Should Zimbabweans worry about tax exemptions?

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Introduction

On the 27th of January 2021 the government of Zimbabwe through the Minister of Finance gazetted the Income Tax (Exemption from Income Tax) (Great Dyke Investments Private Limited) Notice, 2021 or the Statutory Instrument 26 of 2021. In a context where the country has been exposed for its fragile public health and education services by the Covid-19 pandemic, the act of surrendering the tax rights by government confirms that government is not pro poor. Especially considering that there is no empirical evidence that shows tax incentives attract meaningful mining investment in developing countries. It is baffling to observe that tax exemptions are generously granted to mining companies who engage in harmful and aggressive corporate behaviour that undermine tax revenue mobilisation efforts of the government. At a time when Africa has shifted gears for a continental free trade agreement, tax incentives goes against the spirit of pan-Africanism if they are nor harmonized with other African countries – a race to the bottom can be the result. In this situation, countries outdo each other to attract investment by lowering taxes rates, giving investors the opportunity to spur a tax regime beauty contest to the detriment of domestic resource mobilization for financing sustainable development.

Details of Statutory Instrument 26 of 2021

The notice to grant a five-year tax incentive notice was made in terms of subparagraph (g) of paragraph 3 of the Third Schedule to the Income Tax Act [Chapter 23:06]. The Income Tax Act is the main legislation in terms of matters that relate to income tax. The purpose of the Statutory Instrument (SI) 26 of 2021 was to notify the public of a five year tax exemption that was granted to Great Dyke Investments a mining company situated in Darwendale, Zimbabwe

According to the SI 26 of 2021, the receipts and accruals of Great Dyke Investments (Private) Limited, as per the Special Mining Lease Agreement signed between the Government of Zimbabwe and Great Dyke Investments (Private) Limited are approved, for the purpose of subparagraph (g) of paragraph 3 of the Third Schedule to the Income Tax Act, as being exempt from income tax. The receipts and accruals must be generated from the exploitation of Platinum Group Metal deposits at Darwendale. The consequence of this approval is that the receipts and accruals of Great Dyke Investments (Private) limited are exempt from:

a) income tax for a period of five years commencing from the date of receipt of income from mining operations and sales of mining output; and
b) resident shareholders' tax payable on dividends paid to shareholders of Great Dyke Investments (Private) Limited resident in Zimbabwe in connection with special mining lease operations of Great Dyke Investments (Private) Limited; and
c) additional profits tax for a period of five years commencing from the date of receipt of income from mining operations and sales of mining output payable in respect of the special mining lease area for any year of assessment.

Why countries offer tax incentives?

Before delving into the implications of the SI 26 of 2021 in Zimbabwe, it is important to understand the pros and cons of tax incentive and the possible reasons why countries such as Zimbabwe offer tax incentives to mining companies. Most often, proponents of tax incentives argue that tax incentives tax policy may be able to play a purposive role in improving on market outcomes that are inefficient or unfair. The economic rationale for tax incentives must thus be evaluated in terms of their ability to achieve clear goals in ways that are both effective and efficient, relative to alternative policies, both tax and non-tax, that could achieve the same objectives. However, the disadvantages of tax incentives are that they risk compromising these principles to the extent that they complicate the tax system, create horizontal inequities, and distort production efficiency; and they may forgo revenue that could have been spent more productively or needs to be replaced in other and more damaging ways.

In terms of reasons why countries offer tax incentives, firstly, exemptions are granted to stimulate economic growth. These exemptions should normally lead to increased investment, employment, output growth and thus lead to more tax revenues in the long run. In its justification, the government of Zimbabwe argues that the Darwendale claims were sitting for a long time and doing nothing in terms of their contribution to the national economy. Granting tax incentives for a five-year period was a way of attracting investors and also absorbing those who are not employed. Secondly, in many cases tax exemptions are granted where activities of certain organisations do not earn them a profit but have a direct benefit to society which the Government may not be able to otherwise procure. This basis is used to grant exemptions to charities including religious organisations. Thirdly, where consumption of certain goods are deemed to have direct benefit to society. For example, during the Covid-19 pandemic medicines were exempted from Value Added Tax (VAT). Exempting such goods from taxes increases their consumption, which in return brings greater benefits due to their positive effects on society. Fourthly, governments may generously grant tax exemptions to companies falling under the export processing zones. Mining companies holding special mining lease operations are also eligible to tax exemptions.

Under special mining lease agreements, investors can individually negotiate incentives with government, including royalties and other statutory obligations, and are allowed to carry on investments without changes to their agreement with government for the duration of the lease. There are a number of issues to be concerned about here. One, countries often lack the capacity to negotiate better deals which consequently lead to African governments reaping sub optimal benefits from mineral resources extraction. This lack of capacity in contract negotiations can be attributed to a number of factors like inexperience, asymmetrical information and external influences. Corruption is also another important factor. Zimbabwe has a Minister of Mines and Minister of Finance who are well knowledgeable and corruption account for the gap between policy and practice. The majority of the African governments have suffered from the lack of highly-skilled and well-resourced negotiators in comparison to the mining companies.

