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The Effects of Tax Incentive and Political Stability on Marginal Oil Field Investment Climate: A Theoretical Framework

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ABSTRACT

This paper presents a theoretical framework on political stability and tax incentive that will affect the marginal oil field investment climate in Malaysia. The study attempts to evaluate the effects of political stability and tax incentive on the marginal oil field investment climate. Indeed, the study provides a new stream of research in investigating both variables of tax incentive and political stability in recognizing the significant effect towards the investment climate. In doing so, informed views on political stability and tax incentive are collected from target respondents via the questionnaire method. The study also adopts economic rent theory and transaction cost theory. The findings of the study will expect to give positive relationship towards the marginal oil field investment climate. In conclusion, the study contributes to suitable policy implementation for the host oil and gas producing countries and most importantly to the marginal oil fields operators for investment decisions.

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INTRODUCTION

Oil, Gas and Energy industry plays a vital role in Malaysia's economy, contributing significantly about 20 percent of the national Gross Domestic Product over the past decade (Malaysia Petroleum Resources Corporation (MPRC), 2014). However, recent evidence proved that the total of Oil and Gas production in Malaysia has been declining due to natural depletion at maturing field (Lee, 2013). This situation opts for the government to include in one of the 13 Entry Point Projects (EPPs) under the National Key Economic Areas (NKEAs) to sustain the oil and gas production by considering the development of marginal oil fields. The aim of this EPPs is to turn Malaysia into the number one oil and gas hub in Asia Pacific region by 2017 (MPRC, 2014). Due to this, Malaysian government has provided new incentives to attract more investors to capitalize the marginal oil field.

Besides the implementation of tax incentives, political stability plays a vital role in influencing the investors in the marginal oil field investment climate. It has been suggested that key determinants of the investment climate include stability and security, regulation and taxation, finance and infrastructure and workers and labor markets (Mundial, 2004). Hence, Shepherd (1997) summarizes that stability is the rule of law, together with strong institutions rather than powerful individuals, a responsive and efficient bureaucracy, low corruption and a business climate that is conducive to investment.

In a different study, Johnston (1994) suggests that despite having good geological potential, Malaysia has one of the toughest fiscal systems in Southeast Asia but Malaysia has good geological potential. The author agrees as well that many investors would be attracted to explore in the significant geological potential in Malaysia. Therefore, in order to provide a sound and conducive environment to attract the investors, and maintain a stable flow of investment in the country, the government will need to design and implement consistent policy to deal with the issues at hand (Le, 2004).

This paper presents a study of the impact of tax incentives and political stability on the marginal oil field investment climate. The main purpose is to evaluate the relationship of tax incentive and political stability towards the marginal oil field investment climate. According to Van Parys and James (2009), the investment climate is crucial for determining the

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effectiveness of incentives in attracting the foreign investors.

As noted by Clark, Cebreiro, and Böhmer (2007), incentives have become the important tool for the governments to increase their share of investment in order to gain the attention of potential investors. Therefore, tax incentive is offered to promote investment which includes tax holidays for new firms, tax credits for new investments and exemptions from import duties on inputs (Fletcher, 2002). According to Surrey (1970), tax incentive is adopted to assist particular industries, business activities, or financial transactions.

Meanwhile, Shepherd (1997) suggests that political stability means a predictable political environment, which in turn attracts investment, both internally and externally. Political stability is closely related to the performance of the private sector in general and will directly affect the investment performance (Kim, 2010). According to Kelsall (2013), the main investors are attracted to Tanzania because they are certain about the political stability of the country which generally has a climate of peace and comparatively low crime rate. Therefore, tax incentive provided and performance of political stability are the important elements in attracting investment (Clark *et al*., 2007; Kelsall, 2013; Kim, 2010; Shepherd, 1997; Van Parys & James, 2009).

