behaviours. There is some evidence that consumption behaviours have changed following the introduction of health or environmental excise taxes but little evidence that the intended outcomes (reduced obesity, reduced smoking, reduced pollution, etc.) are being achieved. To better understand the role of taxation in achieving health and environmental outcomes, a revenue authority, in collaboration with appropriate other public sector authorities, should determine joint outcome-based performance indicators, qualitative and quantitative, in addition to output-based performance indicators that measure only the change in consumption of legal products subject to the excise tax.

Structural Options for Excise Taxation

There are three options for the structure of an excise tax:

- **Specific (also known as volumetric)**: levied by reference to the weight, quantity, volume, size or contents of the product. Specific taxes are usually applied in tiers.
  - Whilst many tax experts consider the use of a specific (or volumetric) structure is the easiest and cheapest structure to administer and control, there is a drawback in using specific structure systems in that a specific tax does not keep pace with inflation. The facility for regular updates in the tax rate to keep the rate in line with inflation should be included in primary legislation with the caveat that the government may decide not to update the tax rate.
- **Ad valorem**: levied as a fixed percentage of (usually) the producer's sales price, although sometimes values may be prescribed or computed (e.g., the SACU[22] rules for the value of the goods subject to an ad valorem tax such as cars and mobile phones).
  - Ad valorem taxes keep pace with inflation, but the application of ad valorem tax rates can be problematic for administrators. It is often extremely difficult to establish market value for the output of small-scale industries that have widely differing cost structures, selling prices, marketing and trading arrangements. For larger manufacturers, the common interests of sellers and buyers can complicate matters as can transactions between sister companies. Consideration needs to be given to areas such as volume and trade discounts, packing and selling expenses, insurance and freight charges all of which may be included in the wholesale price of some manufacturers but not of others.

[22]Southern African Customs Union.

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  - In some countries where the ad valorem structure is used for excise, the list prices of selected manufacturers are taken as the value for the whole industry, but this is only feasible for a small number of products.
- **Mixed**: a combination of a rate applied as a specific tax and a rate based on price (sometimes with a caveat to apply the tax to the greater of the two).
  - Mixed (or hybrid) excise tax structures apply both specific and ad valorem excise taxes. The tax under both a specific and an ad valorem structure are calculated and the actual tax charged is based on the higher amount of the two tax calculations. This is also sometimes called "ad valorem with specific floor taxation." The use of a minimum specific tax floor ensures that a certain minimum excise tax will be collected on all brands, regardless of their retail selling price.
  - A mixed excise tax structure can be a compromise solution — as for tobacco taxation in the EU — where it was politically impossible for all member states to agree on either a specific or an ad valorem structure. Other countries use a mixed tax structure in an attempt to ensure they collect the maximum revenue due.

See Annex 1 for a detailed analysis of the advantages and disadvantages to each option.

Keep It Simple

Effective administration of an excise tax begins with a tax structure that is as simple as possible. This also minimises compliance costs to the taxpayer. Policy decisions, both in selecting the tax structure and setting an appropriate tax rate, should be taken carefully to respond to the realities of the local market and avoid unintended consequences.

How Do Excise Taxes Relate to Other Taxes?

Import (customs) duties are levied on goods as specified in the Harmonized Tariff Schedule. Import duties were originally devised to protect domestic industries. Import duties are normally imposed on the c.i.f. (cost, insurance, freight) value of the imports. Under WTO rules, excise taxes should be non-discriminatory in that they should not be applied, in law or in practice, in such a way that has the effect of protecting a domestic industry. In tax rates and administrative procedures, WTO members must treat all imported and domestic products equally.

As excise taxes are levied on all products of the same description whether produced domestically or imported, the tax should be levied on the import duty inclusive value of goods.

VAT and other general consumption taxes intended to raise revenue as neutrally and efficiently as possible are then levied on top of any excise tax. The hierarchy of taxes for imported goods subject to excise taxation is:

1. Import duty on the c.i.f. value; plus
2. Excise duty levied on the value including import duty; plus
3. VAT levied ("ad valorem") on the excise inclusive value of the goods.

If excise goods are diverted from legal supply chains or smuggled into a market, then the government loses not only the excise tax but also any import duty and VAT (or sales tax) due.

Determining Excise Tax Rates

What are the Considerations in Setting an Excise Tax Rate?

The main considerations in setting the rate of tax for any goods or services subject to excise are the desired outcomes. The revenue forecast, in combination with the Laffer curve, will form the basis for a revenue outcome. The health or environmental drivers need to have their own outcome (and outputs). With new excise taxes designed to achieve health or environmental objectives — e.g., a new tax on SSBs — the initial rate of tax should be sufficient to influence manufacturers to reformulate existing products and design new products with a lower added sugar content. It is unlikely that the tax rate will be sufficiently high as to require the same level of administrative procedural requirements as for alcoholic beverages, tobacco products and hydrocarbon oils.

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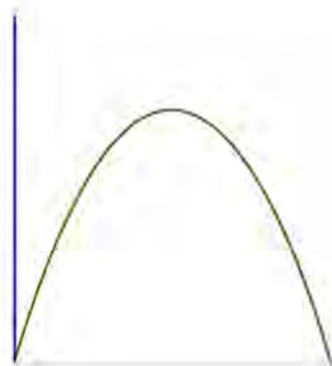
Laffer Curve



The Laffer Curve, developed by economist Arthur Laffer, demonstrates that there is a revenue-maximizing rate at which governments can apply an income tax, beyond which revenues will fall. At both extremes — an income tax of 0% and 100% — the government collects no revenue from income tax: a 0% tax rate means the government's revenue is, of course, zero. By imposing a 100% tax rate, the government collects zero revenue because taxpayers have no incentive to work or earn as all earnings would go to the government in the form of taxes. But governments can (and do) impose some level of income tax without completely discouraging people from working, and therefore generate tax revenues. Somewhere between 0% and 100%, therefore, lies a tax rate that will maximize revenue (t*). As tax rates increase from zero, government revenues will also increase up to the optimal, revenue-maximizing point (t*). Beyond the optimal point, overall tax collections will begin to decline as people work less or evade taxes. Although the model was developed to describe income taxes, the basic concept holds true for other types of taxes, including excise taxes.

As mentioned earlier, sudden huge rises in excise taxation should be avoided in order not to shock the market and lead to unwelcome consequences for employment, etc. Rather, it is better to increase excise taxes by small amounts regularly and to signal the increases well in advance as part of a comprehensive health or environmental tax strategy so that industry can plan accordingly. Once consumers have access to ready supplies of cheap illicit products that they find acceptable, reductions in tax rates rarely entice these consumers back to legitimate tax-paid products so it is best to adopt an approach of gradual tax increases.

In setting tax rates on goods, it is useful to consider both their affordability and the rates of tax applicable to the goods concerned in neighbouring countries/states and the effectiveness of border controls. Where the tax rates are lower in neighbouring countries there will be a level of legal cross-border shopping and of smuggling. Even in countries with comparatively low excise tax rates on products there can be a level of fraud or smuggling. It is worth considering the capacity and capability of revenue enforcement when determining tax rates.

Other Excise Tax Design Considerations

It is essential to define the goods or services meticulously to avoid confusion and errors. This is relatively easy for homogenous goods used only for one purpose. Most products differ widely in quality, composition, price, application or use so need careful definition. For the purpose of excise duty, goods and services can be classified as follows:[23]

- *On the basis of the nature, plant or animal origin of the commodity*: A simple example is use of a chemical formula — e.g., alcohol is ethyl alcohol but not methyl or propyl alcohol; sugar is sucrose but not fructose, lactose or

[23]Sijbren Cnossen, *Excise Tax Policy + Administration: in Southern African Countries*. University of South Africa, 2006.

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glucose. Tobacco, tea and coffee all derive from clearly identifiable plants;

- *According to the use of the commodity*: Various appliances, musical and photographic instruments may be used for household, industrial, scientific, educational or recreational purposes and excise rates can differ accordingly. A preferential rate or exemption may apply to industrial or domestic use of electricity, gas and water;
- *On the basis of the degree of harm to the environment or health*: Different product could have different harm profiles. Combusted and non-combusted tobacco and nicotine products, electric cars and cars with internal combustion engine or sugary drinks with different levels of sugar content could be examples of this. In this approach, the level of tax applied should reflect the level of harm that these products are causing to the environment or health (i.e., more harm more tax; less harm less tax);
- *By reference to the nature of the production process*: Beer is made of wort, obtained by dissolving sugar or molasses in water, or by extracting the soluble portion of malt or corn in the process of brewing;
- *On the basis of capacity or size of plant and equipment*: Motor vehicles are usually taxed on the basis of engine displacement, brake horsepower, size, gross weight or seating capacity. Other excise rate structures may be tiered according to the size of the plant or production capacity. Sometimes industrial machinery is taxed on a capacity basis as a proxy for production quantities; and
- *On the basis of the value of the commodity*: Cheaper brands of cigarettes, tea or coffee may be taxed at a lower rate subject to retail price. Passenger cars are often taxed on the basis of their value.

To avoid litigation and/or expensive laboratory testing it is best to avoid taxing goods on the basis of use or nature such as "primarily used in" or "primarily consisting of."

To reduce the opportunities for misclassification and litigation it is best to avoid a complex classification system for excise taxes. Ideally, the customs tariff classification should provide the basis for classification of both imports and domestically produced excisable goods.

What Else Should Influence the Design of an Excise Tax?

It is international good practice for the revenue authority to publish proposals for a new tax or a major change in an existing tax and to invite stakeholders to comment. This entails allowing stakeholders sufficient time to assimilate the proposals and to formulate their responses — usually 3 months. Then the revenue authority needs to consider what changes need to be made and to publish revised proposals explaining why the changes were made and why some proposals were not accepted. By inviting comments from stakeholders, the industries whose products or services are to be taxed will be able to inform the government of the expected implications for their businesses and of any major defects in the policy proposals. Publishing all consultation responses and revised proposals helps ensure that taxation does not have unintended consequences for the domestic economy and allows industry to "buy in" to the final proposals which, in turn, results in improved compliance.

Whilst tax policy drives the legislation, excise tax design should include lower level administration details such as tax registration/licensing or approval requirements, returns and payment requirements, security/bonds/guarantees, record keeping requirements, powers to enter premises, seize illicit products/records/manufacturing equipment and vehicles used to transport illicit products. It should be mandatory to destroy illicit products and manufacturing equipment rather than auction them to avoid re-use.

Excise taxes on alcoholic beverages, tobacco products and hydrocarbon oils are usually high enough to provide huge profits to criminals who can sell them well below the tax paid retail price and usually with little risk attached. In considering the tax policy it is important to try to "crime proof" legislation as far as possible by understanding the range of revenue risks and using lessons learnt from other jurisdictions.

What are the Main Reliefs Granted Under an Excise Tax?

As imports are subject to tax and exports are not, a consumption tax normally falls on consumption in the country. There are other

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reliefs that apply across goods subject to excise taxes. These can include deliveries to:
- Duty-free shops and stores;
- Ships' stores;
- For diplomatic and military use;
- For use in producing other goods — e.g., ethanol used in the manufacture of pharmaceutical products, tobacco products used in the production of insecticides, alcohol used in the production of varnishes, for medications or in hospitals, sugar used in brewing beer;
- For agricultural use — e.g., hydrocarbon oils products used by farmers; and
- For use by the disabled — e.g., specially adapted motor vehicles.

Many countries have some differentiation of tax rates on the basis of output capacity to encourage artisanal and small-scale industries.

There have been occasions when these reliefs have been abused and, indeed, "ghost" exports feature widely in illegal trade in alcohol and tobacco products. For this reason, it is important for policy makers to require the destinations relieved of tax to be registered/certified and, where practicable, subject to audit.

There are additional reliefs in some countries for excisable products such as alcohol and hydrocarbon oils. With environmental taxes on carbon or energy there can also be exemptions. There are rarely any additional reliefs for the manufacture of tobacco products.

Effective Tax Administration

The Essential Ingredient for Success

Whatever the excise tax policy, it can only achieve its goals if it is administered and enforced effectively. Whilst large multi-national companies may well pay a high proportion of the tax due there will be many medium and small enterprises who choose not to pay excise tax or as much excise tax as should be due. These undermine tax, environmental and health policies as well as feeding illicit trade and criminal activities and, in extreme cases, contributing to making inward investment in developing countries undesirable.

Key Components for Effective Tax Administration

The key components of effective tax administration and enforcement are common across excise taxes with physical checks applying only to goods. These include:
- Powers required (e.g., legal powers regarding requirement for record-keeping, for plant diagrams, recipes used etc.) with all changes to be notified (goods only), access to records, seizure and destruction of goods, identification of "tax point" for each excise tax, vehicles and equipment, sanctions including civil and criminal non-compliance with requirements, provision of facilities for revenue officials, entry and search of premises, closure of premises suspension of operations/movements of goods under tax/duty suspension (e.g., between import and inland bonded warehouse, between production and export);
- Sampling requirements and means to measure/test products (test equipment, laboratory facility or access etc. (goods only);
- Supply chain controls (goods only);
- Processes (e.g., registration/approvals, guarantees, returns and payments, debt management/insolvency, assessments/ appeals, application of civil penalties);
- Assurance (e.g., audit — both full and partial, risk-based compliance management with physical and/or financial and computer systems-based audits with unannounced visits to production and storage premises, credibility checks, desk-based audits);
- Taxpayer services (e.g., website information, electronic facilities, media publicity, call centres, hotlines to report "suspicions of smuggling/fraud," awareness seminars and surgeries);
- Partnership working across the public sector, with legitimate industry and their representatives, with foreign administrations under mutual assistance agreements and with regional/global organisations (e.g., World Customs Organization, Interpol, Europol).

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In the interests of brevity this paper does not go into detail about all the above as they are worthy of a separate publication.

Partnership Working Across the Public Sector

Partnership working between revenue authorities and other public sector organisations such as the Health, Education and Consumer Protection Ministries can be a forceful tool in reducing evasion/illicit trade in highly taxed excisable products. This may mean achieving some convergence in areas of legislation such as data sharing.

Where there are porous borders, poor official controls of Free Trade Zones and a large informal economy it is essential to work collaboratively not only with the national Customs/Borders and Police authorities but with the appropriate officials in neighbouring countries (or states where there is a federated system of government), with regional organizations such as the EU or regional customs unions and with international organisations such as Interpol and the World Customs Organization. Again, legislative provisions for mutual assistance agreements and exchange of information may be needed to facilitate collaboration in tackling illicit trade.

Working with Trade Associations and Legitimate Industry

Effective partnerships are built on mutual respect and an efficient, practical and transparent administration and enforcement. Both the revenue authority and the taxpayer should commit to zero tolerance of corruption. Some revenue authorities have developed voluntary Memoranda of Understanding (MoU) through trade associations representing the producers and others in the industry subject to excise taxation under which both parties have obligations.

Large or multinational businesses keep a careful watch on domestic markets and sometimes employ compliance teams to identify any counterfeit or otherwise illicit goods being sold that undermine their own products. Such compliance teams can acquire information/intelligence that is extremely useful to enforcement officials and a direct channel should be made available for intelligence to be fed through to revenue officials for investigation.

Compliance Costs to Businesses?

No government is likely to want to discourage economic development and inward investment. Best practice is to assess the compliance costs to excise operators when considering any change to laws, policies or administrative procedures. The objective is to ensure that procedures and requirements are as current and straightforward as is possible; avoid unnecessary costs to legitimate business; and reduce opportunities for taxpayer mistakes.

The overriding principle should be that information should only be required from excise operators if it is essential for policy making or for tax administration or enforcement and, as far as possible, the same information should be required only once.

Are There any Measures in Place to Facilitate Small Business Growth?

For duty on alcoholic beverages and SSBs, some countries allow small producers of alcoholic beverage products to benefit from a lower rate of tax (e.g., the United Kingdom has a small brewers relief — sometimes known as progressive beer duty). This allows small brewers to pay a proportional rate of duty on their beer. A brewer producing up to 5,000 hectolitres pays 50 percent of the standard duty rate. The United Kingdom also has a relief from sugar tax for small producers of SSBs.

Understanding Revenue Risks

Key Risks

The following list outlines the key risks to the revenue featuring in what are usually the three most highly taxed and therefore the highest risk areas — cigarettes, ethanol/alcoholic beverages and road fuels. These are:

- Unregistered illicit manufacturing (including of counterfeit goods);
- Undeclared production by registered excise manufacturers;
- Sales (duty not paid) to non-existent customers;
- Fictitious sales (duty not paid) to, or diversions from, known customers;

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- Fictitious removals (duty not paid) to bonded warehouses (including to non-existent bonded warehouses);
- Goods disappearing from bonded warehouses, duty free shops or duty-free store floors (and/or duty not being properly accounted for on removals);
- Theft — from manufacturers, bonded warehouses, when in transit etc.;
- Export diversions (i.e., goods not leaving the country);
- Exports leaving the country but coming back;
- Smuggling of products in from neighbouring countries (including concealment methods and container measurements);
- Smuggling of products brought in by air or sea;
- Transhipments (not being reshipped but diverted for home use);
- Leakages from duty-free users (including from government, diplomats, armed forces);
- Adulteration (mixing of taxed and untaxed products);
- Undervaluation; and
- Origin fraud.

In developing a risk-based compliance management strategy attention needs to be focused on all the risks but they should be prioritised based on the perceived areas of revenue loss in the country and resources allocated accordingly.

What Types of Excise Avoidance/Evasion are Most Common?

Most of the excise revenue lost to the government is likely to be the result of evasion through smuggling and under declaration of domestic production but where there are supplies between sister companies in a multinational group there is also the risk of avoidance through transfer pricing.

The extent of evasion will depend on the type of product subject to excise taxation, the rate of tax charged and the effectiveness of the revenue authority and border controls in the country concerned. For example, cigarettes are light and easily portable, and they are usually subject to very high taxation. A large number of cigarettes can be transported in one container with a huge value in tax. The highest profits for the criminals will be in those countries with the highest tax rates (excise and VAT).

