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What You Pay  
NORWAY

NOVEMBER 2013

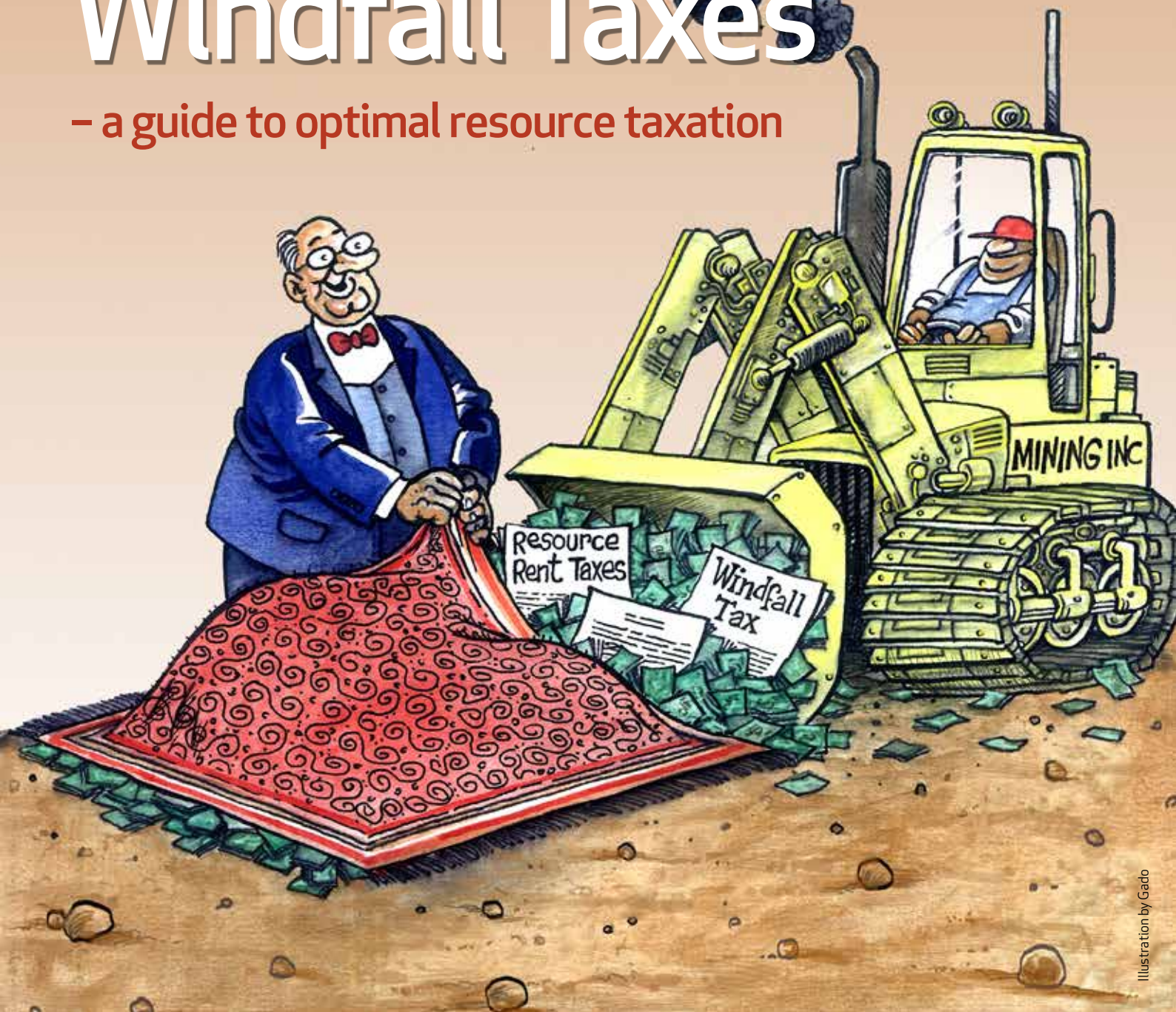
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- In 2012, government expenditure worldwide was USD 28 656 billion. Total tax burden was USD 18 821 billion.
- This huge discrepancy can be reduced by closing loopholes in tax systems and preventing capital flight
- This report is about analyzing and fixing loopholes in tax systems – increasing cost-efficiency and ensuring fairer competition in extractive industries.

Author: Frian Aarsnes, co-author Olav Lundstøl

# The Case for Windfall Taxes

– a guide to optimal resource taxation



**Published by:** Publish What You Pay Norway (PWYP Norway)

**Year of publication:** 2013

ISBN 978-82-93212-08-9

**Author:** Frian Aarsnes, state authorized public accountant with specialization in the extractive industries. Co-author Olav Lundstøl economist. MFA in Tanzania, specializing in extractive recourse revenue management

**Cover illustration:** "Gado", Godfrey Mwampembwa,

**Print:** Copy Cat

This report was made possible with financial support from the Norwegian Agency for Development (Norad).