As the oil and gas production is depleting around the world, operators will likely attempt for more challenging reserves and stranded marginal oil fields (*Economic Transformation Programme (ETP) Annual Report 2013*; Lee, 2013). In the case of marginal oil field in Malaysia, the government will need to attract investors to ensure that the development of marginal oil field will be fruitful. Aziah, Manaf, Mas, Saad, and Ishak (2014) describe that marginal oil field is the oil and gas reservoir not worth developing at a given time due to low revenue accruing from its operations. In 2011, significant moves were made in the Oil, Gas and Energy sector which included the approval of the Petroleum Income Tax Act (PITA) Amendment Bill. Therefore, to ensure the taxation imposed would not discourage the business activities, Malaysian government initiates new incentives under the ETP. As highlighted in the EPPs, one of the point is to sustain oil and gas production by developing small fields which then would increase Malaysia's oil production by approximately 55,500 barrels per day in 2010 (MPRC, 2014).

In line with Aziah *et al*., (2014), which proposed a theoretical framework that discussing the effects of taxation and fiscal arrangement on marginal oil field investment climate, this paper will expand the prior research theoretical framework by introducing a new variable which is political stability towards the marginal oil field investment climate. Meanwhile, tax incentive is chosen to examine the attractiveness of the incentives in the marginal oil field investment climate in Malaysia. In addition, this paper will test the newly proposed framework to see the movement of any relationship of the study.

Literature Review:

Taxation is significant in a country as it is the mechanism for a government to generate revenues on behalf of the society that will likely affect the overall investment climate (Nakhle, 2004). However, in order to induce certain activities or behaviour in response to the monetary benefit available, tax incentive plays a vital role in this matter (Surrey, 1970). The purpose of tax incentive is to induce action which will be considered as the national interest (Surrey, 1970). Zee, Stotsky, and Ley, (2002) defines tax incentive as tax provision that is granted to a qualified project that represents favourable deviation from the provisions applicable to investment projects. Hence, tax incentive is only applicable to certain projects in order to stimulate investments.

Furthermore, Clark *et al*., (2007) suggests that tax incentives are chosen by the government to attract investment and foreign investors because they are much easier to provide, do not require an actual expenditure of funds or cash subsidies to investors and lastly, they are politically easier to provide than funds. Morisset (2003) states that there are increased number of governments trying to attract multinational companies in order to enhance the associated technology using the tax incentives and this have become a global phenomenon. Fletcher (2002) suggests that tax incentive will only attract investors if more tax-sensitive projects receive more favorable tax treatment. While tax incentive can be a primary determinant of investment, the key feature includes what it is granted to a qualified investment project. According to Coyne (1994), suggested that small firms are more responsive to incentives than big ones. This implies that the marginal oil fields which are mostly dominated by small firms would be more responsive to incentives than larger fields; this justifies the investigation on the effect of tax incentives on the investment climate. In a study conducted by Kazikhanova (2011) stated that increase in value allowances will improve the investment attractiveness in small and marginal fields. This proved that tax incentive plays a significant role in attracting more investors in the marginal oil field sector.

According to the Malaysia Petroleum Resources Corporation, the impact of strong growth in the region has made Malaysia an attractive destination for foreign companies to use Malaysia as their regional base to enter other markets in Southeast Asia or to Asia Pacific region. Hence, due to this factor, Malaysia government has established new tax incentives to be incorporated in the Petroleum Income Tax Act (PITA) to promote development of oil new oil and gas resources. This new incentives

are expected to lead to additional petroleum revenue of RM 58.2 billion to the government over the next 20 years (*ETP, 2013*).

With the new incentive, the capital expenditures include investment tax allowance of between 60 – 100 percent of capital expenditure to be deducted against statutory income. The reason behind this is to encourage the development of capital intensive projects. Furthermore, accelerate capital allowance for marginal oil field development is reduced from 10 years to 5 years where full utilization of capital costs deducted will improve project viability. On top of that, the transfer of qualifying exploration expenditure of between non-contiguous petroleum agreement with the same partnership or sole proprietor would enhance contractors' risk taking attitude, which could encourage higher level of exploration activity. In addition, waiver of export duty on oil produced and exported for the marginal oil field development is implemented to improve the commerciality of the developments. Moreover, the new tax rate is now 25 percent lesser than the previous rate which was 38 percent.