Items that are subject to a comparatively low tax rate and are far bulkier such as SSBs are likely also to cost more to transport. Criminals are likely to choose the high profit option of cigarettes though there is evidence that, once an illicit market has been developed for one product, criminals add other lower taxed and/or prohibited products to their range of illicit goods. They usually supply whatever they can sell. See the 2016 OECD publication "Illicit Trade: Converging Criminal Networks."[24]

In general, for goods subject to excise tax, the most common types of excise evasion are smuggling of legal or counterfeit goods, undeclared manufacture and ghost exports. These illegal activities are usually organised by international criminal organizations and even by terrorists. The top people in criminal organizations are never the ones doing the smuggling on the ground. They use local people who are then caught with the goods. They hire vehicles so that seizure of vehicles is not effective. In many emerging economies with a lack of commercial and economic opportunities close to the borders, there is a ready pool of poor people keen to earn money. When such smugglers are caught, there are always more to take their places.

There can also be cross border shopping in commercial quantities and illegal sales of goods supplied tax free to diplomats and to the military.

The illegal trade in alcoholic beverages includes counterfeiting — sometimes with liquids very damaging to health such as battery acid. It includes refilling of used bottles and unscrupulous restaurant staff/barmen substituting lesser quality drinks once the customers have had a couple of drinks of the real thing. It is essential that there are strict excise revenue controls on all ethanol producers and any ethanol produced that is not intended for the food or beverage industries should be denatured (made non-drinkable).

[24] OECD, "Illicit Trade: Converging Criminal Networks" (2016).

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Anhydrous ethanol intended for road fuel use must be fully denatured before it leaves the distillery. With road fuels, the fuel can be "stretched" or diluted as well as smuggled. There have been many instances of fuel deliberately "leaked" from pipelines. Nowadays, there are very good fuel markers that can help authorities detect motor fuel siphoned from the pipeline.

Aviation fuel is usually relieved of tax under long-standing international agreements but the level of global concern about climate change may cause governments to remove this relief.

A common feature of the illicit trade in excise products is corruption that involves officials in Customs and/or the revenue authority.

For excise goods subject to ad valorem taxes there can also be valuation frauds with the value of goods on production under declared/incorrect. There can be avoidance by separating out some costs from production (e.g., marketing and overhead costs) and loading these onto a distribution company; and transfer pricing manipulation on purchases of key ingredients from associated companies either in country or abroad.

Free Trade Zones (FTZ) — The Need for Controls on Excisable Goods

In countries with free trade zones (FTZs), having effective customs controls on operations carried out therein and on movements of goods in and out are key to stemming the flood of counterfeit and tax-unpaid goods. These can include, for example, cigarettes exported legally from a country and smuggled into their destination country via an FTZ. Legislation should allow for customs controls on FTZ in accordance with the revised Kyoto Convention Annex D.[25]

Other revenue risks are associated with:

- Corruption of customs and/or revenue officials;
- Failure of excise audit and enforcement staff to understand the weak points in the production, storage and movement processes of goods under bond; and
- Failure of audit and enforcement staff to carry out sufficient announced and unannounced physical checks on excise operators' premises.

Supply Chain Controls

Under the provisions of an excise registration or licence, it is advisable to require the excise operator to apply due diligence to all transactions with suppliers and wholesale customers. If there is any suspicion that a supplier is also supplying inputs to an illicit operator or that a wholesale customer is also supplying retailers with illicit products, the excise operator should be required to notify their revenue authority and, if appropriate, to cease transactions with that supplier or customer.[26]

Operators authorised by Customs to act as an Authorised Economic Operator will have had supply chain security of their international shipments audited by Customs.

Operators sending shipments of tobacco products from/to/through countries that are implementing the (WHO's) Framework Convention on Tobacco Control's Illicit Trade Protocol[27] are required to monitor supply chain security using a track and trace system that aggregates/disaggregates products from packet to master case to pallet and vice versa. With the development of blockchain for international shipments, supply chains should become even more secure and render other supply chain security systems such as tax stamps redundant.

What About Tax Stamps/Digital Identifiers?

There are ever more sophisticated tax stamp systems available now including digital identifiers. The WHO's Framework Convention on Tobacco Control Illicit Trade Protocol (ITP) requires all parties who implement the ITP to use a track and trace system that allows for products to be aggregated (cigarette packet to carton to pallet to container) and disaggregated at points in

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[25] World Customs Organization, Revised Kyoto Convention, Specific Annex D (Apr. 17, 2098).

[26] For more information, see *The Development of Modern Revenue Controls on Alcoholic Beverages* by Elizabeth Allen and Doug Godden (World Customs Journal, Vol. 11, No. 2., September 2017); and Elizabeth Allen's "Know Your Supplier/Know Your Customer" published by the International Tax and Investment Center (ITIC) in 2017.

[27] World Health Organization (2013), *Protocol to Eliminate Illicit Trade in Tobacco Products*.

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the supply chain to the first wholesale customer. This has called for a digital identification system working on real-time data and operated by an independent third party, not by the tobacco manufacturers.

Digital codes using unique numbers can be imprinted on packets, bottles and cans or on the metal tops to bottles and cans. The codes are then supported by a database maintained by the producer and made available to the revenue authority. Where manufacturers can use the digital identification system of their choice, providing it complies with the GSI standard, the cost is more competitive than the cost of using one mandated supplier. Because of the ability of criminals to reuse/refill bottles and replace labels it is not advisable to use this technology for bottled products, other than those with metal tops, as it could provide revenue authorities and consumers with a false sense of confidence.

The only way duplicate identifiers can be found is to carry out large-scale checks on goods in the retail sector. If duplicate codes are found, the challenge is to identify which product is the genuine one. One solution promoted is to engage consumers in carrying out such checks using a smartphone on products they purchase. So far, consumers have shown little inclination to carry out such checks.

The main advantage seen so far in the use of digital identification systems that aggregate and disaggregate products across supply chains has been that it is useful to investigators to be able to identify exactly when and where a supply of legitimate products left the legal supply chain.

Conclusion

With the shock of COVID-19 lockdown resulting in economic downturns and governments around the world incurring massive debts to support their populations through the crisis, governments are considering how best to obtain tax revenues without further endangering economic development. This paper has sought to show that levying higher excise taxes gradually and implementing new, politically acceptable excise taxes can be part of revenue strategies for economic recovery.

Annex 1. Structural Options for Excise Taxes

Structure	Advantages	Disadvantages
Specific Tax Structure	• The tax can reflect the amount of potential "harm" in the product — for example, by levying tax on the weight of tobacco/tar content or on alcohol content. • The tax is generally easy to calculate if based on something that is easily measurable. • The tax can be relatively easy and efficient to administer and control if levied on production and import. • The tax is more difficult to evade when based on an indisputable measurement and official control covers the whole production process. • The tax is non-discriminatory if applied at the same rate for all directly competing products — for example, all spirits drink or even all alcoholic drinks or all cigarettes (e.g., a bottle of champagne valued at $100 and sparkling wine valued at $5 are taxed the same for excise).	• The tax will not adjust automatically to reflect changes in price or inflation, so provision for regular adjustment needs to be built into legislation. • The tax bears more heavily on cheaper products in comparison with premium products (e.g., the tax may reflect 30% of the value of cheap sparkling wine and maybe 5% of expensive champagne). • The tax does not reflect the value of packaging or convenience of sales outlet to the consumer. Ease of access to products can be important in the development of illegal trade in excisable products, especially in rural areas where consumers rely on goods available locally.

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Annex 1. Structural Options for Excise Taxes *(Continued)*

Structure	Advantages	Disadvantages
Specific Tax Structure	• The tax fosters consumer choice by not distorting underlying differences in prices based on differences in quality. • The tax encourages investment and product development through not penalizing producers of high-quality products. For example, under a specific tax regime, the highest quality Scotch whisky bears exactly the same excise tax as blended supermarket own brands. • By applying an equal tax burden to all similar products regardless of origin, type or value, specific taxes promote trade expansion, and lead to an overall increase in economic activity. This can encourage start-up businesses and new regional brands, especially where there are special rates for small producers.	
Ad Valorem	• The tax adjusts automatically to reflect changes in price. • The tax is less regressive in that it bears comparatively less heavily on cheaper products. • Where based on retail price, the tax reflects the full value of the goods including packaging.	• The tax is more likely to be subject to undervaluation/evasion. • The tax does not reflect the potential "harm" in the product and for high value/quality products may operate as a luxury goods tax. • As an "ad valorem" tax structure provides more room for low-priced products, revenues then become increasingly dependent on consumers' purchasing decisions and may result in less stable and less predictable tax revenues. • Widens the price gaps between premium priced brands and lower priced brands, resulting in less significant impact on the consumption of harmful goods. • Requires increased monitoring by tax administrators as product prices can change frequently and can vary significantly between the high and low-priced brands.
Mixed Excise Tax Structure	• The tax can be constructed to reflect some of the benefits of both specific and "ad valorem" tax structures. • Sometimes, a mixed tax structure provides an acceptable political compromise in a customs union where some countries have a history of specific excise taxes and others have a history of "ad valorem" excise taxes.	• The more complex structure is more difficult to administer both for revenue authorities and for business. There is more scope for errors — deliberate or otherwise. • External factors outside the control of the manufacturers, such as increases in fuel prices or packaging, may distort costs and add significantly to the selling price on which ad valorem tax is charged.

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Oil and Gas Fiscal Policies: The Impact of Oil Price, Investment, And Production Trend

by Carole Nakhle and Theophilus Acheampong

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Oil and Gas Fiscal Policies: The Impact of Oil Price, Investment, And Production Trend

by Carole Nakhle and Theophilus Acheampong

This article is part of the series, "Post-COVID-19: How Governments Should Respond to Fiscal Challenges to Spur Economic Recovery," coordinated by the International Tax and Investment Center (ITIC) to offer tax policy guidance to developing countries during the post-pandemic recovery phase.

Carole Nakhle is the chief executive officer and Theophilus Acheampong is a senior consultant with Crystol Energy in London.

In this installment, the authors analyze whether oil and gas host governments might revisit their upstream fiscal regimes following the coronavirus pandemic and, if they do, what measures they might adopt in the shorter term.

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Abstract

The coronavirus (COVID-19) pandemic and subsequent "Great Lockdown" have profoundly disrupted the oil and gas industry, causing a collapse in prices and slashing of investment spending across the sector. Because of the severity of the crisis, some oil companies requested direct government bailout — wrongly in the authors' view — while others hoped for a relaxation of the fiscal terms.

The objective of this paper is to analyze whether host governments might revisit their upstream fiscal regime following the crisis, and if they do, what measures they are likely to adopt in the more immediate term. The list of factors that drive fiscal changes is long; the analysis carried out in this paper focuses on three common and interrelated key drivers — namely oil price, investment trend, and production performance. For illustrative purposes, the paper studies 10 major offshore provinces both in the OECD and emerging markets, which are considered directly competing for international capital. These provinces share similar commercial and technical challenges but government fiscal responses tend to differ, depending on several factors, including the way the fiscal regime is designed, health of the industry before the crisis, and degree of economic dependence on oil revenues.

Key Findings

The analysis confirms the inherent fiscal instability in the oil and gas sector, with the prominent role of oil prices, investment, and production trend as some of the common drivers of fiscal changes. Other factors include the dependence of an economy on oil revenues and the "neighborhood" effect; politics also play a role, albeit more muted. Even in the world's most stable fiscal regime — that is, the Norwegian regime — changes have been implemented to adapt the regime to changes in local and international conditions.[1] The Norwegian experience confirms that no fiscal regime is cast in stone, but changes can be made while maintaining the stability of government take.

Overall, there seems to be consistency in the direction of travel in the more immediate future; the perception is that the industry is going through an unprecedented cycle and an alleviation of the fiscal and regulatory burden may be needed to sustain investment, production, and revenues. However, the reaction of host governments will differ, as are the measures that might be introduced and the speed at which they

[1] Norwegian Government, "Package of Measures to Support the Oil and Gas Industry and the Supply Industry," Press Release No. 76/20 (Apr. 30, 2020).

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will be pursued. The longer low oil prices prevail, the higher the pressure to accelerate fiscal reforms is, especially if investment remains subdued.

Host governments, particularly those in developing economies, are usually slow to react to collapse in oil prices (especially as compared to their reaction when prices increase). For those countries that are heavily dependent on oil and gas revenues to meet budgetary needs, this can even take much longer. Furthermore, governments typically attempt to soften the regulatory burden before considering pursuing fiscal changes, since the financial implications on their coffers are lower.

Some governments started to review their fiscal terms before the COVID-19 crisis hit the world economy and subsequently the oil industry. The review was often driven by a decline in activity. Under current circumstances, it might be accelerated to avoid worsening an already challenging pre-crisis situation. However, not all governments will be convinced of the need to relax their fiscal terms, especially those that are more dependent on oil revenues and others where resource nationalistic politics play a central role.

A competitive fiscal regime does not necessarily imply low tax rates. Indeed, evidence shows that such regimes are often unstable. Simple measures such as a focus on swift payback and recovery of capital spending can hold equivalent or even greater appeal to investors, as do low headline tax rates. Similarly, profit-based instruments are much more likely to engender investment than front-loaded, revenue-based instruments, such as royalty and signature bonuses, and are characteristically more stable.

The way the regime is designed will affect the need for, and type of, changes to be made. Profit-based regimes have long proven their superiority to revenue-based regimes: The government share increases or decreases with profitability, thereby automatically adjusting to changes in a wide range of conditions. On the contrary, a regressive regime (the government share varies inversely to profitability) needs continuous tinkering to adapt to changing conditions. Investment typically favors progressive regimes even with higher government share. That said, regressive instruments such as royalty — when properly designed and implemented — are an important source of revenues, especially for poorer nations and regions.

Countries, which are particularly struggling in terms of declining investment and production, can consider measures such as providing fiscal incentives for the development of marginal fields or encouraging exploration and appraisal expenditure within hub catchment areas. Depreciation rules in the tax regulations can also be modified to allow faster front-loading or introducing an uplift on exploration expenditure. This would create a major incentive for operators to reinvest capital to improve project economics.

Introduction

The coronavirus pandemic has caused acute pain the world over. To stop the spread of the virus, countries around the world imposed strict lockdowns, which have hit the global economy and subsequently, oil demand, hard. Nearly all businesses have suffered substantial financial pain and enduring uncertainty, with those in the transportation, hospitality, and energy sector amongst the most severely affected.

The collapse in economic activity brought oil demand down with it; demand destruction exceeded 20 percent virtually overnight. The outcome was an unprecedented decline in oil prices, with West Texas Intermediate prices turning negative in April 2020 for the first time in the industry's history. The severity of the crisis is evident from the actions taken across the industry, from reductions in capital expenditure, operating costs, oil field shut-ins, and in the case of Shell, the first dividend reduction since World War II.

For oil-producing countries, especially those with limited economic diversification, the suffering is particularly severe. The fiscal breakeven oil price, which is needed by oil-producing countries to balance their budgets, is one illustration of the scale of the challenge facing these countries. At current oil prices, for instance, oil producers such as Nigeria, Ghana, and Angola run substantial fiscal deficits (Figure 1). Continued development of oil and gas reserves will be more of a priority for such countries — in particular, to restore public finances and support the local economy.

Some oil companies requested direct government bailouts, wrongly in the authors'

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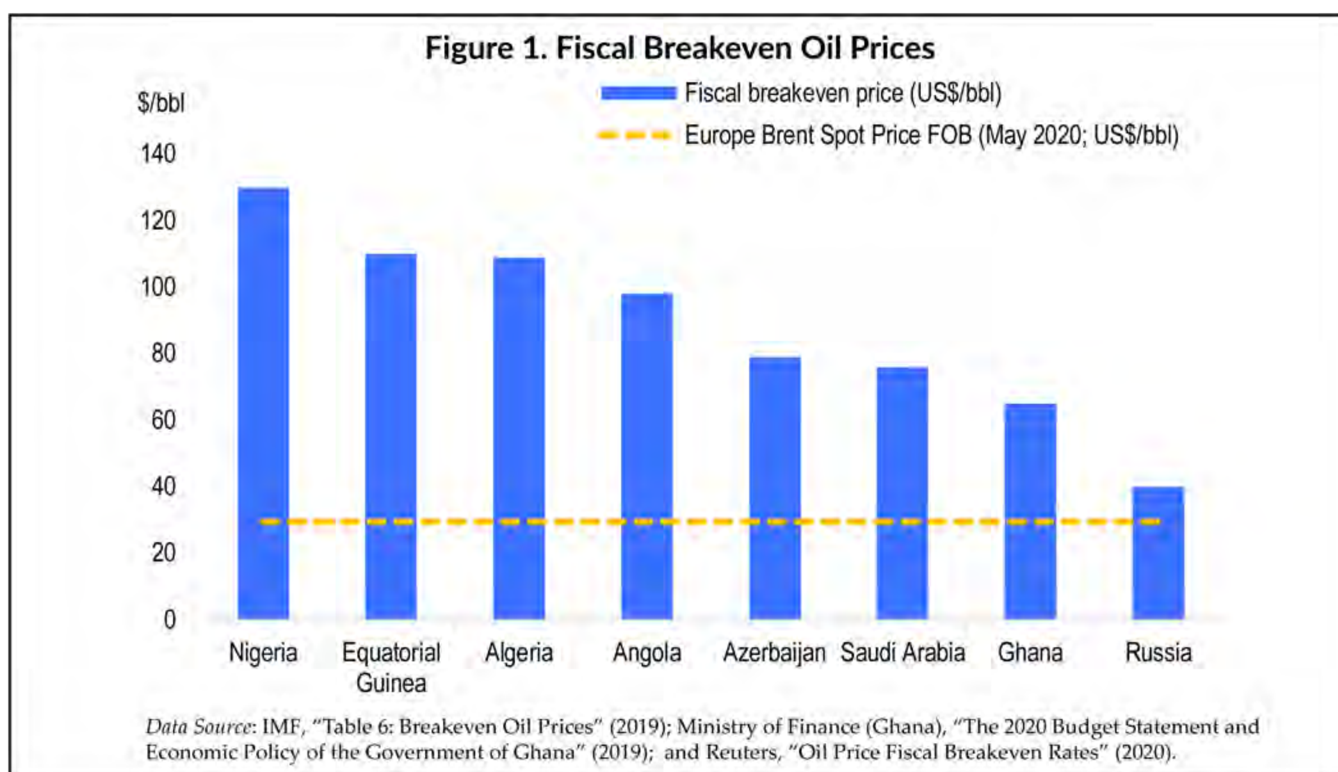

Data Source: IMF, "Table 6: Breakeven Oil Prices" (2019); Ministry of Finance (Ghana), "The 2020 Budget Statement and Economic Policy of the Government of Ghana" (2019); and Reuters, "Oil Price Fiscal Breakeven Rates" (2020).

view. Investment can be supported without the need for direct financial aid: The solution lies with the fiscal regime. As the world emerges from the crisis, host governments will be increasingly competing for international capital, which will be much more cautious, selective, and disciplined in today's highly uncertain environment. Investors will therefore have the luxury of more opportunities than can be financed.