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## Preface

Although there are countries with internally divergent economic systems, the economic systems that are in place between countries are fully based on capitalism - and it is within these systems that multinational companies operate. It is not possible to address how to fix weaknesses in individual country tax systems without addressing these cross-border aspects and the overall economic model that it is based upon - capitalism.

In this report, Publish What You Pay Norway would like to address the problem of tax regulation abuse, and show that it is actually possible to fix loopholes in tax systems with tax mechanisms that work in order to avoid the massive tax evasion that is going on in the world today.

Tax regulation abuse stems from the following issues with tax regulation processes

- Lack of a neutral framework to analyze tax mechanisms within
- Lack of a comprehensive catalogue of tax mechanisms that work
- Lack of understanding of how imbalances between the private and the public sector create suboptimal tax systems
- Lack of understanding how massive loopholes are created through lobbying by multinational companies

This report focuses on that a key element of capitalism is trust. A key element in trust is regulation: trust in the value of money, regulation to ensure markets are working efficiently etc. With respect to tax regulation abuse, trust can only be based on the premise that there is an optimal regulation, effectively maintained, that secures that neither companies nor governments can get away with tax regulation abuse.

Tax regulation abuse by a government is defined as effectively using regulation to increase the taxation above the optimum. Tax regulation abuse by a company is defined as effectively using loopholes in the regulation to reduce the taxation below the optimum.

The optimum taxation is defined as the taxation that protects citizens and companies against excessive taxation when income or profits are lower, but which, at the same time, provides for adequate funding of public goods when income or profits are higher. This assumes that companies provide the demanded goods and services at the lowest possible cost through competition, and that governments are providing the desired public goods at the lowest possible cost. To the extent that goods and services are not provided at the lowest possible cost, then a market failure exist on the side of the companies, or a governance failure exist on the side of government. For non-renewable resources, optimum taxation includes capturing the resource rent inherent in these resources.

This report is written from the perspective of the informed investor, but is also targeted towards government officials, media, civil society and other constituents concerned with tax evasion.

The objective of this report is to build upon and expand our report “An extended country-by-country reporting standard for the extractive industry. A policy proposal to the EU” as updated in November 2013. The report presents our proposals for reducing or eliminating tax regulation abuse, while at the same time achieving the objective of providing goods and services at the lowest possible cost. It also complements the report “Protection against derivative abuse” in securing that the countries that want to, are able to, create regulation which eliminates some of the worst tax evasion practices, while at the same time making governments responsible for the tax systems that they create and uphold.

Mona Thowsen  
General secretary,  
PWYP Norway

# The Case for Windfall Taxes – a guide to optimal resource taxation

## How to expand and fix the toolbox to build lasting societies for the benefit of all

This report has been written in order to create a bridge between investors, governments, media and civil society on the subject of building lasting societies through optimal taxation - neither too high nor too low. Investors are the owners of the businesses that in many cases participate in, and facilitate, capital flight through tax evasion and corruption. Investors are, however, very much removed from their businesses, and this report is written in order for: (1) the investor to become more involved in protecting his investment through following up that the company adheres to the tax systems enacted; and (2) the media and civil society to interact with investors and governments to ensure that tax systems created are not unbalanced, and thus leading to situations that are detrimental to everybody, including investors. To facilitate the interaction, this report has been written from the perspective of the investor, but it is also highly relevant for governments, media and civil society.

Capitalism is an economic system in which capital assets are privately owned and goods and services are produced for profit in a market economy based on competition. There are different forms of capitalism, but the mixed economy has become the dominant form of capitalism in the industrialized world. A mixed economy combines private economic freedom to compete with government regulation of the competition, funding of the public sector tasks by taxation of the profits generated in the private sector through the competition, and capturing of the resource rent<sup>1</sup> to the owner (society) on production of natural resources with monopolistic or regulated access to the resource.

Why the need for government regulation? According to the author Francis Fukuyama<sup>2</sup>, trust is a key ingredient in creating prosperity, just like free markets, competition and hard work. High degree of trust requires less regulation; low degree of trust requires more regulation, but often it is regulation that builds trust. Regulation builds trust in that the interaction between people and between businesses is done on equal terms, to ensure that it is the most efficient business that “wins” the competition, not the most ruthless.

Why the need for taxation? The private sector, in the meaning society, effectively “outsources”<sup>3</sup> certain tasks to the public sector because the public sector can do the tasks more efficiently than each individual in the private sector. Also, the public sector performs the task effectively at cost, i.e. no-profit. Taxation of salaries and normal profits is effectively the payment for this outsourcing. In addition, taxation can capture for the society as owner, the resource rent on extraction and production of amongst other non-renewable resources. Since there is no common agreement in the private sector (society) for what the payment

<sup>1</sup> Resource rent is the surplus value (often termed “super-profit”) of a resource after all extraction costs, all production costs, all external costs and normal profits have been deducted. Resource rent is considered a return to the owner. “The public interest in resource rent”. Jim Sinner and Jörn Scherzer, New Zealand (after 2007)

<sup>2</sup> Francis Fukuyama: «Trust. The social virtues and the creation of prosperity», Penguin Books 1996.