Similarly, government in other countries, have initiated many programs to stimulate the development of marginal field areas. For example, in 2001, the Nigerian government initiated Marginal Fields Programme (MFP) in order to expedite the development of hydrocarbon resources and promote indigenous participation in the upstream factor. Meanwhile, the UK government initiated a range of fiscal incentives in 2012 to target commercially marginal fields that included Small Field Allowance (SFA), from £75 million to £150 million. This initiative increased the investment as a total of 224 applications were submitted for 418 blocks compared to previous licensing round of only 37 applications. In conclusion, it is proven that each government from the previous examples have attracted the industry players based on the provision of the tax incentives. These incentives can be recognized to target the incremental investment.

Today's investors are seeking for a certain level political stability in a country before deciding to penetrate the business environment. Political stability is very significant for normal macroeconomic and business environment of a country (Shahzad, 2012). Political stability is defined as the political behavior act by any member of the society that will affect the decision making (Ake, 1975). The author (ibid.) suggests that political is explained as human behavior that is potentially political. Meanwhile, Shepherd (1997) defines stability as a way of predictable political environment which will lead to attract investment, both internally and externally.

In contrast, political instability is known as the inclination of government collapse and it is to investigate whether the political instability and economic growth is interrelated. Hence, Alesina, Ozler, Roubini, and Swagel (1996) agrees that if the occurrence of a government to change increases, this will definitely impact the potential growth. This will lead to the political instability if it is not regulated and monitored. Political stability is reflected by the rule of law, strong institutions rather than powerful individuals, a responsive and efficient bureaucracy, low corruption and a business climate that is conducive to investment (Shepherd, 1997). Thus, political stability is a significant factor that would attract investors to capitalize the market and consequently would lead to economic the growth of the respective country. Many studies have indicated that foreign investors are essential to the economic growth of the developed and developing countries (Shahzad, 2012).

Le (2004) states that not only economic failures in developing countries lead to a decline economic growth but also political and institutional failures affect economic performance. The relationship of political stability will affect the investment climate because political stability is related to the chances of drastic changes in government and policy, and these changes might impact business and nature of investment (Partners, 2013). It is obvious that foreign investors would prefer a stable political environment, with less uncertainty of policy and property rights in order to venture into the business environment (Alesina *et al*., 1996).

Moreover, Kim (2010) agrees that political stability measures the performance of the private sector in general and how it will affect the investment performance in a country. Therefore, political stability is crucial to growth and growth in turn is crucial to stability (Shepherd, 1997). For instance, Tanzania performs reasonably well in the area of political and macroeconomic stability, whereby foreign investors rarely incur unexpected and arbitrary forms of political interference (Kelsall, 2013). According to Investment Climate Index 2014, it states that Malaysia is ranked eleventh in the Asia Pacific region for its political stability. This indicates that Malaysia scored above its neighbors in Southeast Asia, with the exception of Singapore and putting Malaysia the investment destination to be pursued by scoring strongly on the openness to international trade and business and taxation. Shahzad (2012) examines that Pakistan's GDP decreasing trend during 2007 and 2011 was due to the downfall of the nation's political stability and increased corruption in the government sector which lead to the biggest security threats in the business environment in Pakistan.

Kim (2010) indicates that if a country has a low corruption index, it means that the country has high political stability. Since Malaysia is in a fair state of corruption level, this proved that the political stability is relatively stable in increasing investment in the country. Voskanyan (2000) agrees that Malaysia is one of the least corrupt countries which have undergone significant improvements over the

year. It is well-known that corruption is harmful to the development of a country by all means are needed to prevent it from happening. The definition of corruption is known as the perceptions of the abuse of entrusted power for personal gain in the public and private sectors (Partners, 2013). Meanwhile, Klitgaard (1998) suggests that corruption is the misuse of office for unofficial ends.

As illustrated in the Investment Index 2014, Malaysia was ranked ninth in the Asia Pacific region for the level of corruption, behind New Zealand, Singapore and Australia. In addition, in the Corruption Perceptions Index 2013 by Transparency International, depicts that Malaysia scored 50 which is a fair score between highly corrupt and very clean as compared to other 177 countries in the world. Both Denmark and New Zealand are ranked first in the index which successfully scored 91 which portrays both countries are very clean from corruption.