The second issue is that special mining agreements override statutory frameworks of governments. The terms of the agreements supersede national tax and labour laws. This creates and opportunity for the mining companies negotiate for lower tax rates, royalties and longer tax breaks. What this mean is that the SI 26 of 2021 has superseded the Income Tax Act which stipulated that mining companies should pay income tax to the Zimbabwean government at a rate of 24.72%. It is important to note that Zimbabwe might be compensating incorrectly its lack of political stability, quality infrastructure – power and transport, for instance; unstable policy environment – by offering incentives to investors. Recently the country has made a summersault on indigenization policy which resulted in Zimbabwe lacking of political image to make the country interesting to investors.

Implications of SI 26 of 2021 on tax revenue

Resources rich countries are already grappling with a plethora of challenges with regards to mineral sector revenue collection. The challenges that surround poor revenue collection from the minerals sector are as a result of weak and inadequate legal and institutional frameworks, poor royalty administration. This reduces the amount of taxes collected from the mining sector. Most legal frameworks of resource rich countries in Africa have weaknesses that can be exploited and therefore do not adequately prevent revenue losses. Mining companies take advantage of the porosity of the legal and institutional frameworks to reduce their tax burdens and in some cases to evade paying taxes. They may also carryover losses perpetually and not pay anything to government. As a resource rich country, Zimbabwe is not immune to these challenges is also highly susceptible to this.

Tax incentives granted to mining companies entail foregone government revenues thereby limiting the potential of tax revenue from the mining sector. The negative effect of revenue losses is enormous on the social economic development. Given that the country desperately needs resources to deal with the Covid-19 pandemic, the move to offer incentives to mining companies may not be ideal. Simply put, tax incentives discount socio-economic development opportunities.

After being granted tax incentives, there is a general behaviour response that mining companies may increase their income during the tax-free period by speeding up the rate of production, and shifting the profits offshore. By the time the exemption period expires, a lot of resources would have been extracted and probably stocked somewhere they sold when there are favourable prices on the international market. Mining companies will be preferentially extracting high-grade ore which fetch more. Lower grade ore is then extracted after the expiration of tax incentive. Given that Great Dyke Investments has been exempted from additional profits tax for a period of five years commencing from the date of receipt of income from mining operations and sales of mining output payable in respect of the special mining lease area for any year of assessment, there is motivation to extract high grade ores at a faster rate so as to maximise profits which will not be taxable until the five years exemption period lapse.

Furthermore, tax incentives may provide an additional motivation for investors to engage in base erosion and profit shifting (BEPS) practices. This happens in two ways, one: when related companies distort the price of a transaction to reduce their taxable income and two: a mining company may be financed through a high level of debt compared to equity, which results in excessive interest deductions. The use of tax incentives may make government revenues more vulnerable to these BEPS practices, than if the general tax treatment applied. The HLP report on IFFs from Africa explicitly mentions how susceptible the sector is to abuse of tax incentives. Also, important to highlight that the IMF Spillover paper of 2018 concludes that incentives of this kind do not benefit developing countries.

What should be done?

The Zimbabwean government has a responsibility to transform its mineral wealth into lasting development outcomes. To achieve that, there is need to consider the following recommendations:

1. Government should limit the holiday period to the time anticipated for a specified tonnage to be extracted. Government may reduce the risk of high-grading by agreeing a tax holiday on a tonnage-of-ore-extracted basis i.e. once the agreed tonnage has been extracted the tax holiday expires.
2. Before agreeing to any tax incentives, the Zimbabwean government should use a financial model to estimate the cost and benefits of incentives, and their impact on socio economic development. Costs estimates should include potential behavioural responses. Combinations of incentives being considered should always be analysed together to determine the collective effect on revenues foregone. Unbeneficial incentives should be scrapped.
3. There is need to improve transparency and accountability in the negotiation of mining agreements as enshrined in Section 315(2) (c). This can be enhanced through public participation and inclusive contract negotiation processes. The signed agreements should be fed into the public domain. Civic society organisations should complement these efforts through analysing the implications of the agreements on government revenues.
4. Information disclosure on tax exemptions through national budget should be improved. Such information should be how much potential revenues has been lost through tax exemptions. Furthermore, adherence to the principles of EITI may also enhance transparency and accountability.
5. To improve contract negotiations, there is need to correct information asymmetries through the contracting of world-class consultants to support the state in these crucial contract/license negotiations and the concurrent development of the state's own capacity. Governments should also invest in training of world class negotiators. Mining agreements should have flexible fiscal regime which is sensitive to price movements and stimulates national development.

6. The HLP Report recommends that African countries need to establish regional and sub-regional standards for tax incentives to end the existing “race to the bottom”. At the same time measures should be taken to combat the abuse of incentives such as tax holidays that enable IFFs, notably through the exploitation of rules relating to change of ownership as well as directly through base erosion.
7. Countries such as Zimbabwe should also domesticate the aspirations of the AMV especially those in the fiscal pillar so as to minimise the leakage of resources from the extractives sector.