<sup>3</sup> “Outsourcing” is a business term with negative connotations for most people. In this context it means that the society effectively transfers certain tasks to an elected government instead of letting citizens or businesses taking care of these tasks.

should be, the citizens within a country effectively vote in the government that the majority of voters believe will give them the best services for the least pay (unless there are other reasons for changing government).

In 2012, World GDP<sup>4</sup> was more than USD 79 138 billion<sup>5</sup>. In the same year, tax burden was USD 18 821 billion, or 23.8% of GDP, whereas government expenditure was USD 28 656 billion, or 36.2% of GDP. What is happening? Governments are effectively borrowing their own tax money from companies with funds stashed away in tax havens or from countries in a net savings position.

This report is about how tax evasion and tax avoidance from large oil & gas, mining, and other multinational companies essentially destroys the "outsourcing contract" between the private (society) and the public sector by removing un-taxed revenues from the countries providing the resources and the free markets, and placing these revenues in tax havens. This effectively creates a large number of free riders in the form of multinational companies who are seeking profits from resources and free markets, but are unwilling to pay their share. This is an unsustainable world that will lead to distress, restless populations, conflict, nationalizations, war, and the loss of property, investments and life for businesses and citizens.

This report provides for the first time

- The general public with a complete framework for evaluating the tax systems used to tax multinational oil & gas, and mining companies, thus making it possible to evaluate the efficiency, or inefficiency, of the tax system in a country or in a sector
- Governments with a complete and neutral framework that they can use to check, and fix, industry regulation for industries that move profits out of reach of taxation

The goal of this report is not to have every resource-rich country introduce windfall taxes, but to have every country scrutinize its tax system to secure that there is a good balance between trust and regulation. It is better for a country to have analyzed and introduced the optimal regulation for all the situations that can occur, before they occur.

The goal of this report is not to have every country maximize their tax either. Creating tax systems that protects the private sector against taxation when revenues and profits are small but at the same time protects the funding of the public sector when profits are higher will in the long run create a society which creates the highest prosperity and happiness for everybody with the least cost - economically, environmentally and socially. This is called optimum (resource) taxation, and we believe this report can lead to that

- A closure of loopholes in tax systems creating opportunity for tax evasion are closed
- Companies seeing the long-term benefits to investors, of paying optimum taxes
- Governments seeing the long-term benefits of creating tax systems with no loopholes and lower tax rates, to promote taxpayer trust and cooperation as well as lower costs

<sup>4</sup> GDP - Gross Domestic Product

<sup>5</sup> According to the "2013 Index of Economic Freedom", The Heritage Foundation.

# 1. Summary

There is a growing understanding in the world today that the tax systems that we have created are not sustainable. A growing opposition to the current state, started by amongst other civil society, is now spreading to other parts of society, not the least investors (institutional and others) that are concerned with the sustainability of their own investments.

This report takes its point of departure that our economic system has grown out of the co-existence of trade between countries, and is likely to continue, as the alternatives are either a major restructuring, or a breakdown, of society as we know it today. In order to avoid the last we need to fix the first, i.e. our economic system need an overhaul in the form of tax system reform that removes the loopholes used amongst other by multinational extraction companies to move un-taxed revenues into tax havens, creating unfair competition between businesses and removing funding for the society in general and governments in particular. Avoiding this change will put major investments at risk for investors all over the world, and investors as unlikely as it may seem, are thus increasingly aligned in interests with civil society and governments.

The common denominator for most of the countries from which this economic system has grown out is that they are based on some form of mixed economy capitalism. Mixed economy combines private freedom with government regulation. The mixed economy today can largely be split into civil society, business community and government. At the center is the citizen.

This report also takes its point of departure that the Universal Declaration of Human Rights is the closest we get to a recipe for how to avoid breakdown of society by protecting the citizen

“Whereas it is essential, if man is not to be compelled to have recourse, as a last resort, to rebellion against tyranny and oppression, that human rights should be protected by the rule of law”.

The declaration starts in article 1 with that “All human beings are born free and equal in dignity and rights”. The core of our civilization is thus a free and equal citizen, and our economic system should ensure that this citizen has equal opportunities. When this report define “the private sector” we are mainly talking about the citizens which in investor language constitutes the “markets” for consumption of the goods and services made by companies and the consumption of public goods created by government. Equal opportunities can only be achieved to the extent that companies that are created by citizens also have equal opportunities. Equal opportunities can only be achieved to the extent that governments formed by the citizens create the necessary regulation to secure these equal opportunities.

The declaration of human rights does not place a time stamp on the right to equal opportunities and it prohibits race, color, sex, language, religion, political or other opinion, national or social origin, property, birth or other status as reasons for not having equal opportunities. This means that these equal opportunities cannot be used to the detriment of other citizens. Extraction of non-renewable resources should thus benefit all citizens within a country, across generations, and this cannot be done without the ability of that society to tax the extraction industry and extract the resource rent in such a way that both companies and existing and future citizens benefits from the extraction.

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...the tax systems that we have created are not sustainable

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...our economic system need an overhaul...

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...equal opportunities cannot be used to the detriment of other citizens.