According to Voskanyan (2000), high level of corruption has very harmful effects on the economic and political development. Klitgaard (1998) agrees that all forms and instances of corruption are equally harmful. The effects include decrease in the efficiency of public spending, and in the budget revenues, rise in the budget deficit, hindrance of investments, reduction in the effectiveness of the use of aid, dissipate political legitimacy and hindrance of the democratic development (Voskanyan, 2000). All of these causes including fraud and abuse will threaten growth and stability that will lead to discourage in business (Wei, 2001). Most importantly, corruption will affect the political stability in a country which then will result in decrease in the investment climate in Malaysia. As a result, corruption may decrease the efficiency of a country's performance which then will hinder the foreign investors to invest (Voskanyan, 2000).

In conclusion, corruption will impact negatively on the economic growth, and then it will lead to destabilizing the political factors in the country (Michael, 2007).

Marginal Oil Field Investment Climate:

Marginal oil field as defined by the Nigerian Department of Petroleum Resources is any field that has reserves booked and reported annually to the department of petroleum resources (DPR) and has remained unattended to for a period of ten years (Adetoba, 2012). In addition, U.S. Officia (2011) states that marginal oil field in Nigeria is the oil field that does not produce enough net income to make it worth developing at a given time. However, if the technical and the economic conditions change, the field becomes commercial. In terms of Malaysia, qualified marginal field is a specific area determined by the Minister, and is a field in a petroleum area that has potential crude oil reserves not more than 30 million stock tank barrels of oil or natural gas reserves not exceeding 500 billion standard cubic ("Petroleum (Income Tax) (Accelerated Capital Allowances)(Petronas Marginal Field) Rules," 2014). Oil, gas and energy industry plays a vital role in Malaysia's economy, contributing significantly about 20 percent of the national GDP over the past decade *(ETP, 2014*). Recent evidence proved that the total of oil and gas production in Malaysia has been declining due to natural depletion at maturing field (Lee, 2013). This situation opts for the government to include in one of the 13 Entry Point Projects under the National Key Economic Areas (NKEAs) to sustain the oil and gas production by considering the development of marginal oil fields.

Investment climate is defined by how the governments regulate the tax firms and transactions domestically and internationally (Mundial, 2004). A country's investment climate is determined by the risks and transaction costs of investing in and operating business (Hallberg & Jammi, 2004). Therefore, government plays a vital role in influencing the quality of their countries' investment climates through organization, policies and their relationship with the private sectors (Dollar, Hallward-Driemeier, & Mengistae, 2006). If the government is highly bureaucratic and corrupt, financial service and regulation of infrastructure are inefficient. As a result, the returns on investment will be weakening. Obviously, this environment will discourage the potential investors to capitalize the business in the respective country. World Bank's overall development strategy in 2005 suggests that the first pillar of their strategy will be to improve the investment climate. In order to ensure this improvement is happening, government will need to create a good governance and business environment that are conducive in order to achieve a high investment in a country.

Mundial (2004) suggests that a good investment climate will benefit society as a whole and improves the opportunities and incentives to invest productively. In addition, the heart of a good investment climate relies on formal rules than informal relationships which concentrate on institutional reform, in particular the advice to prioritize the legal protection of property rights and the legal enforceability of commercial contracts (Moore & Schmitz, 2008). Policymakers need to find mechanisms to provide sufficiently attractive returns to private investors while guaranteeing accessibility and affordability of services for all (United Nations Conference on Trade and Development (UNCTAD), 2014).

Research findings by Aziah *et al.* (2014) also point out towards that investment climate for developing oil and gas resources is determined by the country's internal and external factors. Internally, investment climate will reflect on the attractiveness of the country by the expected rate of return and level of risk associated with the projects. In contrast,

it is determined by geological potential, political stability, level of corruption, tax regime and government regulation (Otto & Cordes, 2002). This paper will only focus on the external factors of the investment climate that consists of the political stability and tax incentive. These factors are significant in dealing with the marginal oil field investment climate in Malaysia.

According to Investment Climate Index 2014, Malaysia is ranked ninth out of all the twenty countries in Asia Pacific for its investment climate based on the six pillars of rule of law, openness to international trade and business, political stability, taxation, corruption and fiscal and monetary administration. UNCTAD (2014) states that the policymakers need to find the right balance between creating a climate conducive to investment, removing barriers and as well protecting public interests through regulation. In addition, incentives are widely used by governments as a policy instrument for attracting investment, despite persistent criticism that they are economically inefficient and lead to misallocations of public funds (UNCTAD, 2014). Van Parys and James (2009) agree that investment climate is crucial for determining the effectiveness of incentives in attracting foreign direct investment in a country.