The objective of this paper is to analyze whether host governments might revisit their upstream fiscal regime following COVID-19 to safeguard and attract investment, and if they do, what measures they are likely to adopt in the more immediate term. The list of factors that drive fiscal changes is long; the analysis carried out in this paper focuses on three common and interrelated key drivers — namely, oil price, investment trend, and production performance.

For illustrative purposes, the paper studies 10 major offshore provinces both from OECD and emerging markets, which are considered as directly competing for international capital. These provinces share similar commercial and technical challenges, and most have significant potential deepwater resources that they are keen to unlock. Nigeria and Brazil, for instance, hold the largest remaining crude oil deepwater and ultra-deepwater reserves, respectively.[2]

Furthermore, the impact of a downturn cycle in the industry tends to be more notable on offshore investment, given the higher cost and longer payback period of such projects, which usually worsen with rising water depth. Following the collapse in prices in 2014, companies increasingly diverted their capital to projects with shorter payback periods, such as onshore and especially shale, at the expense of offshore projects (Figure 2). As put by the International Energy Agency (IEA), the rapid growth of shale's weight in the global upstream investment in recent years implies that the industry is shifting toward shorter cycle projects able to generate cash flow faster.[3] In this respect, the COVID-19 crisis is likely to have a bigger and more enduring impact on the offshore industry.

The remainder of this paper proceeds as follows: The next section analyzes the drivers of

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[2] According to GlobalData Upstream Analytics, as quoted in *Offshore Technology*. *See* "Nigeria Tops Countries With Largest Remaining Deepwater Oil Reserves" (Feb. 2, 2018); and "Brazil Tops Countries With Largest Remaining Ultra-Deepwater Oil Reserves" (Feb. 8, 2018).

[3] IEA, "Share of Upstream Oil and Gas Investment By Asset Type, 2000-2018" (last updated Dec. 9, 2019).

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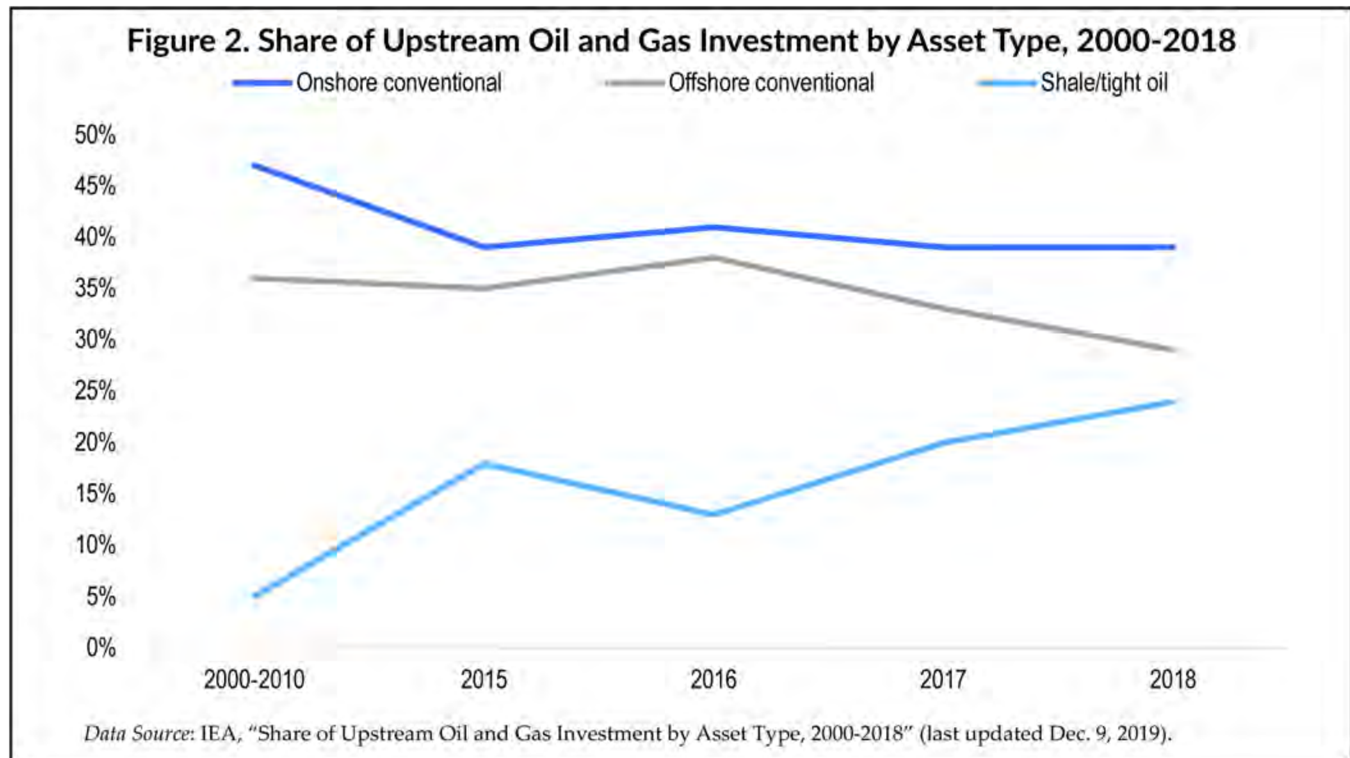

Data Source: IEA, "Share of Upstream Oil and Gas Investment by Asset Type, 2000-2018" (last updated Dec. 9, 2019).

fiscal changes; the third section studies the measures taken by the selected provinces, focusing on the main fiscal modifications implemented, if any, following the fall in prices in 2014, then those announced or likely to be implemented after the oil price collapse in 2020; and the final section provides the recommendations and concluding remarks.

Drivers of Fiscal Change

Although the importance of fiscal stability is a popular mantra for the oil and gas industry, it is rarely delivered, particularly in extractives-based developing economies, as circumstances are constantly changing. Several factors can drive governments to revisit their fiscal terms and for companies to lobby for fiscal changes. The list of such factors is long.[4] (See Figure 3.)

The oil price is the most obvious driver, as it has an immediate palpable impact on government revenues, as well as its impact on the perception of fairness with respect to the sharing of the proceeds. Other factors include investment trend, which is a function of both market dynamics and domestic policies, and production life cycle. Factors such as climate change policies will play an increasingly important role in the longer term and deserve a separate detailed analysis in their own right. Of course, it is difficult to attribute fiscal changes to only one factor; a combination of factors, some mutually reinforcing and others exogenous to the oil industry, leads to fiscal changes.

A certain degree of flexibility is to be allowed in any tax system if it is to adapt to significant changes in domestic and market conditions. The government response, however, largely depends on the design of the fiscal regime and its ability to adjust automatically to such changes. For instance, a regime in which the fiscal take is heavily front-loaded and revenue-based typically requires more tinkering than a profit-based system. In Nigeria, where the system's reliance on royalty — a regressive instrument — is notable, the revision to fiscal terms is legislated, and seems to be getting more frequent under newer legislation. For instance, the 2019 amendment of the Deep Offshore and Inland Basin Production

[4] For a detailed analysis, see Mario Mansour and Carole Nakhle, "Fiscal Stabilization in Oil and Gas Contracts: Evidence and Implications," Oxford Institute for Energy Studies Paper: SP 37 (Jan. 2016); and Nakhle and Raymond Hall, "The Taxation of Upstream Oil — Principles, Practice and Prospects," Centre for Global Energy Studies (2012).

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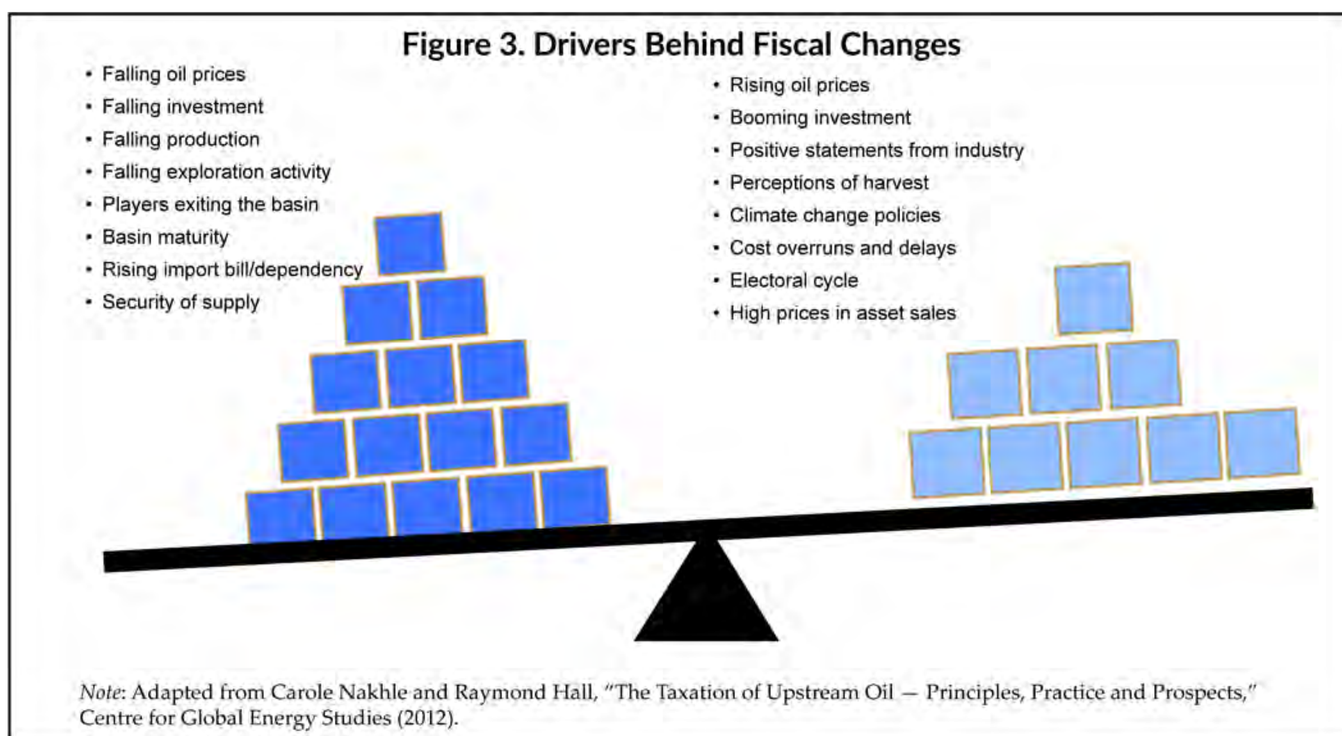

Note: Adapted from Carole Nakhle and Raymond Hall, "The Taxation of Upstream Oil — Principles, Practice and Prospects," Centre for Global Energy Studies (2012).

Sharing Contract Act (BOIBPSCA) calls for a review of the production-sharing contracts (PSCs) every eight years — that is several times throughout the duration of the contract. If Nigeria's petroleum fiscal regime had more progressive features built in that adjust automatically to changing conditions and projects, it wouldn't need all these regular reviews.

Oil Price Effect

Host governments typically want a "fair share" of the economic rent from the exploitation of the nation's oil and gas resources. The U.K. government's objective with respect to the fiscal regime imposed on the U.K. Continental Shelf is "to obtain a fair share of the net income from those resources for the nation, primarily through taxation."[5] In Liberia, "the fiscal regime shall create incentives for responsible investors while providing a fair and equitable return to" the country.[6]

Achieving this goal is rarely that simple, since there is no objective definition of what represents a "fair share," and it is seldom that both government and the industry agree for long as to whether a fiscal regime is fair or not. The dynamics of oil price volatility ensure that views of what constitutes a "fair share" constantly change. While a government take (total tax paid divided by pretax value, a metric that can be discounted or undiscounted) of 50 percent to 60 percent might be acceptable with oil prices of $60 per barrel (/bbl), it is unlikely to be the view when the oil price shoots up above $100/bbl. In this respect, the issue is always controversial, and governments keep the question of a "fair share" under almost constant review.

The U.K. experience is a good illustration of how governments closely follow the oil price when it comes to tightening or relaxing their fiscal terms (Figure 4). In Nigeria, the BOIBPSCA of 2004 stipulates that the fiscal regime's reviews are supposed to be triggered when oil prices exceed $20/bbl in real (inflation-adjusted) terms.[7]

[5]HM Treasury, "Driving Investment: A Plan to Reform the Oil and Gas Fiscal Regime" (Dec. 2014).

[6]Liberian Government, "Liberia National Petroleum Policy" (2012).

[7]The provision, however, was never enforced, leading to the 2018 Supreme Court ruling that the oil companies owed the government more than $62 billion. See Dulue Mbachu and Elisha Bala-Gbogbo, "Nigeria Demands $62 Billion From Oil Majors for Past Profits," Bloomberg, Oct. 9, 2019.

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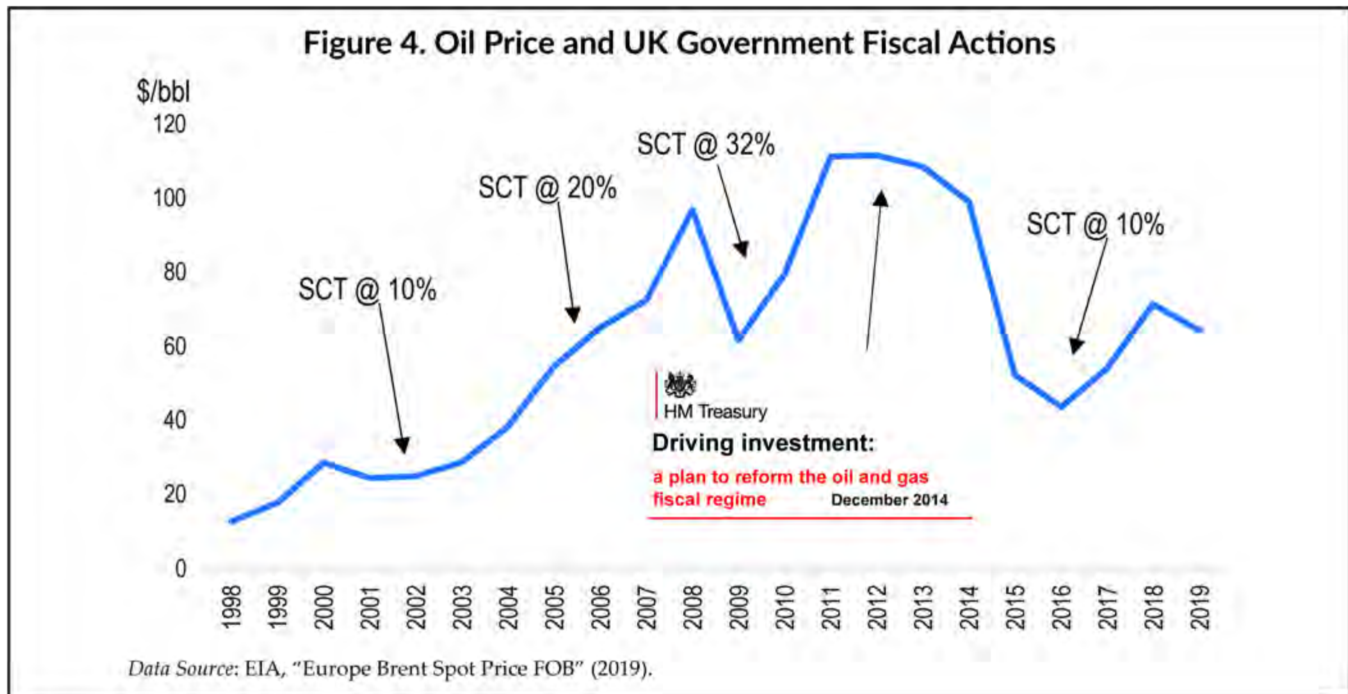

Data Source: EIA, "Europe Brent Spot Price FOB" (2019).

Oil prices play a significant role in determining the degree of bargaining power each party has at the negotiating table. Typically, when the oil price is high, the government has the upper hand; when the price moves in the opposite direction, the pendulum swings in favor of the companies (due to the capital constraints this entails), albeit at a slower pace and asymmetrically.

In the first years of this century, oil prices were on an upward trend, rising from $26/bbl to $100/bbl between 2002 and 2008 (nominal terms), and subsequently triggering a "fiscal storm."[8] From Angola to Argentina, China, Ecuador, India, Kazakhstan, Libya, Nigeria, and the United States (Alaska), governments tightened their upstream fiscal terms on the ground that they were not receiving their fair share of the increasing profitability from the sector. According to *The Economist*, the then-surge in oil prices presented a shift in the global balance of power away from companies to host governments.[9] Following the financial crisis in 2008 and the ensuing collapse in prices, some of those measures were relaxed, but the crisis was short-lived and oil prices rebounded to record high courtesy of OPEC cuts.