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This report is thus based on the premise that in order for our economic system to work, and equal opportunities to be created, it is necessary to have the right regulation and the right supervision of, among others, the extraction of non-renewable resources:

- Investors need to supervise their investments in multinational companies – hence the need for extended country-by-country reporting where tax payments are put into its natural and meaningful context
- Governments need to supervise and manage their tax systems in order to secure the optimum taxation of citizens and companies, particularly the multinational companies – hence the need for reports like this and the report on derivatives abuse, which puts tax system and tax level into a complete and neutral framework, protecting the funding of government
- Media, civil society and the interested constituents need to supervise both companies and governments to ensure that they perform their tasks in an optimal and consistent manner

We use business terminology because many of the people that can improve the regulations are familiar with this language either through education or otherwise

We argue that there is a need to fix both the supervision of and the taxation of multinational companies, and while the report "An extended country-by-country reporting standard" promotes instruments for supervision of companies extracting resources, this report promotes a framework that can be used to analyze and fix resource tax systems around the world.

In 2012, World GDP was more than USD 79 138 billion<sup>6</sup>. In the same year, tax burden was USD 18 821 billion, or 23.8% of GDP, and government expenditure was USD 28 656, or 36.2% of GDP.

It is pretty obvious to most that this situation is not sustainable, and thus needs to be fixed. A country can, just like a citizen, not spend more than they earn unless they loan money. There is also a limit to how much money that can be lent, as the interest paid on the loan will start to limit the economic freedom of the country, inter alia its citizens. All of this constitutes a problem for the investors, the governments and the citizens of this world.

Just as government spending needs to decrease, government funding in the form of taxation needs to increase. Both are in the hands of politicians, and although this report has a broad audience, government officials and politicians have a fundamental responsibility in creating the right balance between funding and spending.

This report provides a framework, the Quadrant Cross<sup>7</sup>, that can be used to analyze tax systems in order to establish whether they are designed to meet all the situations that can occur, before they occur. Identification of the loopholes is the first important step in closing them. However, it is not possible to close the loopholes before there is political will or pressure to do so. Investors, civil society and media are the three likely pressure groups, and of these it is the investors that have their personal money at stake in a world with unsustainable tax systems. Therefore, they have the biggest incentive to fixing these tax systems, and expanding the multinational company reporting with extended country-by-country reporting.

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...necessary to have the right regulation and the right supervision...

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<sup>6</sup>According to the "2013 Index of Economic Freedom", The Heritage Foundation.

<sup>7</sup>The Quadrant Cross is copyrighted to Frian Aarsnes, and all references to the Quadrant Cross should have the citation "Source: Frian Aarsnes, 2008"

## 2. Why this topic?

Any transfer of non-taxed profits is a permanent loss for the tax jurisdiction in question

### 2.1 Tax systems a major weakness

Tax evasion<sup>8</sup> and tax avoidance<sup>9</sup> from large resource extracting companies and other multinational companies are major issues for most resource-rich but economically poor countries. This has been the case in the entire history of these industries and is one of the key elements why any transfer of countries rich in resources are bogged down in conflicts, lower than expected tax revenues, corruption etc.

While tax avoidance is the use of legal methods to reduce taxes, the line is fine towards tax evasion. Utilizing legal methods within a tax jurisdiction to lower tax payments are usually unproblematic as most often the taxes are permanently lowered by instruments approved by the tax jurisdiction in question or are only temporarily delayed.

When other tax jurisdictions are included in lowering the taxes in a particular tax jurisdiction, though, things becomes much more problematic. Any transfer of non-taxed profits is a permanent loss for the tax jurisdiction in question and in most cases the tax jurisdiction has not approved of the methods beforehand. In many cases, countries are not even aware of that such methods have been used. That an instrument like a derivative is legal to use within one tax jurisdiction does not mean that it is legal to use it for reducing the taxable revenue in another tax jurisdiction. That it is legal to own shares across a border does not mean that all ownerships are legal. Treaty-shopping is a term whereby an indirect ownership replaces a direct ownership in order to reduce the taxes in ways that were not intended by the tax jurisdiction that loses the tax revenue.

Gross Domestic Product (GDP) is the term for all the finished goods and services within a country within (normally) a year.  $GDP = C + G + I + (Ex-Im)$  where:

- "C" is equal to all private consumption, or consumer spending, in a nation's economy
- "G" is the sum of government spending
- "I" is the sum of all the country's businesses spending on capital
- (Ex-Im) is net exports, calculated as total exports minus total imports

G is the component that needs to be covered through taxation. A government that spends more than its taxation is either reducing savings, is dependent on loans or is aid-dependent. A government that spends less than its taxation is essentially carrying over savings to future years.