Besides the implementation of tax incentives, political stability plays a vital role in influencing the investors in the marginal oil field investment climate. It has been suggested that the key determinants of the investment climate include stability and security, regulation and taxation, finance and infrastructure and workers and labor markets (Mundial, 2004). Hence, Shepherd (1997) summarized that stability is the rule of law, strong institutions rather than powerful individuals, a responsive and efficient bureaucracy, low corruption and a business climate that is conducive to investment. In a different study, Johnston (1994) dubs Malaysia as having one of the toughest fiscal systems in Southeast Asia but with good geological potential. The author agrees that many investors would love to explore in Malaysia and the government is aware about it. Therefore, in order to provide a sound and conducive environment to attract the investors, and maintain a stable flow of investment in the country, the government will need to design and implement consistent policy to deal with the issues at hand (Le, 2004).

In conclusion, by providing attractive tax incentives, certainly it will attract more investors to invest in the marginal oil field. On top of that, if Malaysia can sustain the stability of the political state in the country, this will offer the investors a stable and supportive investment climate for a conducive business environment. For instance, the Netherlands offers a stable and supportive Exploration and Production investment climate in their country as in 2010, the Dutch government successfully introduced the Marginal Fields Tax Allowance (MFTA) to improve the attractiveness of investment in developing marginal offshore gas fields (Energie Beheer Nederland (EBN), 2014).

This study is focusing on the investment climate in the marginal oil field in Malaysia which consists of political stability and tax incentive. The more attractive the tax incentive provided by the Malaysian government will result in more investors to engage in the marginal oil field. On top of that, if Malaysia can sustain the stability of the political state in the country, this will offer the investors a stable and supportive investment climate for a conducive business environment. For instance, the Netherlands offers a stable and supportive Exploration and Production investment climate in their country as in 2010, the Dutch government successfully introduced the Marginal Fields Tax Allowance (MFTA) to improve the attractiveness of investment in developing marginal offshore gas fields (Energie Beheer Nederland (EBN), 2014).

Theoretical Framework:

So far, however, there has been little discussion about the tax incentive under the economic rent theory as previous studies mainly focus on taxes levied on economic rent theory. Aziah *et al*., (2014) indicates that there have been relatively few recent studies relating to such effect particularly in Malaysia. Accordingly, the previous study attempts to describe economic theory that focuses on the produce of the earth derived from labor and capital. This theory deals with how this resource is divided among the laborers, owners of the capital, and landowners through wages, profit and rent.

Moreover, economic rent theory can be defined as returns to a factor of production over and above what is required to retain that factor in current use (Kelsall, 2013). Furthermore, the taxes levied on economic rent are not generally perceived to act as a disincentive to the initiation or continuation of business operations (Nakhle, 2004). The findings of the economic rent definition are consistent with the study by Johnston (1994), in which economic rent in the petroleum industry is the difference between the value of production and the costs to extract it. Besides that, many governments have attempted to capture as much economic rent as possible through levies, taxes, royalties and bonuses. In addition, governments capture economic rent when transfer of rights through signature bonuses and during production through royalties, production sharing or taxes. Meanwhile, Raja (1999) describes that economic rent recognized four factors of production which are land, labor, capital and enterprise. Each of these factors requires compensation for its services. Economic rent is that return that is present after all costs to the relevant factors have been met. In conclusion, many researchers have agreed that economic rent deals with the excess profits or returns.

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Tax regime will provide for the division of rewards between the investor and host country (Andrews-Speed, 2000). In the case of marginal oil field in Malaysia, government will need to attract investors to ensure that the development of marginal oil field will be fruitful. Therefore, to ensure the taxation imposed will not discourage the business activities, Malaysian government initiates new incentives under the Economic Transformation Programme. Aziah *et al*. (2014), describes that marginal oil field is the oil and gas reservoir not worth developing at a given time due to low revenue accruing from its operations.