Since 2014, however, oil markets have been fundamentally reconfigured thanks to the shale revolution in the United States and which sowed the seeds for the current situation. As the U.S. tight oil boom commenced in earnest around 2010, it brought not only new supplies to the market but, just as important, much more flexible supplies. Traditionally, a conventional oil project may take seven to 10 years to convert investment into production. For tight oil projects, however, this time lag has shrunk to months, making production very price sensitive. Such a simple yet powerful feature has had major implications on global oil markets, established producers, and geopolitics; and it will continue to dictate market trends in the foreseeable future. The challenge of not only plentiful, but more flexible, oil supplies was so big that in 2016 OPEC assembled the biggest alliance in the history of the oil industry to agree on coordinated production cuts with non-OPEC producers, led by Russia. The alliance became known as OPEC+, which stopped the relentless pressure on prices and managed to set a floor on the price of oil. Tight oil, however, set the ceiling over the entire period of interventions, as it rebounded as soon as oil prices recovered.

[8]As referred to by Wood Mackenzie in "Fiscal Storms Perspective" (2008).

[9]"Energy and Nationalism — Barking Louder, Biting Less," *The Economist*, Mar. 8, 2007.

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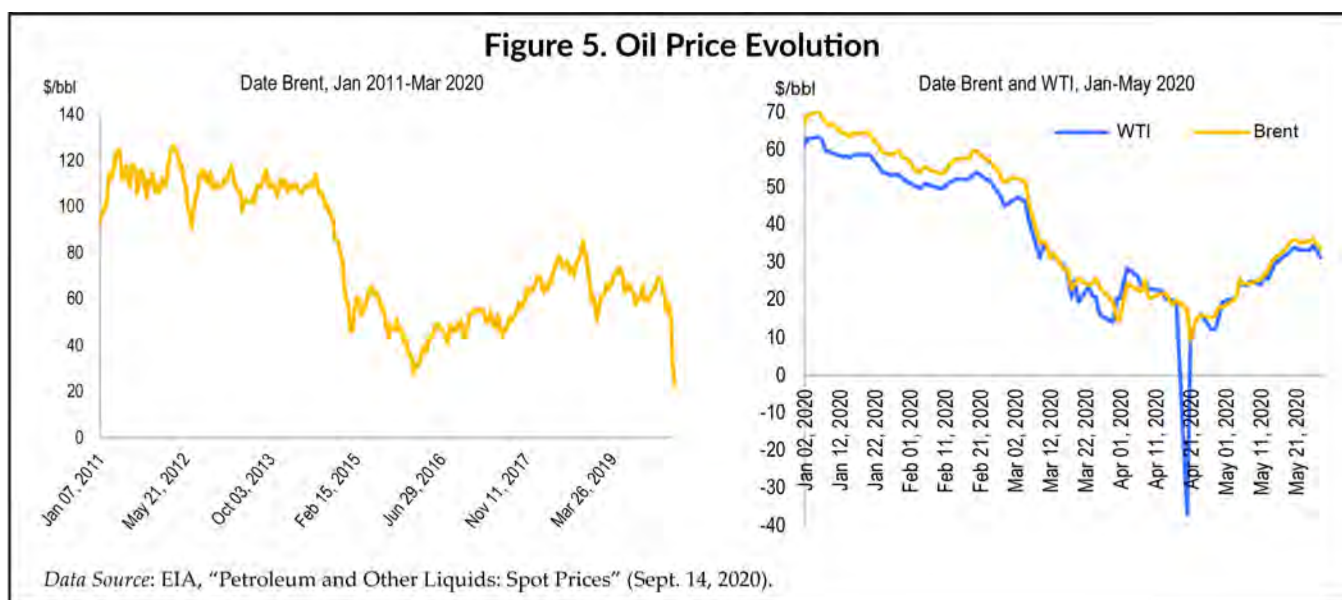
Figure 5. Oil Price Evolution



Data Source: EIA, "Petroleum and Other Liquids: Spot Prices" (Sept. 14, 2020).

Since then and up to March 2020, prices continued to react upward to cuts and downward to increased shale production; however, this artificially induced volatility gradually diminished as prices moved into a well-defined corridor (around $60/bbl +/- $10/bbl) toward the end of the period (Figure 5). In February 2020, oil prices were back where they had been in December 2016, just when the first production cut of OPEC+ was announced, and despite substantial supply disruptions in key producers such as Iran and Venezuela.

The other important aspect to consider is that the crisis gave producers a glimpse of how the market will look when oil demand peaks, and as a result the oil market starts to shrink and low oil prices become the norm. In such a market, the low-cost producer always has the edge, while the high-cost producer is the first to leave the market.

In a low oil price environment, capital becomes scarce and pro-investment policy reforms are more evident as countries compete harder for global capital. In fact, such a trend is more evident since 2014; from the Americas to Europe and the Middle East, Africa, and Asia, governments have announced and implemented reforms designed to make their countries more attractive investment propositions than elsewhere. As the U.K. government clearly stated in a 2014 paper, "shifts in the global oil and gas landscape may make it harder to continue to attract global capital without substantial improvements in the fiscal and regulatory landscape."[10] The race can largely be expected to intensify, given prevailing market conditions.

Investment Trend

Typically, rising investment encourages host governments to believe that they can introduce a tax increase with little pain. Unexpected declines in investment may trigger the opposite response. Investment, however, is a function of several variables; chief among them is oil price in addition to cost, as well as the fiscal regime (particularly its international competitiveness and long-term stability) — all of which affect expectations about future returns. Following the collapse in oil prices in 2020, capital expenditure (capex) cuts of between US$85 billion[11] to US$120 billion[12] have been announced globally (figures 6 and 7).

As observed during the 2014-2017 downturn, sub-Saharan Africa is likely to witness the most significant capex cuts during the latest downturn due to the industry's high dependence on foreign investors for funding upstream projects, complex projects spanning multiple geologies, and high political and regulatory uncertainty (political risks) in some key producing countries. Some

[10] HM Treasury, *supra* note 5.

[11] Offshore Technology, "Over $85bn of 2020 Forecast Expenditure Erased From Oil and Gas Sector" (Apr. 23, 2020).

[12] OilNow "CAPEX Cuts Hit US$120 billion Across 170 Companies — Guyana Offshore Pushes On" (May 12, 2020).

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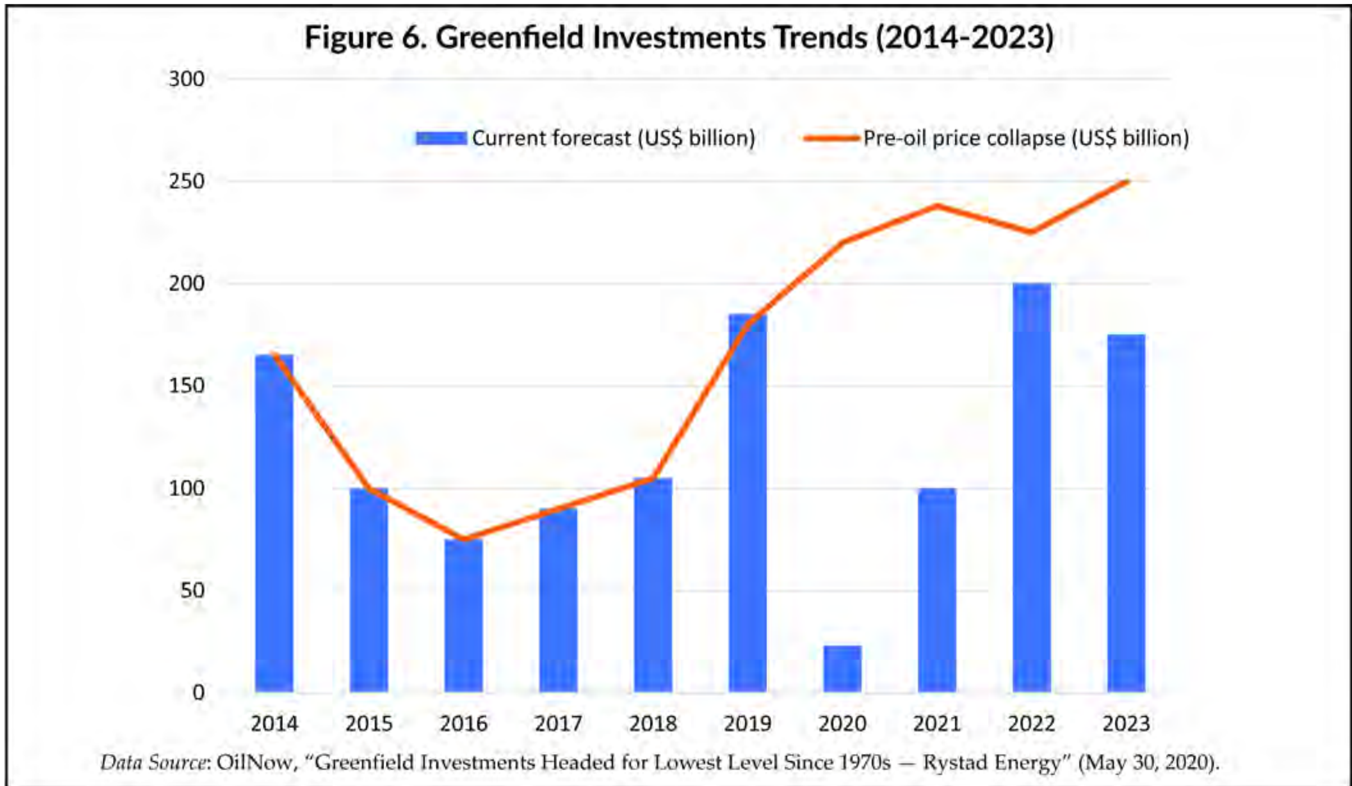
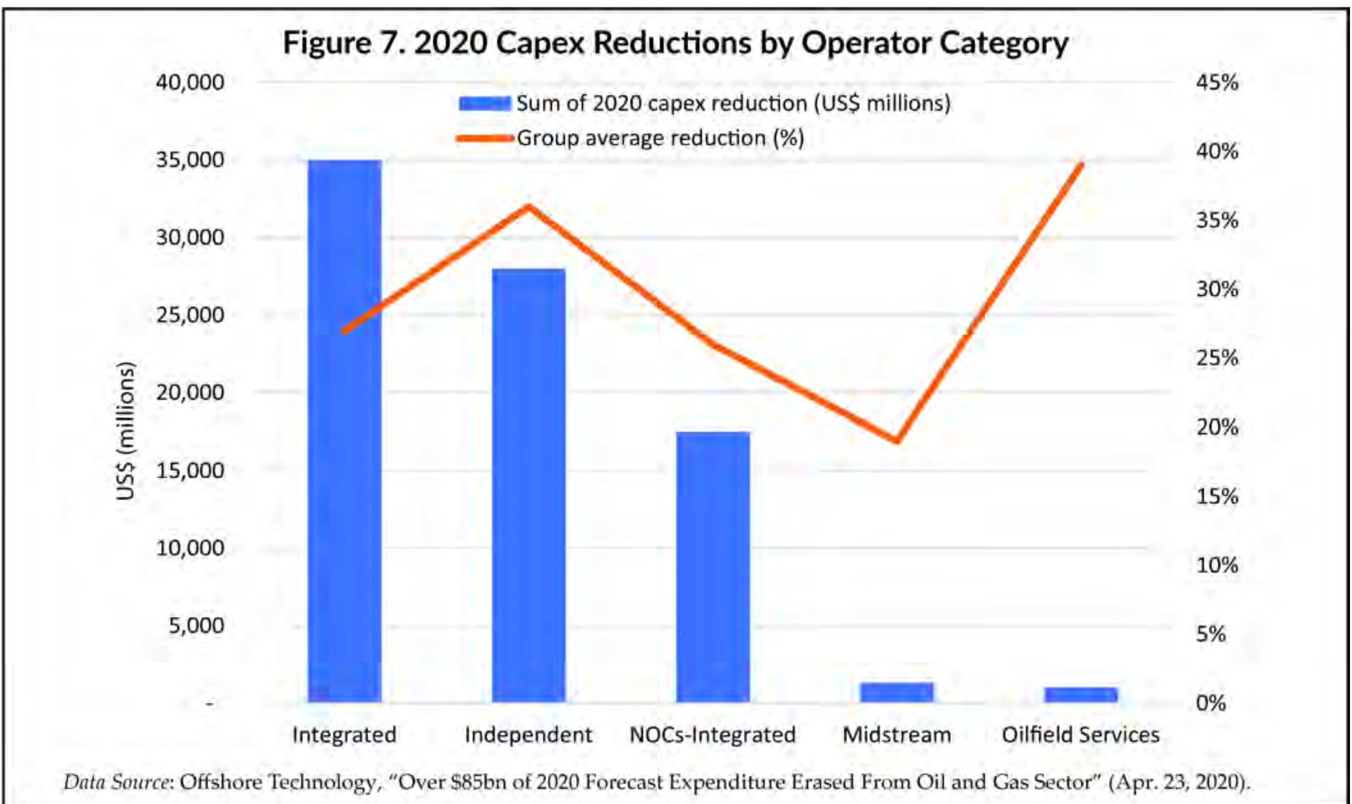


Data Source: OilNow, "Greenfield Investments Headed for Lowest Level Since 1970s — Rystad Energy" (May 30, 2020).



Data Source: Offshore Technology, "Over $85bn of 2020 Forecast Expenditure Erased From Oil and Gas Sector" (Apr. 23, 2020).

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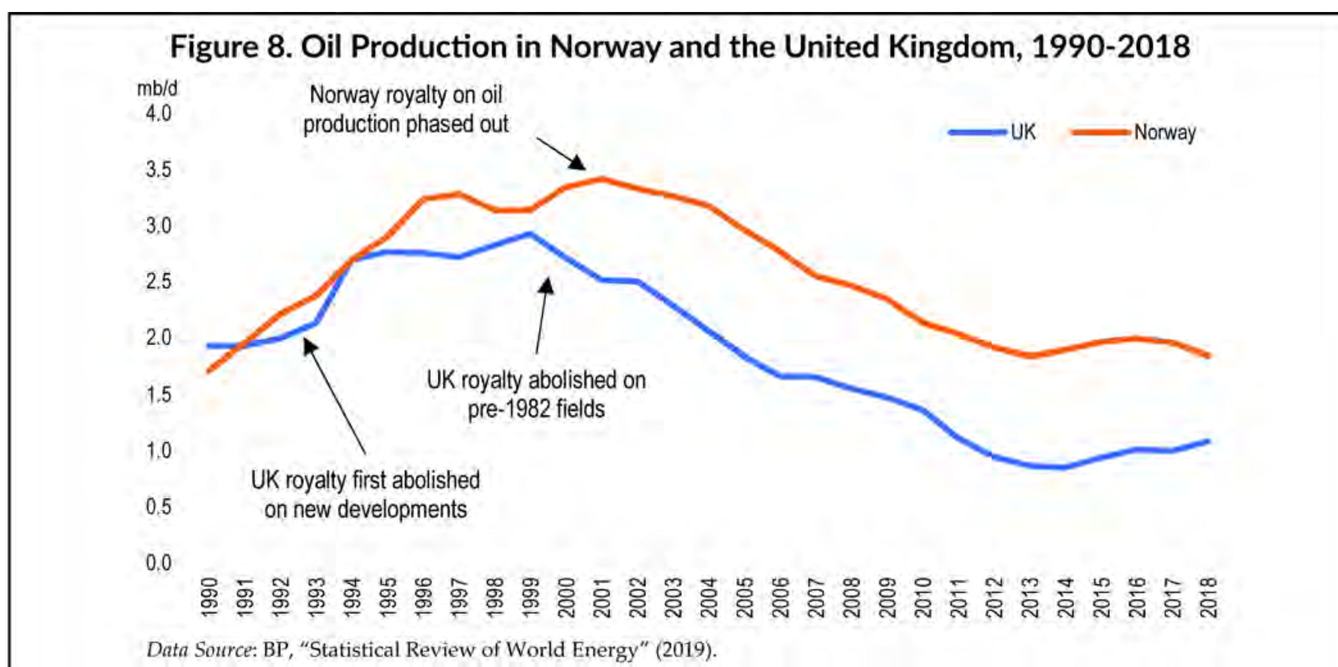

Data Source: BP, "Statistical Review of World Energy" (2019).

industry sources estimate that the continent would be one of the worst regions for capex cuts and delays to discretionary spending,[13] estimated to be 33 percent (US$10 billion) for 2020, compared with cuts of 20 percent during the last downturn.[14]

While oil prices go beyond any government control, through the fiscal regime, which is one of the chief policy instruments within government control, the government can improve or worsen the attractiveness of the investment proposition in the country. The U.S. Gulf of Mexico (GOM) provides an interesting example. In the early 1990s, the GOM was declared a dead sea for exploration. To reverse that perception, the U.S. government introduced new fiscal incentives, through the Deep-Water Royalty Relief Act of 1995. Despite the then-low oil price, the region witnessed a remarkable jump in leases for deepwater — from 171 in 1995 to 620 in 1996, reaching a record high of 1,110 in 1997.[15]

Though not common, some governments introduce fiscal changes in favor of the industry, even during periods of high oil prices, if investment is struggling and causing a decline in production. In Algeria, for instance, auctions held between 2008 and 2011 revealed limited international interest. Hoping to rescue its economy by stimulating interest in new energy developments and to reverse the decline in the country's oil and gas production (which peaked in 2007 and 2005, respectively) the Algerian government revised its hydrocarbon law in 2013, providing tax incentives and relaxing some of the sector's otherwise strict regulations.

Production Life Cycle

At the beginning of the life of a basin, the host government has an incentive to provide an attractive fiscal regime to oil companies to encourage them to make the investment. Once commercial discoveries are made, the bargaining power shifts in favor of the host country that owns the (now-proved) resource, possibly promoting the introduction of a new law, or the amendment of an existing law, for the government to capture the upside of those discoveries.