In 2012, World GDP<sup>10</sup> was more than USD 79 138 billion . In the same year, tax burden was USD 18 821 billion, or 23.8% of GDP, and government expenditure was USD 28 656 billion, or 36.2% of GDP. In 2011, Tax Justice Network carried out an investigation<sup>11</sup> into potential tax evasion losses in the entire world, and came to approximately USD 3 100 billion. This report however only focused on methods to estimate the loss from the estimated shadow economy in the countries and kept the tax at a level of the tax in the non-shadow economy. It did not try to attempt to estimate the tax loss from tax evasion from the existing non-shadow economy<sup>12</sup> nor estimate the tax capacity of the countries<sup>12</sup> should they want to change the tax systems to plug the loopholes. The non-shadow economy is much larger than the shadow economy, but if we assume that the tax loss from this part is equivalent to the tax loss on

<sup>8</sup> Tax evasion is the illegal practice of misrepresenting taxable profits by under-reporting revenues or over-reporting costs or to wilfully create non-essential transactions or transaction elements to transfer taxable profits or taxable capital gains across a national border in order to avoid taxation (do not confuse with legal tax avoidance). Tax evasion can attract criminal charges and severe penalties in most jurisdictions.

<sup>9</sup> Tax avoidance is the term for using legal methods within a tax jurisdiction to minimize the taxes paid in any given year. Tax avoidance usually entails securing that all tax deductions and tax credits are utilized as well as securing that losses carry forward are utilized against taxable revenues before payable taxes are calculated. Tax avoidance is usually limited to using legal methods within a tax jurisdiction.

<sup>10</sup> According to the "2013 Index of Economic Freedom", The Heritage Foundation.

<sup>11</sup> "The cost of tax abuse", Tax Justice Network 2011

the shadow-economy then the taxes could have been in the range of USD 25 000 billion and not USD 18.821 billion as the numbers for 2012 showed.

(billions US\$)	1995	2000	2005	2010	2012
World GDP	29 991	32 745	46 539	65 141	79 138
Taxes	4 388	4 714	6 562	8 319	18 821
Expenditures	5 063	5 331	7 953	11 556	28 656
Undercoverage	- 675	- 617	- 1 391	- 3 237	- 9 835

Sources: 2012 The Heritage Foundation, all other years World Bank. Data are prone to more weaknesses the further back in time the data covers. Only 2012 data are complete.

If this estimate is even close to the truth, then closing the tax loopholes would be a very effective way towards a sustainable society where government funding and spending were more balanced. There is an indication that this estimate is true, though. The countries with the best estimate for the shadow economy are the countries in Europe. The Tax Justice Network estimate for Europe alone was USD 1 512 billion. Europe does not have most of the multinational companies or most of the resource extraction. Most of the multinational companies are in North America, and, to an increasing degree, in Asia. The continents with the highest tax loss related to evasion of resource taxes are Africa, Asia and South America. It is highly likely that the estimates from these continents where registration and oversight is not as rigorous as in Europe are much higher than the reports indicate.

An interesting aspect of this is that the gains from growth increasingly accrue to capital (as opposed to labor), according to an article in *le Monde*:<sup>13</sup>

“A large share of this capital cost (interest and dividend) does not match any performed economic service, neither to the companies themselves nor to the society at large. We are therefore faced with a cost that is completely unproductive, that is only a result of interest expenses that one obviously can do without by financing the companies in other ways – for example with a system only based on bank loans, invoiced at the lowest possible cost”.

This is in essence exactly what we are talking about: more and more of the profits (cost of capital increases) are moved to tax havens. This particular mechanism that the author is talking about here is the combined effect of mark-to-market economics within multinational companies, combined with chains of ownership that entail using tax havens to a significant degree along with an increasing use of derivatives in multinational companies. The combination of these techniques to limit profits in countries with higher taxation is lethal compared to the traditional instruments of reducing taxation, like transfer mispricing and deferring taxation within one and the same tax jurisdiction.

The best example here is the US, where the real median salary has been stagnant over several decades while dividends are increasing, and profits that are stashed away in tax havens are increasing the most. From this emerges part of the explanation why the gap between government expenditures and tax is growing in the US – because the taxation of capital is lower than the taxation of salaries, and when profits are moving outside of the US tax base due to the combination of mark-to-market economics, chains or conglomerates of businesses centered around tax havens and the use of derivatives, the result starts to become ugly.

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<sup>12</sup> As far as can be determined, the effect of derivatives and mark-to-market rates and possibly many other instruments to route non-taxed cash flows outside of countries by multinational companies seems not to be part of the shadow economy estimate by Tax Justice Network.

<sup>13</sup> “The cost of capital” or “Coût du capital, la question qui change tout”, Laurent Cordonnier, *Le Monde Diplomatique*, July 2013

According to the latest report from PWC<sup>14</sup>, "on average across the eight years of the study the cost of tax, the Total Tax Rate, has fallen by almost 1% for each year ..." That is a phenomenal 8% drop in Total Tax Rate over the last 8 years!

However, it is possible to stop the leakage through a combination of fixing the tax systems (this report is an introduction to this theme) and monitoring the flow of capital within multinational companies (extended country-by-country reporting).