However, the concept of economic rent and neutrality lie at the heart of the process of reconciling the interests of government and company. Hence, it is found that both governments and investors want to maximize their revenue by levying taxes on the resources (Andrews-Speed, 2000). Therefore, this study proposed a framework of having the economic theory to support the effect of tax incentive towards the marginal oil field investment climate. The government formulates an attractive tax policy in order to increase investment and government will likely reap more reward from the industry. To conclude, tax incentive is given to balance the interest of the government and investors.

Meanwhile, transaction cost theory is adopted to support the relationship between political stability and the marginal oil field investment climate. The theory was established by (Coase, 1937) and then it was further studied by Williamson (1985). The theory is defined by the transaction as the basic unit of analysis that economizes the central study of organizations through assessing how the governance structures serve to economize these transactions (Williamson, 1985). Meanwhile, North (1990) defined transaction costs as the costs of measuring the valuable attributes of what is being exchanged and the costs of protecting rights and enforcing agreements. Carpenter (2010) defined transaction cost theory as the institutions are rules, and organizations are aggregation of rules which involved the humanly devised constraints on action and rules of the game. Furthermore, the theory is based on the two basic assumptions about human behavior which consists of rationality and opportunism (Kyari, 2013; Williamson, 1985)

This theory point towards those human agents is subject to the bounded rationality and opportunism. However, by rationality means the economic exchange could be efficiently organized by contract, while people could also be dishonest in economic transactions. Meanwhile, according to Williamson (1985) opportunistic behavior is lying, stealing and cheating which may be a serious situation due to investment in specific assets. On top of that, the vital dimensions for transactions are 1) uncertainty, 2) frequency and 3) asset specificity, proposed by the Williamson (1985). Therefore, it can be concluded that asset specificity is the important dimension amongst others because once the investment has been made buyer and seller are effectively operating in an exchange relation for a considerable period. For instance, based on Williamson (1985) asset specificity can be related to site, physical asset and human asset. Hence, if the contract is breached, the assets related to the contract will be sunk costs. As a result, the transaction costs amongst the involved parties will be expensive.

Kyari (2013) suggested that the transaction cost theory for further investigation to seek towards examining the opportunistic behavior of the host country. Hence, this study adopts transaction cost theory because it is based on the opportunistic behavior of the host government. According to the theory, if Malaysia is full of corruption that depicts the opportunistic behavior as suggested by Williamson (1985), the investment in a country will decrease then it will result in increased of the transaction costs.

After satisfying the significance and relationship of all the theoretical foundation, then the theoretical framework for the current study is developed. In order to determine the effect of the tax incentive and political stability towards the marginal oil field investment climate, the following research framework is devised to investigate direction of the relationship between the independent and dependent variables.

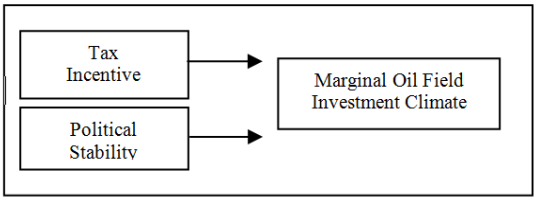

Fig. 1.0: Relationship of Tax Incentive and Political Stability towards the Marginal Oil Field Investment Climate.

Conclusion:

The paper discusses the effect of tax incentive and political stability on the marginal oil field investment climate. It is vital policy information and insights to the Malaysian government, host oil producing countries, investors and academia, after the model is validated empirically. To arrest the declining trend of the oil and gas production, Malaysian government can learn to devise strategic movements to improve the investment climate in marginal oil fields. Furthermore, host oil producing countries will benefit from the proposed framework to develop necessary incentives to enhance the marginal oil field investment climate in their countries. Meanwhile, academia will also benefit as it may provide additional new stream by examining the effect of political stability and tax incentive

towards the contribution of a successful investment climate in marginal oil field. Lastly, this proposed framework when validated will benefit the investors of marginal oil field. In conclusion, the expected findings will provide a positive relationship of both tax incentive and political stability towards the marginal oil field investment climate. Based on the previous literature, both variables play a significant role to attract investors in this related field. Further research can be done using a secondary data and taking into consideration on a different variable such as legal framework.

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