Following the gas discoveries made offshore Israel between 1999 and 2000, the authorities applied a moratorium on all offshore activities to amend existing regulations and fiscal regime accordingly. More than six years later, the sector was opened to new exploration, but with more restrictive terms. The government take was

[13] Alastair O'Dell, "Arrested Development in Africa," *Petroleum Economist*, Apr. 7, 2020.

[14] Mackenzie, "Africa Facing Steep Spending, Production Cutbacks," *Offshore Magazine*, Mar. 31, 2020.

[15] Lesley D. Nixon et al., "Deepwater Gulf of Mexico 2009: Interim Report of 2008 Highlights," OCS report MMS-2009-016 (2009).

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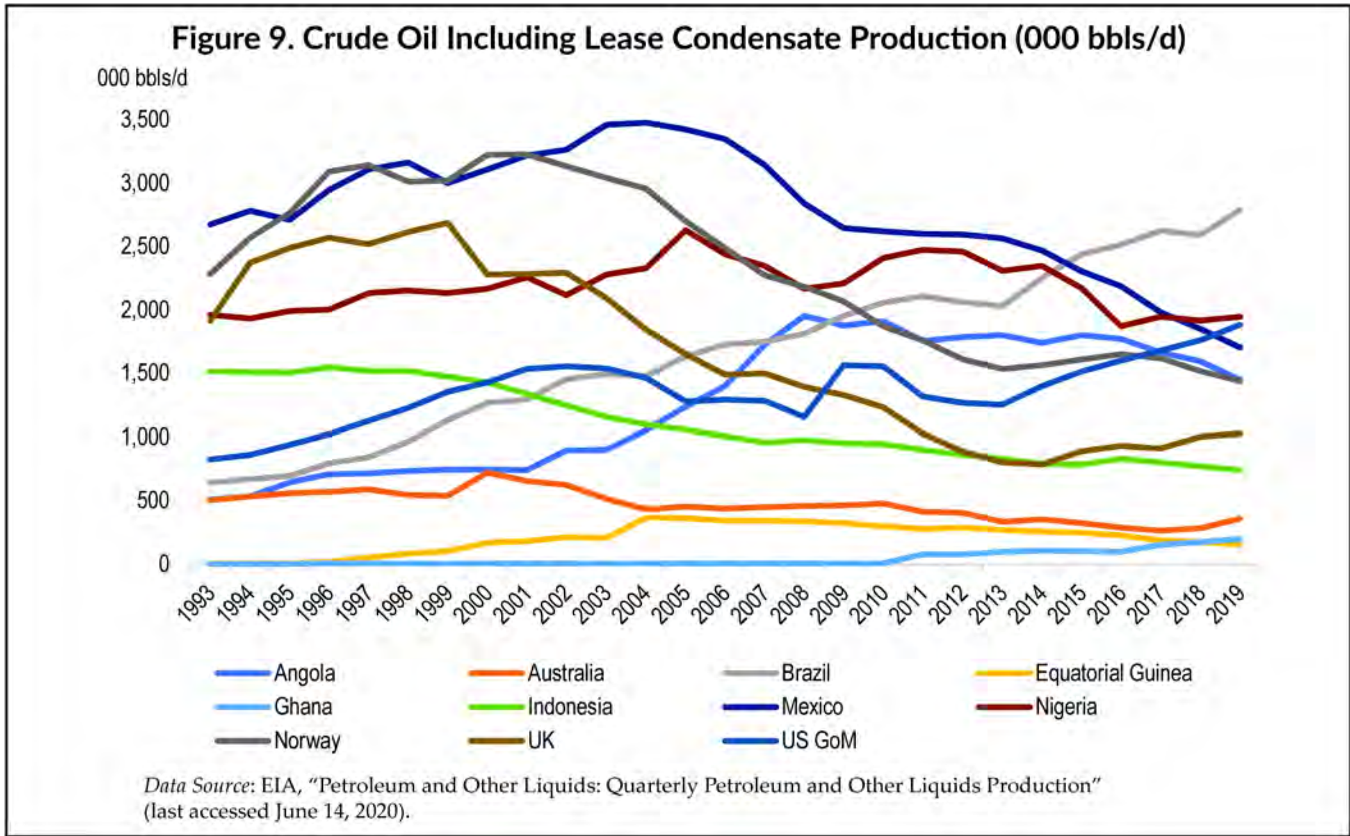
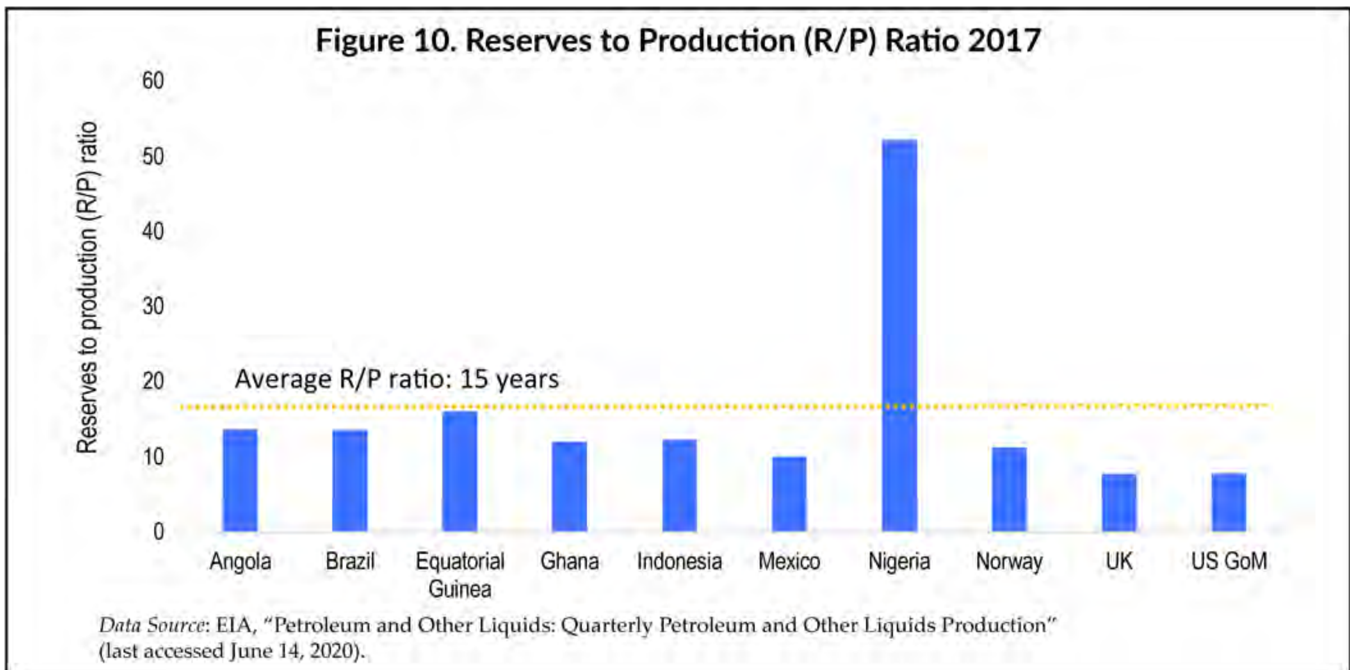


Data Source: EIA, "Petroleum and Other Liquids: Quarterly Petroleum and Other Liquids Production" (last accessed June 14, 2020).



Data Source: EIA, "Petroleum and Other Liquids: Quarterly Petroleum and Other Liquids Production" (last accessed June 14, 2020).

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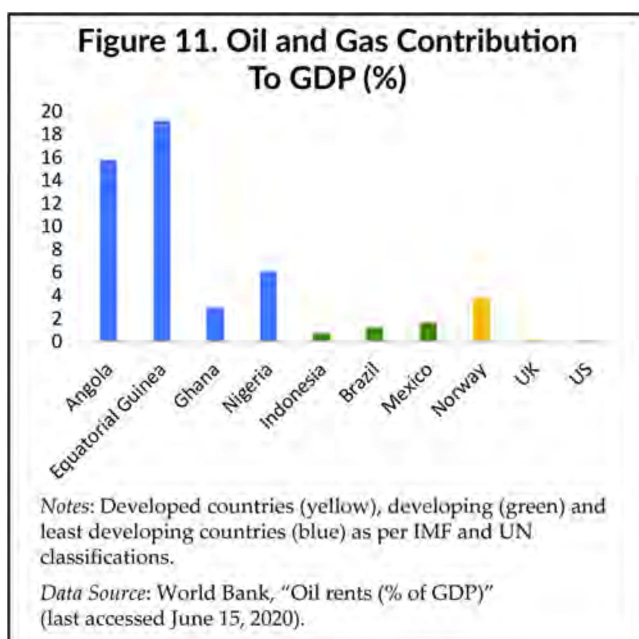

Notes: Developed countries (yellow), developing (green) and least developing countries (blue) as per IMF and UN classifications.

Data Source: World Bank, "Oil rents (% of GDP)" (last accessed June 15, 2020).

increased from around 50 percent to more than 60 percent accordingly. Similarly, the giant discoveries made in Guyana over the last few years have triggered calls for tightening the fiscal terms. The IMF, for instance, has recommended the government increase some of the tax rates to bring them more in line with what is observed internationally.

When a basin matures, however, the tax regime designed for basin opening ceases to be competitive, given that unit costs rise and discovered volumes decline. As the North Sea hit maturity, both the U.K. and Norwegian governments moved to solely profit-based fiscal regimes. The royalty was a key feature of both regimes from the beginning of their oil and gas exploitation in the 1960s. It remained in place as the basin production grew in the subsequent decades. However, as production growth started to slow down, the royalty was abolished in the early 2000s.[16] (See Figure 8.)

Government Reaction

The dynamics of the above three factors strongly suggest that fiscal changes can be expected following the pandemic. This is even more so in countries where production was in decline and investment was struggling even before the crisis, despite the availability of substantial reserves, indicating that above ground factors, primarily the fiscal regime and regulatory policies, were a deterrent — only to be worsened by the crisis. In such countries, calls for fiscal and regulatory regimes to be revisited are likely to intensify. However, in countries that implemented such reforms following the 2014 price decline, there may be less room for maneuver.

The analysis in this section focuses on the experience of 10 offshore producing provinces, both from OECD and emerging economies.

Case Studies Overview

Appendix 1 summarizes the key fiscal and regulatory changes adopted in the selected provinces following the oil price fall in 2014, then identifies the measures taken or announced after the 2020 price collapse. Except for Brazil and Ghana where oil production is rising, the remaining eight provinces are mature, whereby oil production peaked and is declining (Figure 9). Furthermore, except for Nigeria, the reserves to production (R/P) ratio across the provinces is less than 20 years (Figure 10).

In terms of economic contribution, oil and gas production and export remain the economic linchpin of most of the developing countries selected. In countries such as Angola, Equatorial Guinea, and Nigeria, the industry is a fundamental component of their industrial strategy and transition to an upper-middle-income state, acting as the lever to provide jobs and energy security.

The rapid growth of the upstream oil and gas industry in many of these petroleum-producing countries is dependent on external foreign direct investments led by international oil companies (IOCs). In general, the OECD economies have more diversified economies, though the contribution of the oil and gas industry is highest in Norway compared to other selected developed economies (figures 11 and 12).

Underlying Conditions

In order to put the fiscal measures listed in the appendix in context, this section highlights the key factors in the selected provinces that triggered fiscal changes after the 2014 oil price collapse and

[16] In 1993 Norway abolished gas royalties.

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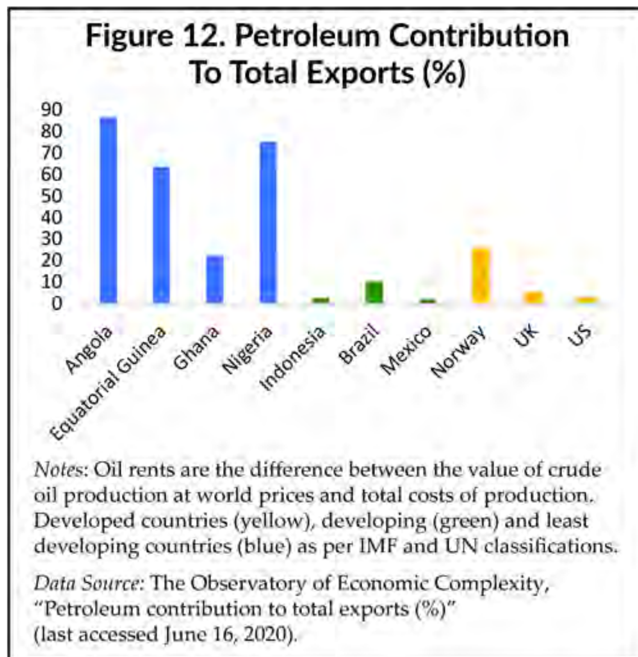

Notes: Oil rents are the difference between the value of crude oil production at world prices and total costs of production. Developed countries (yellow), developing (green) and least developing countries (blue) as per IMF and UN classifications.

Data Source: The Observatory of Economic Complexity, "Petroleum contribution to total exports (%)" (last accessed June 16, 2020).

that can affect the government's decision with respect to further changes following the 2020 crisis.

Angola

Following the financial crisis in 2008 and subsequent oil price recovery, several oil producers managed to resuscitate their industry. Angola, however, lagged. In 2018, oil production, which is largely concentrated in deepwater, reached its lowest level since 2007, as investment could not be maintained. In addition to high investment and operating costs, the total government take out of an oil project can exceed 90 percent, a share which is typically found in countries that sit on much bigger and lower cost reserves like Iraq. As a result, several discoveries have remained undeveloped.

Recognizing the challenge facing the industry and hoping to reverse production trend while boosting investment in exploration, President João Lourenço enacted several reforms as soon as he assumed office in 2017, including halving tax rates on small and marginal fields. Not surprisingly, the industry welcomed such a move; Italian oil company Eni attributed its field discoveries in 2018 and 2019 to these new measures. Interestingly, one of the goals under the new concession award strategy for 2019-2025 is to "increase competition within the industry and encourage a fair return on investments,"[17] though here too, "fair" needs to be defined.

Conscious of the current economic constraints, in June 2020, the government announced it would delay the launch of its licensing round originally scheduled for end of May 2020. Even when the rounds are relaunched, the record signature bonuses that Angola received in the bidding round of 2005-2006 would be simply inconceivable, as oil companies do not have a shortage of opportunities around the world.[18]

Brazil

Brazil is expected to be one of the most significant sources of oil supply growth in the next five years, along with Canada, Guyana, Norway, and the United States, in addition to OPEC members Iraq and the United Arab Emirates. Brazil owes this capacity to its pre-salt layers, which have been driving production growth. Following the discovery of its giant pre-salt fields in 2006, the government introduced a production-sharing agreement with tougher terms than the conventional concessionary system that applies in the rest of the oil sector.

In November 2019, the government held two licensing rounds related to pre-salt. Expectations were high, given the volumes on offer. Energy Minister Bento Albuquerque described one of the rounds as "the world's largest oil and gas tender," referring to the potential of revenues that would be generated from signature bonuses, amounting to around US$25.8 billion in addition to more than US$152 billion over the next 35 years.[19]

Volumes, however, proved to be insufficient for the eagerly anticipated bid round. The government received bids only from one consortium led by the national oil company, Petrobras, with minority equity for Chinese

[17] Gonçalo Falcão and Norman Nadorff, "Angola 2019-2025 New Concession Award Strategy," Mayer Brown (2020).

[18] In the licensing round of 2005-2006, competition was intense, with over 50 companies qualifying; the result of an aggressive bid-round was impressive. Italian Eni offered US$902 million for a 35 percent to 40 percent operated interest in one of the blocks. Two other blocks received the then-highest signature bonus for a block in the history of the oil industry, with Sonangol and China's Sinopec offering US$1.1 billion for each block.

[19] BnAmericas, "All Eyes on Brazil for Pre-Salt Tenders," Nov. 4, 2019.

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partners, in addition to sole bids made by Petrobras.

The fiscal regime, in addition to complex regulations, were largely to blame. Authorities are aware of this shortcoming. "It is an awful system," Economy Minister Paulo Guedes was quoted saying,[20] while Albuquerque stated that the government learned a lesson and would adjust the rules of any future auction accordingly. The current market conditions, where oil prices are less than 60 percent their 2019 levels, will put an additional pressure on the Brazilian government to push ahead with fiscal and regulatory changes, particularly for pre-salt opportunities, in favor of investors.

Equatorial Guinea

Oil and gas production in Equatorial Guinea has declined by about 78 percent since 2010 (from 298,000 bbls/day to 156,000 bbls/day in 2019). Oil and gas output is projected to decline by an average of 6.3 percent from 2019 to 2024.[21] The government has taken several pro-investment initiatives since the 2014 downturn (some since 2006) to reverse the decline, improve the oil sector's outlook and support broader economic diversification drive.

Several elements of the fiscal regime are negotiable (including royalty, cost recovery ceilings, profit shares, and production bonuses). During the EG Ronda 2016 licensing round, minimum signature bonuses ranged from US$200,000 to US$5 million, as compared to US$2 million to US$10 million in 2014, and seven out of 12 companies bidding for the acreage were offered blocks.

Nonetheless, local content requirement has become more prescriptive as the government has sought to retain more value primarily through non-fiscal means. In December 2014, the government introduced new local content rules, which gave preference to local companies, with strong sanctions. The Ministry of Mines and Hydrocarbons maintains a list of eligible local companies to be invited to tender bids, and oil companies must send all requests for services to the ministry before hiring any service companies. Several international oil supply companies, including CHC Helicopters and Subsea 7,[22] have had their operating licenses revoked for flouting the new rules.