## **2.2 Fixing tax systems give benefits to all - even to the corrupt**

Transfers of non-taxed profits out of a tax jurisdiction is however a solvable problem, as it usually only involves closing the loopholes in the tax system. There must, however, be a willingness to close the loopholes, and here is the second reason why this topic has been chosen. Through this report we want to show that it actually benefits all, including corrupt individuals to work towards closing the loopholes and secure a greater economic growth for the country where they are residing. The reason for this is that it legally increases the revenue potential also for these people while at the same time reducing the probability of unstable political situations and thus the risk that these individuals are being ousted in elections, being killed in riots, or falling victim to revolutions or criminal charges when oppositions comes to power etc. It also increases the personal freedom of people. Once a politician or bureaucrat has shown himself or herself to be corruptible towards a multinational company, he or she is forever bound into a very unfavourable and actually not necessarily a lucrative relationship with the extractive industries. They are few and far between who really benefits so massively from corruption that they would not as easily have been able to accumulate the same or more wealth legally and at the same time more securely been able to prosper from their wealth instead of having to hide it in tax havens.

<sup>14</sup> "Paying Taxes 2013 - the Global Picture", PWC, 2013

## 3. Background

Capitalism is an economic system in which capital assets are privately owned and goods and services are produced for profit in a market economy based on competition, and while there are different forms of capitalism<sup>15</sup> we find that the mixed economy is the dominant form in the industrialized world. Why do we focus on the industrialized world in this context? It is because countries in the industrialized world tend to top the rankings of prosperity and happiness for the common citizen, while at the same time are seen as countries which create significant wealth for those who want to pursue that. This is actually why this report also focus on that there is probably more to have for potentially corrupt people to go in the direction of industrialized countries than to keep their own countries down through corruption and weak tax systems which only benefits the multinational companies

A mixed economy combines private economic freedom to compete with government regulation of the competition and funding of public sector tasks by taxation of the private sector. Why the need for government regulation? According to the author Francis Fukuyama<sup>16</sup>, trust is a key ingredient in creating prosperity, just like free markets, competition and hard work. High degree of trust involves less regulation, and vice-versa. However, we are not talking about all kinds of trust, but rather the trust that the private sector has in the public sector and vice versa, and in this relationship it can be fruitful to look at the two main legal systems in the world: common law-based societies and civil law-based societies. Common law-based societies generally place higher responsibility and trust in the individual than civil law-based societies, but in many cases one find that there are more breaches of trust in the former than in the latter. The reason for this seems to be that the precedence setting court rulings in a common law system actually invites conflict, while the codified law of civil law systems seems more designed to limit conflict. The question can thus be asked whether it is the opposite that is the case, i.e. that codified regulation creates trust by levelling the playing field among companies by identifying what are acceptable and not acceptable business practices ex ante (ahead) instead of ex post (after the fact).

Why the need for taxation? The private sector (read the citizens) can choose to "outsource"<sup>17</sup> certain tasks to the public sector because the public sector can do the tasks more efficiently than each individual in the private sector. Also, the public sector performs these tasks at cost, i.e. no profit. This concept of providing a commodity or a service without profit, to all citizens of a society, is called providing public goods. Taxation is effectively the payment for this outsourcing or for these public goods. The payment includes, for the avoidance of doubt, any re- distribution necessary of resource rents between citizens or generations of citizens from non-renewable (or renewable) resources. Since there is no common agreement in the private sector for what the payment should be, the citizens within a country effectively vote in the government they believe will give them the best services for the least cost. That does not mean that the private sector (society) does not need regulation from the government, i.e. less is not better, but then again more is not better either. Just as we talk about optimal tax systems, there is probably a concept of optimal regulation as well. What is optimal will of course depend on the level of trust in the country in question and the need for regulation to balance (lack of) trust or to create trust. The issue of regulating the private sector is often referred to as the government's role (as regulator) in fixing market failures<sup>18</sup>, i.e. fixing the terms under which competition is supposed to work so that the competition works most efficiently so that the citizens get the chosen level<sup>19</sup> of goods and services for the least cost. This is a public good in the sense that a not-for-profit institution

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A mixed economy combines private economic freedom to compete with government regulation of the competition and funding of public sector tasks by taxation

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<sup>15</sup> Major classes of capitalism are mercantilism (an early form of capitalism), free market capitalism, social-market economy, state capitalism, corporate capitalism and mixed economy capitalism.

<sup>16</sup> Francis Fukuyama: «Trust. The social virtues and the creation of prosperity», Penguin Books 1996.

<sup>17</sup> This "outsourcing" is most clearly described in the American Declaration of Independence: "We hold these truths to be self-evident, that all men are created equal, that they are endowed by their Creator with certain unalienable Rights, that among these are Life, Liberty and the pursuit of Happiness.—That to secure these rights, Governments are instituted among Men, deriving their just powers from the consent of the governed". This is what can be called the social contract between the private sector (the citizens) and the public sector (the government). Since the powers of government are derived from the consent of the citizens, it becomes obvious that it is also the citizens (personal and legal) that have to provide funding for the government. This funding cannot be voluntary, and thus taxation is instituted as a universal mechanism on both private and legal citizens to fund the non-profit cost of public tasks.