In February 2020, the government took an important step to convey its commitment to improving the transparency of the oil and gas sector in the country. It published its model and production contracts for the extractives industry for the first time, as part of a three-year IMF program announced in December 2019.[23]

The COVID-19 crisis, however, has had significant negative repercussions on the economy; after all, the oil and gas industry is the foundation of Equatorial Guinea's economy, accounting for about 60 percent of GDP and over 80 percent of exports value.[24] In an attempt to maintain investors' interest, the government has announced investment-friendly measures, including a two-year extension for all oil and gas licenses and exploration programs until 2021, as well as a waiver of fees for oil service companies in the country. Also, the government in June 2020 adopted new petroleum operations regulations (Regulation No. 2/2020) that include 10-year contracts for marginal and mature fields subject to five-year renewals. The new regulations are a key pillar of Equatorial Guinea's post COVID-19 recovery strategy to attract more foreign investment to the country.

Ghana

Ghana is a relative newcomer to the oil and gas industry. Its commercial production started in December 2010 following the discovery of the offshore Jubilee Field in 2007 by a consortium of IOCs. Crude oil production has provided a critical boost to the economy, accounting for 23 percent of total exports and 4.3 percent of GDP. Pre-COVID-19, the plan was to increase

[20] Marianna Parraga, Gram Slattery, and Marta Nogueira, "Big Oil Stuns Brazil in Back-To-Back Auction Flops," Reuters, Nov. 7, 2019.

[21] IMF, "Republic of Equatorial Guinea: First Review Under the Staff-Monitored Program — Press Release; and Staff Report," Country Report No. 18/310 (Nov. 2018).

[22] African Review of Business and Technology, "Equatorial Guinea Directs Cancellation of CHC Helicopter Contracts," (July 19, 2018); and Reuters, "UPDATE 1 — Equatorial Guinea Punishes Subsea 7 for Not Hiring More Locals," Nov. 22, 2018.

[23] IMF, "IMF Executive Board Approves US$282.8 Million Three-Year Extended Fund Facility Arrangement for Equatorial Guinea," Press Release No. 19/472 (Dec. 18, 2019).

[24] African Development Bank, "Republic of Equatorial Guinea: Country Strategy Paper 2018-2022" (July 2018).

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production from 200,000 bbls/day to 400,000 bbls/day by 2024. The government has had a mixed response to the oil price collapse of 2014. On the one hand, the government took several initiatives to reform the industry with the aim to position Ghana as one of the top petrodollar investment destinations in West Africa. In this vein, a new exploration and production law [Petroleum (Exploration & Production) Act, 2016 (Act 919)] was enacted in 2016, replacing the 1984 law (PNDCL 84). This introduced competitive bidding, and in some instances, direct negotiations in the award of blocks, among others. Also, several laws were passed to enhance regulatory capacity, including data management, and health, safety, and environment. Following on from this, the government in 2018 launched the country's first-ever competitive licensing round to award various offshore blocks.

However, the fiscal terms were tightened, as the exploration risk in the country was deemed to be lower once the oil and gas potential was proven, resulting in a higher government take. As per the 2016 fiscal changes announced in the new exploration and production law and subsequent contracts, the regime includes a minimum 12.5 percent royalty for all new contracts, compared to the previous 5 percent to 12.5 percent royalty; a minimum 5 percent additional paying-state participation interest, compared to about 3.71 percent in the pre-Jubilee contracts; and the introduction of minimum US$250,000 signature bonus and production bonuses (all non-cost recoverable). Additionally, the capital gains tax rules have been strengthened — for example, a US$500 million capital gains tax claim by Ghanaian authorities stalled Total's acquisition of Occidental's (previously Anadarko) shares in the Jubilee and TEN oilfields.[25]

Such fiscal changes, along with other factors such as seismic data quality challenges and relatively small block sizes, contributed to the lack of interest in the country's first oil and gas licensing round, which ran from October 2018 to September 2019.[26] Fourteen pre-qualified companies were invited to bid for the five blocks on offer (three under competitive tendering and two under direct negotiations). However, only three companies (both local exploration and production companies and IOCs) submitted bids for just two of the competitive tender blocks. Negotiations of the petroleum agreement with the winners is currently delayed. Likewise, two major IOCs pulled out from the direct negotiations.

In response to COVID-19, the government in June 2020 announced plans to extend the exploration period for oil companies, although details are yet to be communicated. Also, there have been some proposals by industry representatives for the government to revise the exploration and production law and subsidiary legislation. Such a revision would seek, among others, to give oil companies the rights to explore beyond their earmarked production and development areas under the same tax terms as their original petroleum agreements, while also facilitating the tieback of several stranded marginal fields through greater area development plans to maximize economic recovery. Finally, there are calls by the industry for the government to delay its planned second competitive licensing round in 2020 targeted at offering both offshore and onshore oil blocks. This is due to the potential low interest caused by COVID-19 but also offers the government the opportunity to fix the seismic data challenges.

Indonesia

Indonesia's crude oil production has been on a decline from 1.4 million bbls/day in 2000 to 742,000 bbls/day in 2019, triggering a move toward relaxing the fiscal terms, especially when combined with a lower oil price environment. The significant decline in production also forced Indonesia to suspend its membership in OPEC in November 2016.[27]

The most significant recent change in the country's 50-year production history occurred in January 2017 when the government introduced a new form of production-sharing contract (PSC) — the gross-split PSC, replacing the 1966 PSC regime. This followed the expiration of some of

[25] Ekow Dontoh, "Total-Occidental's Ghana Deal Delayed by $500m Tax Claim," *World Oil*, Mar. 2, 2020.

[26] *See* Civil Society Licensing Round Monitoring Group, "Ghana's First Oil Licensing Round Monitoring Report" (2020).

[27] Fergus Jensen and Wilda Asmarini, "Net Oil Importer Indonesia Leaves Producer Club OPEC, Again," Reuters, Dec. 1, 2016).

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these contracts and was driven by the government's desire to attract investment. Under the 2017 gross-split PSC model, the country abolished the cost-recovery system, which was the fulcrum of many PSCs — an indispensable feature of Indonesian PSCs since their inception in 1966 that became a template for several developing countries, replacing their royalty-tax (concession) arrangements in favor of PSCs. The gross-split PSC does not have a mechanism that allows contractors to recoup their investment (capex) costs, after which the remaining production would be shared with the state. Therefore, capex required for operations would be entirely funded by the IOCs at their sole risk. Operating costs are allowed as deductible expenses against the corporate income tax.

The gross-split PSC model introduced two elements applicable on a field-by-field basis: a base split for gas production, 52 percent government and 48 percent investor (previously 70-percent government share); and base split for oil production, 57 percent government and 43 percent investor (previously 85-percent government share). These base splits will be adjusted by progressive elements such as "variable" components (field location, field type, crude type, reservoir depth, availability of infrastructure) and "progressive" components (tied to benchmarked Indonesian crude oil price).

Under the new system, by transferring the capex risk, companies would be forced to be more efficient with their capital (for example, reduce capex savings on projects) while both the government and industry enjoy the upside through the progressive adjustment elements. The changes are supposed to bring more certainty to government oil and gas revenues, as they would not be affected by cost recovery. The regime would also be more efficient and simpler to administer as it eliminates the cost recovery approval by the state.

Mexico

In 2013-2014, Mexico went through an internally controversial process to end the 75-year monopoly of its national oil company, PEMEX, and open up its oil industry to private sector investment, with the swift decline and maturity of its once-prolific onshore basin, engendering a more pragmatic approach. The reforms aimed to attract foreign investment, particularly in deepwater and shale reservoirs, while maintaining a sufficient level of government revenue from the sector. A progressive fiscal system and a series of licensing rounds open to IOCs were implemented to achieve these goals. Mexico organized an average of four licensing rounds yearly, attracting a variety of bidders, including international oil majors.

Many licenses have been awarded on the basis of the new fiscal regimes, where one structurally resembles a PSC and the other a concessionary model (licensing), and different fiscal structures apply, varying with the opportunities on offer. The fiscal regime contains several progressive features, despite the use of royalties as a key element of rent collection. When considering the fiscal structure as a package, the Mexican system effectively captures economic rents for the government through the progressive additional royalty (assuming that there is sufficient competition, since it is biddable) while providing a relatively low tax burden on marginal projects. By being profit-based, the additional royalty is effectively a non-distortionary mechanism, but at the expense of simplicity.

The reforms, however, have not produced the increase in production, discoveries, and, subsequently, revenues Mexico was hoping for, and the government, under the leadership of President Andrés Manuel López Obrador, who was elected in 2017 and was never a fan of the 2013-2014 reforms, threatened to revisit the terms of existing contracts and suspended further bid rounds in 2018 until 2022.

There are a couple of things to consider with respect to the Mexican experience. First, indeed, on the face of it, the reforms did not make any difference to Mexico's production, which has continued to decline. This is partly because not enough time has passed since the contracts were awarded for the investments to be converted into production. Second, companies are partly to blame for the frustration; after making a discovery, they frequently trumpet its potential long before a full appraisal can give a more realistic picture about how much of the discovered resources can be actually produced and by when. With such announcements, companies typically target the financial

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community but forget about the heightened expectations they arouse in the host country's wider population, setting the stage for tension if those expectations are not met. The risk is much higher in a country like Mexico, which entered the new oil era with so much hesitation. Finally, it is believed that some companies overbid the royalty element to win the license only to request its downward revision later on.

Following the COVID-19 crisis, the direction of travel in Mexico is unclear, as politics — not economics — may play an important role.

Nigeria

Nigeria's oil production has been on an overall declining trend since 2010 and its oil reserves have plateaued and started to fall in recent years. This by no means indicates that Nigeria is running out of opportunities; on the contrary, its deepwater potential largely remains untapped. The exploration and development of such resources, however, will not be cheap.

For years, Nigeria has been juggling the idea of changing its fiscal terms for upstream oil and gas. The main argument put forward is that the aim is to improve the competitiveness of the fiscal regime from an investment perspective while securing a fair share to the government. In reality, it seems that the latter objective is the main driver — not surprisingly, given the government's substantial dependence on oil revenues. Furthermore, there is a widespread feeling in the country that the government lost significant revenues because of an obsolete law. The problem, however, is that modernizing legislation that governs the sector has proven to be a highly controversial task, and to date remains a work in progress. At the time of writing, the government is debating a new bill that is supposed to pass this year and introduce new fiscal terms.

From a fiscal point of view, the Nigerian system scores poorly: a high government take combined with regressive instruments, especially high royalty rates, and frequent fiscal changes (whether debated or introduced). Some bills were introduced only to be rejected after many years of discussions. The Petroleum Industry Bill, for instance, was introduced in 2008 to establish a more modern, transparent, and competitive legal, fiscal, and regulatory framework for the Nigerian petroleum industry. The bill, however, went through numerous revisions and became the subject of intense debate among various stakeholders. Furthermore, the fiscal regime is unnecessarily complex: It is a tapestry of different structures and rates, with special focus on royalties, which, in turn, varies with terrain, water depth, oil price, and oil and gas production — all a poor proxy of profitability.

The frequency of the fiscal changes proposed and/or implemented strongly suggests a structural weakness in the fiscal regime that prohibits it from adapting automatically to evolving oil industry related conditions, both domestically and internationally. This is largely because the regime has lacked progressivity; a progressive regime can better stand the test of time and cope with volatile oil and gas prices, unlike a regressive regime.

At the time of writing, the Petroleum Industry Fiscal Bill (PFIB) has yet to be approved and passed into law. The bill was drafted before the collapse in oil prices in 2020 and its final form, if passed this year or next, is likely to be different from what was originally drafted.

Norway

The basic ingredients of the Norwegian fiscal regime have remained broadly unchanged for decades despite high price volatility and the onset of declining production. The fiscal regime is entirely profit-based, and as of January 2020 comprised state tax (23 percent) and special petroleum tax (55 percent), aggregating to 78 percent. Depreciation is six years straight-line as costs are incurred. With such a high tax burden, there is no imperative for the Norwegian government to raise the tax rate as oil prices increase since most of the upside is captured by the fiscal regime in any event. With the fiscal regime being profit related, the state has remained reluctant to lower the tax burden at periods of low prices, especially because it has proved difficult for the industry to demonstrate that the fiscal regime alone is preventing projects from proceeding. The Norwegian fiscal regime is based on the "one size fits all" model, so taxation is levied at the "basin level" with no ring fences of field-specific taxation or allowances. The only specific incentives are uplift on capital costs and an exploration tax credit.

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It is important to note that Norway, like many OECD countries in recent years, has lowered its corporate rate to ensure its non-oil sector remains internationally competitive. However, to maintain the stability of the regime, the Norwegian government increased the special petroleum tax rate in similar steps but in the opposite direction. A tax credit for exploration costs is allowable for those investors not in a current-tax paying position, helping to ensure a level playing field whether tax paying or not for exploration decisions.

The severity of the COVID-19 crisis led the government to consider a small fiscal package to support the industry during the crisis. The change seems to be taking the fiscal regime one step closer to that of the United Kingdom, with the rapid recovery of capex. However, it is understood that the overall government take will remain at 78 percent.

United Kingdom

The United Kingdom has the world's most mature basin but the adaptive fiscal measures the government has taken has sustained the attractiveness of the province to international investment. The U.K. probably features the most attractive fiscal regime of any mature basin. Although the U.K. is often cited as the basin with the most unstable upstream fiscal regime in the world, this is not necessarily as damning as it might sound, as over the decades the overall fiscal burden in the U.K. has remained consistently lower than in many other provinces, including Norway (though it has to be acknowledged that the fields in the U.K. sector are smaller and more mature than in Norway). The enduring priority of government policy has been to maximize current production to minimize the import bill for oil and gas and contribute to security of supply. The fiscal regime has always been regarded as an enabler of this policy.

Following the oil price collapse in 2014, the supplementary charge tax has been reduced in a series of reductions to 10 percent, but the differential remains: 40 percent for the oil industry versus 19 percent for the rest. In part, the U.K. government has been able to justify the differential treatment by virtue of the more favorable treatment of capital allowances for the oil industry alone. The 2002 fiscal reform, which introduced the supplementary charge tax (and removed the royalty, from 2003, from the dwindling band of fields developed pre-1982 still paying it) also heralded the introduction of 100 percent capital allowances (replacing a much slower form of depreciation). From this point forward, no project in the United Kingdom would pay any tax until payback had been reached. The outcome is that pretax project initial rate of return remains the same posttax. Subsequently, it is difficult to assert in the U.K. that tax is preventing projects from proceeding. The industry is currently lobbying for additional tax reliefs; it is unlikely that these would be granted, but such a strategy may protect the industry from potential tax increases.

U.S. Gulf of Mexico

The recent increase in GOM oil production has been largely driven by the development of fields that were discovered many years ago and brought onstream during the preceding period of high oil prices. Also, the magnitude of proven oil reserves has gone in the opposite direction, suggesting that the reserves' replacement is not being maintained. In the longer term, if recent trends continue, the maturity of the GOM will become increasingly more pronounced.

The headline rates for the GOM look competitive and compelling, comprising just royalties in the range 12.5 percent to 18.75 percent and federal corporate tax at 21 percent. As a result, the marginal tax rates are amongst the lowest of any major global oil and gas province — in the range 31 percent to 36 percent. However, these headline rates disguise many key features that erode the apparent competitiveness. Lease bonus payments are a material component of the fiscal regime which, due to their upfront nature, materially erode life cycle returns. Additionally, the rate of depreciation of costs is relatively slow by global benchmarks. The royalty burden at up to 18.75 percent serves to make the fiscal regime very regressive. The regime is also a complex tapestry of rates, reliefs, and allowances, symptomatic of the difficulty in designing a universal royalty regime suitable for a range of prices, field sizes, and commercial potential.

A detailed study by Crystol Energy found that the current regime is particularly damaging to

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small and economically marginal fields.[28] Many projects that are economical pretax are projected to become significantly uneconomical posttax due to the regressive impact of the royalty regime — deepwater projects particularly so, given the higher 18.75 percent royalty. The U.S. authorities recognize the investment disincentive that the royalty regime imposes and have devised, over the years, a complex system of reliefs and allowances to ameliorate the most damaging aspects. However, this does not go far enough, with many of the reliefs largely ineffective or applied on an inconsistent basis. The study recommended a royalty framework that reflects underlying project profitability. The COVID-19 crisis may provide the catalyst for a modification in that direction.

Direction of Fiscal Travel

The above analysis confirms the inherent fiscal instability in the oil and gas sector, with the prominent roles of oil prices, investment, and production trends as the main drivers of fiscal changes. Other factors include the dependence of an economy on oil revenues; politics also play a role, albeit more muted. Even in the world's most stable fiscal regime — that is, Norway's — changes have been implemented to adapt the regime to changes in local and international conditions. The Norwegian experience shows that no fiscal regime is cast in stone, but changes can be made while maintaining the same overall government take. The Norwegian government puts high priority on fiscal stability, partly justifying its higher take, especially as compared to their neighbor across the North Sea.

Apart from this fundamental difference between Norway and the United Kingdom, both countries share several fiscal characteristics, with the most notable one being the reliance on solely profit-based regimes. The suggested changes in Norway post-COVID-19 brings their regime closer to the United Kingdom's by activating a key tool that is probably more powerful than lower tax rates: rapid capex recovery, which in turn shortens the payback period.

The "neighborhood" effect is typically strong, especially if countries are at similar levels of economic development, but also with respect to the oil and gas industry. A tax increase in one country, for instance, may be swiftly followed by copy-cat increases among its neighbors, especially if the perception takes hold that the changes have had little adverse impact on investment and competitiveness. The neighborhood effect may work in reverse, but the process is much slower and needs a collapse in investment to provide the catalyst. The fiscal reforms in Angola, for instance, may well affect the type of changes Nigeria will consider as the latter revisits its fiscal terms primarily to boost investment.

The way the regime is designed will also impact the need and type of changes made. Profit-based regimes have long proven their superiority to revenue-based regimes: the government's share increases or decreases with profitability and thereby automatically adjusts to changes in a wide range of conditions, unlike regressive regimes where the government's share varies inversely to profitability and needs continuous tinkering for the regime to adapt to changing conditions. Investment typically favors progressive regimes, even with higher government share. That said, properly designed regressive instruments such as royalties are an important source of revenues, especially for poorer nations and regions. In this respect and in line with the recommendation of the OECD on durable extractive contracts, a desirable fiscal regime includes both progressive and regressive elements, but more weight should be given to the former to ensure overall progressivity of the regime. A fiscal regime that "is progressive overall will help to align the interests of the host government and the investor."[29]

Furthermore, headline tax rates are misleading. In this respect, international comparison on this basis alone should be treated with caution. For instance, the GOM has a marginal tax rate of around 30 percent after royalty and federal taxes (though this varies across projects): in headline terms, no other established oil and gas province comes close.

[28] Crystol Energy, "The U.S. Gulf of Mexico Policy Initiatives: An Analysis of the Licensing and Fiscal Policies" (Aug. 6, 2018).

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However, the GOM fiscal regime is highly regressive, as it largely relies on signature bonuses and relatively high royalty rates.

Looking further ahead, overall there seems to be consistency in the direction of travel: The prevailing mood is that the industry is going through a difficult cycle and an alleviation of the fiscal and regulatory burden may be needed. The reaction of host governments will differ, as will the measures that might be or are introduced and the speed at which they will be pursued.

Host governments, especially those in emerging economies, are usually slow to react to the new reality of low crude oil prices. This was the case during the 2014 downturn and is likely to be so with the 2020 downturn. For those countries that are heavily dependent on oil and gas revenues to meet budgetary needs, this can even take much longer (and sometimes lead to counterproductive increases in government take) to mitigate the revenue shortfalls. It is inevitable that a sustained downturn in oil prices will continue to force revisions to fiscal terms, albeit delayed.

Experience from the 2014 oil price downturn shows that governments are slower at relaxing the fiscal terms, compared to tightening them when prices increase. It also indicates that governments attempt to soften the regulatory burden before considering pursuing fiscal changes (see, for instance, the measures announced by Equatorial Guinea in 2020) for several reasons, chief among them that regulatory changes do not necessarily translate into loss of financial returns to the authorities. Also, some contracts may be restricted by fiscal stabilization provisions, thereby limiting the scope of fiscal changes.[30] Another common reaction is the suspension of licensing rounds (such as in Indonesia and Brazil) for fear of lack of interest.

Furthermore, some of the fiscal changes made during the 2014 downturn are yet to fully manifest in many countries — most producer countries were just about recovering from the last downturn only to be hit by another. In this respect, developing oil and gas producers in particular do not have much room for maneuverability, especially on the fiscal front.

The collapse in oil prices in 2020 is likely to accelerate pro-investment reforms considered in recent years in most countries. That may well be the case in Brazil, for instance, especially following the disappointing results of the pre-salt bidding rounds in autumn 2019 and given the overall policy direction of the existing administration. However, in other countries, changes may go in the opposite direction, and host governments might take a more aggressive stance toward private investment.

In Mexico, for example, the pro-investment reforms implemented during periods of high prices have been criticized for not delivering the promised increase in output. In this case, the government may not be easily convinced of the need for a further relaxation of the fiscal terms despite the current challenging market conditions.

Politics will also have a say, especially when combined with an important role of the oil and gas industry to local economy. U.S. President Trump, in a tweet in April 2020, promised to "make funds available so that these very important companies and jobs will be secured into the future. . . . We will never let the great United States Oil & Gas Industry down." Thanks to the shale revolution, the United States moved from being a net oil importer to a net exporter, from being solely the world's largest oil consumer to also becoming the world's largest producer, with significant economic and political implications. It is therefore not surprising to see the current administration keen on protecting the oil and gas industry. With the presidential elections looming, gaining the support of such a large political base and of the states that are shaped by it adds to the interest.

Conclusion

COVID-19 and the subsequent "Great Lockdown" have profoundly disrupted the oil and gas industry, causing a collapse in oil prices and the subsequent cancellation of several oil and gas projects, as well as severely affecting the supply chain and disrupting revenues and macroeconomic policy management in producer countries. There are significant risks and

[30] For analysis, see Mansour and Nakhle, *supra* note 3.

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uncertainties concerning the duration and magnitude of the pandemic's effects on the global economy; the impact on the oil and gas industry; and the fiscal and regulatory initiatives that producer countries can enact to sustain oil and gas investments, production, and revenues.

This paper analyzed whether host governments might revisit their upstream fiscal regime following the COVID-19 crisis and if they do, what measures they are likely to adopt. The analysis focused on 10 major offshore provinces both from OECD and emerging markets, which are considered in direct competition for international capital. These provinces share similar commercial and technical challenges but government fiscal responses to collapse in oil price tends to differ, depending on several factors, including the way the fiscal regime is designed, the health of the industry before the collapse, and the degree of economic dependence on oil revenues.

The analysis reveals the following:

- Fiscal instability is inherent to the oil and gas sector, with a long list of factors driving fiscal change. In the more immediate term, oil prices, investment, and production trends will play a key role in pushing fiscal changes and shaping their direction. Other factors include the dependence of an economy on oil revenues and the "neighborhood" effect. Politics also play a role, albeit a more muted one.
- Overall, there seems to be consistency in the direction of travel in the near future. The perception is that the industry is going through an unprecedented cycle and an alleviation of the fiscal and regulatory burden may be needed to sustain investment, production, and revenues. However, the reaction of host governments will differ, as are the measures that might be introduced and the speed at which they will be pursued. The longer low oil prices prevail, the higher the pressure to accelerate fiscal reforms is, especially if investment remains subdued.
- Host governments, particularly those in developing economies, are usually slow to react to collapses in oil prices (especially as compared to their reaction when prices increase). Furthermore, governments typically attempt to soften the regulatory burden before considering pursuing fiscal changes, since the financial implications on their coffer is lower.
- Some governments started to review their fiscal terms before the COVID-19 crisis hit the world economy and subsequently the oil industry. The review was often driven by a decline in activity. Under current circumstances, it might be accelerated to avoid worsening an already challenging pre-crisis situation. However, not all governments will be convinced of the need to relax their fiscal terms, especially those that are more dependent on oil revenues and where resource nationalistic politics play a central role.
- A competitive fiscal regime does not necessarily imply low tax rates. Evidence shows that such regimes are often unstable. Simple measures such as a focus on swift payback and recovery of capital spending can hold equivalent or even greater appeal to investors, as do low headline tax rates. Similarly, profit-based instruments are much more likely to engender investment than front-loaded, revenue-based instruments, such as royalty and signature bonuses, and are characteristically more stable.
- The way the regime is designed will affect the need for, and type of, changes to be made. Profit-based regimes have long proven their superiority to revenue-based regimes. Investment typically favors progressive regimes even with higher government shares. That said, regressive instruments such as royalties — when properly designed and implemented — are an important source of revenues, especially for poorer nations and regions. In this respect, a desirable fiscal regime includes both progressive and regressive elements, but more weight should be given to the former to ensure overall progressivity of the regime.

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Appendix 1. Review of Regulatory and Fiscal Changes

Country	2014-19 fiscal and regulatory changes	2020 fiscal and regulatory changes (including proposals)

Angola	• Major oil and gas industry restructuring process with amendment to the 2004 Petroleum Law, including the creation of the National Oil Gas and Biofuels Agency (ANPG) as national concessionaire and exclusive holder of the mineral rights for oil and gas exploration and production (previously held by Sonangol)
	• 50 oil and gas blocks planned to be auctioned between 2019 and 2025
	• New fiscal terms and incentives for marginal fields introduced in 2018[1]
	  • Reduction in petroleum production tax from 20% to 10% for marginal fields (less than 300 million barrels of reserves) or those not economically viable due to lack of infrastructure
	  • Reduction in petroleum income tax on marginal fields from 50% to 25%
	• New fiscal incentives for natural gas exploration, production, and commercialization:
	  • 5% gas production tax (10% for oil); 25% associated gas income tax (same as for oil) and 15% non-associated gas income tax for proven reserves smaller than 2 trillion cubic feet (tcf)[2]
		• Delay of the onshore licensing round covering blocks in the lower Congo and Kwanza basins[3]

Brazil	• Petrobras no longer the sole operator for pre-salt (Law No 13,365/2016)
	• Publication of multi-year bid round plan covering both concession assets and pre-salt areas up to 2021 (CNPE Resolutions 10/2017 and 10/2018)
	• Legal, tax and regulatory reforms (2017), including:
	  • Royalty reduction[4] — up to 5% on incremental production of mature fields. The default royalty rate is 10%
	  • Petrobras as operator (with a minimum of 30% stake) of a formed consortium for exploration bid blocks under the PSC regime (Law No. 13,365 /2016)
	  • Special customs regime for importation and exportation of goods for E&P Activities including suspension of federal import taxes (Law 13,586/2017)
	For 2017-2019, nine bidding rounds
		• Suspension of 17th oil and gas licensing round reportedly to offer 130 blocks across five basins[5]
		• Published proposals for new Decommissioning Regulatory Instrument (ANP Resolution 817/2020) which streamlines regulatory rules on decommissioning — single decommissioning plan submission to ANP and environment agency; simplification of field transfer rules from one company to the other, allowing extension of the useful life of the fields and improving recovery factors[6]

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Appendix 1. Review of Regulatory and Fiscal Changes *(Continued)*

Country	2014-19 fiscal and regulatory changes	2020 fiscal and regulatory changes (including proposals)

Equatorial Guinea	• EG Ronda 2016 licensing round offering 17 offshore and onshore blocks with largely favourable (negotiable) fiscal terms
	• Most contract parameters are negotiable since the 2006 and 2014 licensing rounds
	  • Royalties — negotiable rates (minimum 13% since 2006) with negotiable daily production rates (10%-16% previously in 1998)
	  • Cost recovery limit — negotiable cost recovery ceilings net of royalty (since 2006 and 2014); and based on negotiable cumulative production rates; previously 60% ceiling on cost recovery (1998)
	  • Profit share — negotiable; split previously based on contractor's pre-tax rate of return (1998)
	  • Signature bonus: Reduction in 2016 minimum value ranging from US$200,000-US$5 million as compared to US$2-US$10 million (2014)
	  • Production bonuses — negotiable
	  • State participation — minimum 20% carried interest (since 2006); revised from 15% in 1998)
	• Seven out of 12 companies bid including Ophir Energy, Clontarf Energy, among others[7] but Fortuna FLNG development FID delayed due to low oil prices[8]
	• Introduced prescriptive local content regulations and national participation in the oil and gas sector law (Ministerial Order no. 1/2014)[9]
	  • New local content clauses, provisions for capacity building in new petroleum agreements
	  • Preference to local companies in the award of services contracts.
	  • Strong sanctions regime — operating licenses revoked for breach of provisions especially by supply chain companies[10]
		• Two-year extension for all oil & gas licenses and exploration programmes until 2021[11]
		• Waiver of fees for oil service companies in the country[12]
		• The government in February 2020 published its model and some production contracts for the extractives industry for the first time[13]
		• Other reforms include an asset-declaration regime applicable to all senior government officials aimed at reducing political corruption to strengthen investor confidence
		• Adoption of new Petroleum Operations Regulations (Regulation No 2/2020) to attract more foreign investment to the country as key pillar of Equatorial Guinea's post-COVID-19 recovery strategy[14]
		  • Clarifies rules on marginal and onshore fields (the former now defined as having produced 90% of its proven hydrocarbon reserves)
		  • Marginal and mature fields would benefit from new 10-year contracts subject to five-year renewals[15]
		  • Other incentives for investments in deep and ultra-deepwater acreages
		  • Prohibition of gas flaring

Ghana	• Launch of Ghana's first competitive licensing round in late 2018 based on new Exploration and Production Act, 2016 (Act 919) with increased government take
	  • Minimum 12.5% royalty compared to previous 5%-12.5% royalty
	  • Minimum 5% additional paying state participation on top of existing 15%
	  • New minimum US$250,000 signature and production bonus
	• Increased local content and local participation terms via the implementation of local content law passed in 2013 (for example, at least 5% equity participation of an indigenous Ghanaian company in a petroleum license other than the national oil company (GNPC)
		• Government announced a proposal to extend exploration period for oil companies due to COVID-19[16]
		• Proposals to revise the Exploration and Production Act, 2016 (Act 919) and the Petroleum Exploration and Production General Regulations, 2018 (LI 2359) giving E&P companies rights to explore beyond their original production and development[17] areas as part of marginal field development strategy and greater area development plans

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Appendix 1. Review of Regulatory and Fiscal Changes *(Continued)*

Country	2014-19 fiscal and regulatory changes	2020 fiscal and regulatory changes (including proposals)

Indonesia	• Removal of exploration taxes, value-added tax on imported goods and land tax on oil and gas (2016)[18]
	• Gross split PSC model with no cost recovery applicable for conventional blocks (Regulation No 8/2017)[19]
	  • Base split for gas production: 52% government: 48% investor (previously 70% government split)
	  • Base split for oil production: 57% government: 43% investor (previously 85% government split)
	  • Onetime 5% uplift to the Contractor's split if their plan of development moves from exploration and development to production phase[20]
		• No formal announcements made yet on fiscal and regulatory changes mitigate the impact of COVID-19 and falling oil prices

Mexico	• Passage of various legislations from 2014 onwards to effect the 2013 reform programme governing legal, contractual and licensing frameworks
	  • Oil and gas revenue law; PEMEX law; E&P law
	  • Main aim: "To produce more hydrocarbons at lower cost, allowing private companies to complement Pemex's investment through contracts for oil and gas exploration and extraction; and to achieve better results through competition in refining, transportation and storage"
	  • Different fiscal packages introduced depending on opportunities
	• Several licensing rounds were held on a yearly basis since the reforms were introduced.
	• However, in December 2018, the government cancelled any new licensing rounds until at least 2022
		• No formal announcements made yet on fiscal and regulatory changes to mitigate the impact of COVID-19 and falling oil prices
		• However, there is a proposal to:
		  • Reform PEMEX's hydrocarbon production sharing payments (represents 80% of PEMEX's fiscal burden)[21]
		  • Fiscal relief decree — reduce PEMEX profit-sharing rate/ duty from 65% to 58% and 54% in 2020 and 2021 respectively.[22] This would help mitigate the impact of falling oil prices on PEMEX's balance sheet and liquidity Heavily indebted PEMEX's credit rating was downgraded to junk status by Fitch and Moody's in April 2020[23]

Nigeria	• Amended 1999 PSC in 2018[24]
	  • Introduced a flat 10% royalty for oil and condensates for all deep offshore in waters greater than 200 metres water depth fields (previously 0%-12% based on water depth)
	  • 7.5% flat royalty for oil and condensates at frontier or inland basin (10% under the previous Act)
	  • Additional price-based royalty ranging from 0% to 10% if oil is between US$0 and US$150/bbl
	• More frequent reviews of fiscal terms legislated
	• Drafted two bills to revise the fiscal terms primarily for concessionary terms:
	  • National Petroleum Fiscal Policy Draft (NPFP) in 2017
	  • Petroleum Industry Fiscal Bill (PFIB) in 2018
		• At the time of writing, PFIB (2018) is under review
		• Major oil fields bid round delayed

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Appendix 1. Review of Regulatory and Fiscal Changes *(Continued)*

Country	2014-19 fiscal and regulatory changes	2020 fiscal and regulatory changes (including proposals)
Norway	• Reduction in total uplift from 22% in 2016 (5.5 % per year for four years starting with the investment year) to 21.6% (2017), 21.2% (2018), 20.8% in 2019 (5.2 % per year for four years from the date of expenditure) • Reduction in Corporate Income Tax (CIT) marginal rates from 25% (2016) to 24% (2017), 23% (2018) and 22% (2019) • Increase in Special Petroleum Tax (SPT) marginal rates from 53% (2016) to 54% (2017), 55% (2018) and 56% (2019)	• Marginal rate of tax maintained at 78% (CIT, 22%; SPT, 56%) • Introduced 24% uplift (6% per year) for capex[25] • Change to tax write-off rules allowing E&P companies to frontload investments more quickly, thereby deferring tax payments until later years[26] • Replaced linear depreciation allowance scheme for investments spread over six years with immediate deduction against SPT for capital expenditure • E&P companies can claim payment from the State of the tax value for any uncovered loss and unused uplift arisen in the 2020- and 2021-income years.[27] The tax repayments are irrespective of what type of costs in the petroleum activities • These proposals are applicable for the next two years (2020-2021) to E&P companies operating in Norway
United Kingdom	• Zero-rated Petroleum Revenue Tax (PRT) and reduced Supplementary Charge (SC) from 20% to 10% in 2016. The net effect of this change is that the effective marginal rate in the Continental Shelf (UKCS) is 40%, which is one of the lowest in the world[28] • Ring Fence Expenditure Supplement (RFES) which increases losses carried forward value from one accounting period to the next by a compound 10% a year for a maximum of 10 years • Basin wide investment allowance for Supplementary Charge • Transferable Tax History (TTH) mechanism effective November 2018 for late-life assets, allowing companies selling UKCS license interests to transfer some of their tax payment history to buyers. Buyers can offset their decommission costs fields against the TTH.[29] TTH also grants PRT relief when a seller retains decommissioning liability[30] • Government-funded geological surveys to improve prospectivity	• Some proposals among industry groups including tax repayment for trading losses and deduction for finance costs on the SCT as done with Ring Fence Corporation Tax (RFCT)[31]
United States	• The US Congress in December 2017 enacted changes to the US federal income tax system, which primarily includes a reduction in the CIT rate from 35% to 21% • Considerations for reforming the fiscal regime that applies to US GOM, to improve its international competitiveness[32]	• No formal commitment yet on fiscal and regulatory changes • President Donald Trump announced his intent to provide further federal level fiscal relief/ financial aid to the upstream industry[33]

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Taxation of SMEs to Support Economic Recovery Post-COVID-19

by Elizabeth Allen and David Child

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Taxation of SMEs to Support Economic Recovery Post-COVID-19

by Elizabeth Allen and David Child

This article is part of the series, "Post-COVID-19: How Governments Should Respond to Fiscal Challenges to Spur Economic Recovery," coordinated by the International Tax and Investment Center (ITIC) to offer tax policy guidance to developing countries during the post-pandemic recovery phase.