<sup>18</sup> A market failure exists when the allocation of goods and services by a free market is not efficient or, with other words, a more efficient use of resources in the society can be achieved by regulating a market that does not function optimally. Resources referred to are mostly physical capital, human capital, financial capital and environmental capital. Environmental capital includes all unproduced raw materials.

(government) is better at finding the balance for how to level the playing field among the actors in the private sector than having the for-profit private sector institutions (companies) sorting this out themselves. Why level the playing field? Because if there are unequal terms in the competition, one risk that some companies build up excessive profits and cash flow for providing the goods and services in question through utilizing monopolistic competition methods against their competitors (and their investors). This report will argue that this is exactly what is happening in the world today:

Due to lack of balanced government regulation, there exist today a situation where companies that use tax havens to reduce their tax burden through capital flight out of countries with resources or markets are effectively using monopolistic methods to create more wealth for themselves than their competitors. Through capital flight techniques, these companies are creating a situation where they can takeover or outcompete their competitors due to that they have higher cash flows than these competitors. This creates a form of competition that undermines the entire funding of the public sector to do its job of providing public goods, effectively creating instability in capitalism that puts investors and private citizens money and life at risk through loss of profits, capital, wealth and security.

Is this an overstatement? May 21st 2013 the European Commission President Jose-Manuel Barroso in a speech at the European Parliament on estimate of tax evasion in Europe said:

“The total loss of revenue due to illegal fraud and unacceptable evasion is estimated to be around one trillion euros [1000 billion Euros] a year. Let’s put that into some perspective: one trillion euros is nearly double the 2012 combined annual budget deficit of all the Member States.”

There are many other estimates, all of which are based on various definitions (the above being based on “illegal fraud and unacceptable evasion”). One of them is the Tax Justice Network estimate discussed in chapter 2.1 above.

This report is based on a broad understanding based on capital flight from countries with resources or markets, as the fact that some companies are able to accumulate more cash due to not paying taxes effectively distorts capitalism. Instead of it being the most competitive company that are able to become the market leader and thus earn most money to take over or out-compete others, with tax havens in the equation, effectively the companies that are willing to withdraw most of the funding for the “outsourcing contract” between the private and the public sector that earns most money. This is clearly a market failure, because then some companies are taking money outside the market (to a tax haven) in order to have more money to compete.

We are not talking only about capital flight from companies in host or home countries into tax havens, though. There are other ways that multinational companies are increasingly removing themselves from investors, and from the community at large:

<sup>19</sup> The chosen level is the level where citizens of a country through voting in a series of elected governments has been able to express support to various suggested levels of goods and services, expressed through the political platform of at least two competing political parties which have been allowed to freely express their political platform to the citizens. A certain minimum level exists, and this level is, with lack of other unanimously accepted principles, best expressed by the UN Declaration of Human Rights. Although not unanimously supported by all countries in the world, this declaration has the support of most governments by countries where the citizens have been able to vote in a series of elected governments and thus express their chosen level of goods and services.

- The amount of share buy-back has increased tremendously since the 1980s. This is transferring a gigantic amount of value to the management of these companies who sit with large share positions given under option programs designed to increase investor value in the short run, not focusing on the investor value in the long-run.<sup>20</sup> The alternative would have been to dividend the funds to all shareholders, which would have removed this transfer of value to management of multinational companies.
- There is an increasing tendency for economically very attractive companies to become the target of take-overs, and in the process (or subsequently) destroy remaining shareholder value in order to make it cheap to take over the entire company, and then to take it of the stock-exchanges. This effectively creates massive private empires based on investor money and can lead to enormous loss to investors.

Although this report will not focus on this side of investor value destruction, it is worth mentioning alongside the instruments used to deprive investors of massive value that lies dormant within companies, particularly in the tax haven part of multinational firms, a fact that leads companies to have to lend money to pay dividends, as their other cash is locked up.

The point of this report is that there is a need for fixing this market failure so that competition is done on equal terms (with regards to regulation) in order for the most efficient companies to be the ones that are successful in the market place and thus create the market with the least cost. Just as governments are supposed to produce the public goods in the least costly way, markets are also supposed to create their goods and services in the least costly way through competition. If the most efficient companies are not able to win, then the market will not be able to produce these goods and services in the least costly way. Both governments and markets can thus fail the test of capitalism, and this is probably why the mixed economy has established itself as the most dominant form of capitalism in the industrialized world. The private sector should fund the public sector, but only to the extent needed. The public sector should regulate the private sector, but only to the extent needed. The resource rent should be captured through taxation and other mechanisms, but only to the extent there is a resource rent.<sup>21</sup> The point is to find the correct balance. Currently the situation seems to be of under-funding and under-regulation. Correcting the balance with the right regulation should also solve some of the under-funding, but it is then important not to go in the direction of over-regulation and over-funding. Governments also need to reign in their expenditure. The under-funding is why this report will claim that governments (public sector) should be mainly responsible for choosing the tax mechanisms in a tax system (regulation), while citizens and companies (private sector) should be heard to a significant degree when it comes to the level of taxation (funding). It is far better that more tax payers are paying normal taxes, than when fewer tax payers are forced to pay higher taxes because there are free riders in the system (multinational companies which dodge taxes through amongst other tax evasion).