Elizabeth Allen is a former head of a VAT Division (HM Customs & Excise) and of an Excise Division (HM Revenue & Customs), and David Child is a former head of Management and Consultancy Services (HM Customs & Excise).

In this installment, the authors look at the effect COVID-19 has on small and medium-size enterprises and on tax revenues, outlining the short-term help tax systems can provide SMEs to stay in business and how tax policies and administration can be regeared to help the SME sector grow.

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Context

Whilst the impact of COVID-19 lockdowns has differed in each country, businesses large and small have suffered as a result. Many businesses have had to close and have had virtually no business income while having continuing and unavoidable expenses; e.g., property rents and maintenance costs. Others have been able to continue operations but with lower levels of income.

The key to the recovery of small and medium-size enterprises must be cash flow. Governments are doing many things to assist in their liquidity and preserve employment. These range from direct support (paying wages, facilitating loans, and providing cash injections to the self-employed) to indirect support (such as delaying tax payments).[1] However, less affluent governments that are struggling to fund essential (particularly health) services, are unlikely to be able to offer businesses direct support.

Fiscal policy must now complement any direct government support and reflect the changed world we find ourselves in. Governments also need revenue inflows to maintain public services, especially as the cost of some public services such as healthcare will have increased. So, there will be a delicate balance to be struck between the two conflicting aims.

Objectives

As a result of the global COVID-19 pandemic, lockdowns across the world have resulted in severe cash-flow difficulties for many SMEs and huge increases in unemployment. SMEs, while directly paying often less than 20 percent of the direct and indirect tax revenues, support larger businesses as both customers and suppliers. Small business start-ups fuel economic growth, as they can become the successful large businesses of the future. Hence, SMEs are a vital cog in business in all countries and provide employment for millions of employees and business owners. One of the goals of tax policy for economic recovery must be to enable this sector to recover from the financial impact of the business interruption caused by the COVID-19 lockdowns.

To help SMEs maintain cash-flow is the core goal of this fiscal policy and administration guidance. Even more fundamentally, this guidance aims to cover the immediate help that

[1] Examples of these actions for the United Kingdom can be found at U.K. Government, "Part of Coronavirus (COVID-19): Business Support."

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SMEs will need from tax systems to stay in business. It also looks beyond the immediate period toward how tax policies and tax administration can be re-geared so as to help the SME sector grow in the future (and, thereby, provide governments with increased revenue inflows).

Scope

This paper looks at the impact of COVID-19 on both SMEs and tax revenues. Although there is a general understanding of the businesses that constitute SMEs, there is no standard global definition of these, as the economic situation differs in each country. However, most tax administrations segregate large businesses — hence SMEs, de facto, constitute all the other businesses that are required to register for tax.

The revenue from all taxes will have suffered as a result of the COVID-19 lockdowns and the subsequent reductions of economic activity — the affected taxes — are likely to include:

- income tax on profits: company, partnership, and self-employment;
- payroll taxes (including employee social security contributions);
- VAT/sales tax;
- excise taxes;
- environmental taxes;
- withholding taxes;
- capital gains tax;
- taxes on wealth, inheritance, and estates;
- property taxes (including local business taxes and rates);
- customs duties (and other import charges);
- taxes on insurance premiums, property, financial transactions, etc.;
- business trading licenses and occupational taxes;
- license and annual fee charges (e.g., on motor vehicles); and
- user fees imposed by national or local governments (including road tolls, etc.)

The impact of COVID-19 on SMEs goes wider than taxation, as those businesses have to contend with both regulations from other public sector bodies including local and regional authorities and other constraints that contribute to the costs of doing business, including:

In most markets:	In some markets:
• Restrictions on opening hours and other licensing rules • Regulations covering product approvals, content, and labelling • Hygiene and other health and safety requirements • Environmental restrictions • Product labelling and display restrictions.	• Unreliable electricity supplies • Lack of safe drinking water • Inadequate sanitation • Inadequate social and medical benefits • Corruption of public sector officials at all levels and across all parts of the public sector • Flourishing illicit markets • Lack of security and ineffective crime prevention.

Tax Policy and Administration to Support Taxpayers

With many SMEs either being unable to trade or trading at greatly reduced levels of turnover, and in order to facilitate their survival, the sector is seeking ways of deferring or reducing their tax liabilities so they can preserve their struggling cash flows.

The following categories highlight possibilities that tax policymakers and administrations might consider either for all SMEs or for the hardest hit sectors.

For All Taxes Due from SMEs

- Payment grace periods for all or for the hardest hit trade sectors;
- waive penalties and interest and suspend the "harsher" debt collection activities — e.g., distraint, third party liens, court recovery, bankruptcy, or insolvency action;
- allow time to pay agreements for tax owing over a realistic and long period (but conditional on all future returns being made and all taxes being paid in full and on time);
- introduce flexible payment plans so that tax is paid over a long period (at least a year) as and when possible, provided that the quarterly or annual totals are met;
- defer payment dates for a period — so if, e.g., VAT is due 21 days after the tax period ends, that could be extended to, e.g., 51 days;

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- make automatic or rapid payments of tax refunds or rebates to SMEs within set credibility parameters;
- give a discount for timely payments made in full;
- provide a tax subsidy or credit for the hardest hit trade sectors which would then have a flat amount that they can deduct from any tax due;
- allow for credit card payments of tax;
- make temporary changes in audit policy and ways to assure tax certainty;
- enhance taxpayer services to provide full information on websites and through electronic communications and call centers; and
- develop communication initiatives to advise all taxpayers of the COVID-19 tax relief available to them and how to claim if a claim is required.

Customs Duties

- Reductions or duty suspensions for some sectors (where possible under regional external tariffs); and
- deferment periods extended for payment of import duty on goods for resale.

Excise and Environmental Taxes and Duties

- Rate reductions if specific duty rates apply, but bear in mind the potential health and environmental impact. (Ad valorem duties will automatically reduce proportionately as the commodity price reduces — e.g., on road fuel.)

VAT

- Align import VAT payment date to the VAT payment date for the tax period;
- set a lower VAT rate for the sectors hardest hit;
- set or increase a higher tax rate on nonessential and luxury goods — e.g., jewellery, perfume, high-end electrical equipment, luxury cars;
- raise the VAT registration threshold to allow smaller firms to de-register;
- make automated and expedited VAT refunds within set parameters instead of any credits carried over;
- extend the VAT tax accounting periods for SMEs — e.g., instead of monthly tax periods extend to 2 or 3 months);
- introduce (or extend the availability of) annual accounting with phased payments for the smaller businesses; and
- allow cash accounting for all SMEs up to a set (or higher) threshold turnover.

Income Tax on Business Profits

- Tax rate reductions and rate band and threshold increases, including seeking to remove many small businesses from the tax net.
- Where losses are made, no income tax liability accrues and, in order to keep a small business afloat, losses should be allowed to be carried over to the following year and credited against that year's profits. Alternatively, SMEs might be allowed to render tax returns to cover a two-year period (2020 and 2021; or 2020-2021 and 2021-2022).
- Where the 2019-2020 tax year spans the COVID-19 lockdown period, the lack of income over the period may result in no tax due and any stage payments made may have been too high. In this case, a refund should be expedited, and any remaining stage payments canceled.
- For the current tax year, in the most hard-hit sectors (travel, hotels, restaurants, gyms, sports and entertainment businesses etc.), a nil overall profit could be assumed and any advance payments abandoned, deferring all liability to the next tax year.
- Allow 100 percent depreciation for capital goods allowances for businesses in the hardest hit sectors. This would advance the depreciation allowances that otherwise would have affected over a number of years and thus assist cash flow for businesses.
- Where there is a tax regime with a minimum threshold or a presumptive tax regime based on turnover or trade sector, the rates will need to be revised for the current tax year (to ensure that loss making businesses do not end up having to pay any income tax).
- Introduce a new higher rate of income tax for businesses that have made significant profits through the crisis (with this extra tax being available to help businesses who have suffered the most).

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Withholding Tax on Wages of Employees of SMEs

- Increase personal allowances, thresholds, and/or broaden the rate bands;
- reduce the tax rates;
- provide tax credits; and
- allow employers to delay paying the tax deducted for a longer period than is usually permitted.

Other Withholding Taxes Affecting SMEs

- Withholding tax on professional fees and when charged on imports could also be reduced or suspended; and
- withholding tax on property rents could be reduced or suspended.

Encouraging Economic Growth to Aid Recovery

Looking beyond the survival of businesses affected by the COVID-19 crisis, all countries will need to encourage economic growth in future years. This will be to encourage new businesses to be established and to enable existing, perhaps very small businesses, to grow. To create the investment climate that will achieve this will require countries to consider many actions that will assist this development. The following categories provide options.

Simplifying or Reducing Compliance Costs

- Simplify tax registration requirements for businesses and self-employed;
- develop presumptive taxes for the smaller SMEs (see Annex 1 for more detail);
- simplify forms and documents required — e.g., for import and export or temporary customs relief;
- develop single window and other electronic customs schemes sanctioned by the World Customs Organization that reduce form filling and simplify access so importers and exporters can make their own declarations;
- extend the availability of bonded warehouses so businesses can defer the payment of customs duties until the goods are needed for manufacturing or resale;
- work with other countries in regional customs unions or with countries having unilateral or multilateral trade agreements to simplify documentation required across international trade;
- introduce or extend simplified import procedures for low-value goods;
- through consultation, seek to reduce costs on imports and exports — e.g., port and airport fees — and thus stimulate international trade;
- develop simple payment schemes that do not require a visit in person to a tax office — e.g., mobile phone "Pay As You Go" tax payments;
- revise penalties so as to support voluntary compliance — e.g., written warning for first penalty and suspended penalty for second penalty, with third penalty triggering double penalty;
- develop user-friendly electronic facilities for all tax processes;
- exempt all investors from all fees related to companies' registration until the end of 2021; and
- identify regulations from other public sector bodies that contribute to compliance costs for businesses — e.g., licensing, restrictions on trading hours, restrictions on lorry driver hours — and seek to quantify compliance costs — e.g., through an annual survey, focus groups, trade associations — then deregulate as far as possible.

Options for Tackling the Informal Economy

- Develop presumptive taxation schemes where none exist (see Annex 1 for more details).
- Amnesty for back tax and failure to register penalties for previous failures to register or charge and remit the correct amount of tax together with stiffer penalties for those who fail to register during the amnesty.
- Task force to develop mechanisms to improve tax declarations and payments by professionals.[2]

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[2]For case study information about the Kenyan experience of tackling hard-to-tax self-employed professionals, see Daisy Ogembo, "Taxation of Self-Employed Professionals in Africa: Three Lessons from a Kenyan Case Study," International Center for Tax and Development African Tax Administration Paper 17 (Mar. 2020).

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- Provide taxpayer education programs in conjunction with advisers from other public sector organizations who provide business education to those without bookkeeping knowledge or experience and knowledge of other legislation appertaining to the type of business — e.g., consumer protection, health and safety, environmental.
- Develop compliance records for all taxpayers if none exist.
- Develop a risk-based audit program if none exists.
- Put in place an anti-corruption strategy, commitment, and actions to make as much as possible of the revenue processes corruption proof. Examples are:
  - separating decisions on which businesses to audit from the local officials who have to carry out the audit;
  - encouraging electronic declarations and payments as far as possible and developing easy payment processes for those without bank accounts — e.g., "Pay As You Go" tax cards for use with mobile phones;
  - auditing all processes to identify which processes are at the highest risk of facilitating corruption; and
  - requiring staff to declare relationships with any business taxpayers and ensuring that such staff never audit those taxpayers.

Tax Regimes That Might Be Introduced

- Because all countries will have revenue shortfalls and will need funds to enable them to support recovery, consideration might be given to new taxes, such as:
  - luxury tax on designer clothing, accessories, jewellery, precious metals, as well as the use of robots, and luxury cars, yachts, planes, whether or not used for business purposes;
  - additional taxes on telecommunications and e-commerce; and
  - environmental taxes to encourage behavioral change as well as to raise revenue — e.g., plastic bags tax, pesticides tax, single use plastics tax, litter tax (on all fast food take away or drive-through businesses).

Additionally, there are suggestions for longer-term revenue enhancement particularly geared toward developing countries.[3]

Constraints on Tax Policy and Administration

There will be many challenges to be overcome to make both tax policy and tax administration changes, including:

- Funding for changes.
- Legislation may need to be amended after consultation with trade associations, chambers of commerce, etc. This may take time and require top level political commitment.
- IT systems may take some time to amend and will entail significant costs.
- More resources (and staff training) may be needed in the short term to develop special schemes, identify compliance costs that can be reduced through deregulation, administer and assure COVID-19 relief, communications, etc.
- Mobilizing donor assistance can be time-consuming.

Recommendations

- Time is of the essence. What governments do to help SME cash flows needs to be done quickly. Actions need to be simple and clear so that taxpayers know what applies to them and what they need to do to benefit from tax or other regulatory change.
- A first step should be to consult with trade associations and taxpayer representatives to identify their priorities for relief and relaxation of tax and other regulatory requirements affecting SMEs and then draw up a prioritized list for immediate action.
- The constraints on public sector authorities are real, and in an ideal world, it would be good to have plenty of time to develop proposals, consult, and design changes both in legislation and IT. SME cash flow cannot wait for the ideal timescale for implementing tax or other regulatory

[3] *See* Mick Moore, "How Can African Tax Collectors Help Cope With the Economic Impacts of COVID-19?" International Center for Tax and Development blog, Apr. 8, 2020.

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changes, so simple one-off developments may have to be deployed.
- Each country has a different mix of businesses and a different set of tax and regulatory requirements, so there is no "one size fits all." Governments will need to choose the options that best fit their mix of businesses, priorities, and funding capacity.

Conclusion

This paper has aimed to set out a wide range of options both for relief and simplification of taxes and for reducing and simplifying other regulatory requirements. It should always be borne in mind that supporting businesses in their hour of need should result in an early economic recovery that, in turn, will result in future revenues. Where governments are seen to be assisting SMEs with their cash flow difficulties, they are also building trust and goodwill that should lead to improved tax compliance in the future.

Annex 1: Presumptive Taxes

1. What Are Presumptive Taxes?

Presumptive taxes are ways of assessing tax liability using indirect methods such as income reconstruction or by applying baseline taxation across the entire tax base. They are alternatives to formal tax regimes designed to capture the "hard to tax" who fail to register voluntarily, keep records of business costs and earnings, and render tax returns or payments, and are usually small operators with modest incomes derived from cash or barter transactions.

2. Why Use Presumptive Taxation?

In developing countries, presumptive taxation may be the most appropriate method of tax administration for specific groups of taxpayers. Most tax laws are designed by policymakers and drafted by lawyers who assume tax is assessed on well-defined measures of income and well documented in transparent accounting records. The reality is that most taxpayers do not possess the administrative resources to maintain accurate books or navigate complex tax codes. A highly informal economy impedes growth because of inefficiencies of operation. Tackling the issue needs political will to introduce stricter enforcement and better information both for officials and for taxpayers.

3. Advantages and Disadvantages of Presumptive Taxation

In order to achieve a satisfactory take-up of presumptive tax regimes, there needs to be both an enticing reward and an off-putting penalty. They may need to be offered an enticement that is of value to them — e.g., free healthcare for children and the elderly, installation of safe water and sanitation, reliable electricity supplies, etc. Pitfalls are:

- a lack of communication with representatives of the informal sector and a high risk of misunderstanding and distrust;
- surveys used to develop indicators have not been updated regularly, so assessments tend to be arbitrarily applied to vulnerable small entities;
- most presumptive schemes provide little or no analytical data to enable risk assessed audits and enforcement to take place; and
- audit and assurance procedures have tended to be office-based because of the link to "tax clearance" schemes that require taxpayers to physically visit local tax offices, taking them away from their businesses.

Many presumptive regimes are seen as corrupt, unfair, and inefficient with processes that offer little or no incentive for businesses and individuals to graduate to the formal tax regime.

4. The Main Types of Presumptive Taxation

The table below shows the most common types of presumptive regimes.

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Common Types of Presumptive Tax Regimes

<table>
<tr><th>Regime</th><th>Advantages and Disadvantages</th></tr>
<tr><td>Simple lump-sum payments — a license regime: Licenses are easy for taxpayers to understand and comply with. Annual payments can be unaffordable, and more frequent license periods may be required (but at an increased administrative cost).</td><td>The main advantages are that licenses:
• are relatively easy to administer and reduce the opportunities for corruption;
• help authorities know who and where the small businesses are (for guidance, administration of public health, consumer protection laws, etc.); and
• provide an incentive to small businesses to stay on the right side of the law.

However, revenue inflows can be poor, not reflecting individual situations, and licenses can be regressive.</td></tr>
<tr><td>Tax indicator regime: This involves segmenting the small taxpayers according to trade sector, size and region. This usually requires an average tax payment to be calculated using groups of indicators as proxies for business income.</td><td>The reduction in compliance burden can be attractive to small businesses.

This regime can:
• distort investment; and
• present difficulties in obtaining accurate data and selecting appropriate and simple indicators.

For taxpayers, there are winners and losers; the scheme does not provide for a tax reduction in respect of losses.</td></tr>
<tr><td>Turnover regime: A regime based on turnover provides more equity to the taxpayer and an easier transition to the formal tax regimes. They can be designed to give an average proxy for tax on profit; or with variable rates — e.g., for different sectors.</td><td>A turnover-based regime:
• has the potential for higher revenue;
• has a high risk of under declaration;
• can favor businesses with a high profit margin; and
• does not accommodate situations where a loss is made (and hence runs counter to the principle of income tax being charged on business profits).</td></tr>
<tr><td>Agreed regime: This regime involves using indicators to obtain an estimate of tax due which is then subject to agreement between the taxpayer and the tax administration.</td><td>The regime:
• is equitable;
• carries a very high risk of corruption; and
• requires extensive and regularly updated research, data collection, and analysis.</td></tr>
</table>

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