The focus should thus not be on more regulation, but on the right (optimal) regulation. To the extent that the right regulation is not in place, there will be free-riding multinational companies who will try to move non-taxed profits out of tax jurisdictions just as there will be corrupt individuals who are helping these companies to get away with it. It cannot be denied that corruption needs two parties. It is so easy to blame corruption on greedy individuals, but as the saying goes, "opportunity makes thief". This implies that the multinational companies that go along with or actually promote corruption to place themselves more favorably in the competition have a huge responsibility for the state of affairs in many

<sup>20</sup> Ha-Joon Chang: "23 Things They Don't Tell You About Capitalism", Penguin Books, 2010

<sup>21</sup> The resource rent will essentially fluctuate based on (1) the size of the resource that is being monopolized by the extraction company, (2) the quality of the resource, (3) the ease of extraction, (4) the length and cost of getting to the market and (5) the price on the market.

resource-rich, but poor countries. It is good to see that investors and others have influenced many of the largest oil & gas and mining companies to prohibit bribery and corruption. However, as more and more companies have large pockets in tax havens, it becomes easier and easier to circumvent corruption regulation, also internally in a company, when unprecedented cash flows are available outside of investor control in tax havens. Thus, we are time and again reminded in the news that although policies have been polished, it remains to be seen with many large companies whether they are not continuing to feed the hands that give them improper access to resources.

Not only that, global oil, gas, and mining companies and other multinationals, together with legal firms and the global audit firms, carry a huge responsibility for the fact that the right type of tax regulation has not come on the table a long time ago. It is not so that one does not know which tax mechanisms works and which does not. The problem is that a storm is rising every time an effective tax mechanism is introduced. This can however be difficult to discern from the storm that rises when the tax level is set too high. Thus, as discussed above, a government alone should choose which tax mechanisms it wants to use, but it should listen carefully with respect to the tax level that these tax mechanisms are calibrated at. This way we avoid lobbying that destroys the good mechanisms, while we take due notice of what level of taxes that tax payers has to operate under. If governments are setting the tax level alone, there is a high risk that the taxation becomes too high and thus that the funding is higher than desired in order to optimize the companies wanting to work within the economy of a country. However, while due notice should be taken to the private sector when it comes to tax level, it is still the public sector that needs to finalize the final calibration of the tax mechanisms and the tax level in order to test whether the arguments from the private sector are valid or not. The test of tax level should not be a negotiation between the public and the private sector, but rather that the public sector gets all the arguments on the table before deciding on an optimal (not maximal) tax level. The goal must be that all taxpayers within a sector are paying the same taxes, thus broadening the tax base and allowing the government to reduce the tax level (the funding) to attract more companies which will then increase sustainable growth. Sustainable growth is achieved when both public and private sectors are working optimally, producing their respective goods and services at the lowest possible cost, and due care has been taken that all the costs of producing non-renewable environmental resources has been accounted for when pricing the production

The concern today is that instead of fixing the tax systems (getting the correct tax mechanisms in place to diminish or eliminate capital flight) and getting the tax reporting for multinational companies to investors and other constituents correct (extended country-by-country reporting<sup>22</sup> where taxes paid per country is put into their natural context directly in the financial statements of the multinational companies themselves), there can easily come suggestions for increased taxation of those who already pay taxes. This would be a massive, and unnecessary, step in the wrong direction. The recent Fiscal Monitor "Taxing times"<sup>23</sup> concluded amongst other that: "Results reported in this issue show that the scope to raise more revenue is limited in many advanced economies and, where tax ratios are already high...". This means that IMF essentially closes their eyes for the massive capital flight that is running like rivers out of resource rich countries and industrialized societies alike through mechanisms like:

- Tax regulation abuse
- Derivatives abuse
- "Mark-to-Market" adjusted contracts out of tax havens and Transactions outside the market in zero-tax loops
- Transfer mispricing

<sup>22</sup>An extended country by country reporting standard. Publish What You Pay Norway, 2011/2103. Available at [www.pwyp.no](http://www.pwyp.no).

<sup>23</sup>Fiscal Monitor: "Taxing Times", IMF October 2013



Instead of increasing taxes, countries can increase the tax base by closing loopholes and widening the tax base by reducing non-cash deductions in favor of lower corporate tax rates.

**The message of this report is:**

- **Utilize the analytical framework presented to analyze tax systems around the world to assess how large the loopholes or imbalances are**
- **Fix the loopholes in the existing tax systems so that tax evasion becomes much more difficult, and the tax bases will grow significantly.**
  - Will benefit resource rich, but poor countries who can become independent from aid and budget support and have money to service debt levels
  - Will benefit doubly the industrialized world as additional tax revenues may wipe out the current crisis and lay the groundwork for future growth, and in addition, aid that is currently boosting countries that has the potential to be independent from aid will free up these funds for being used where they are really needed
- **Fix the reporting through implementing extended country-by-country reporting to help investors monitor the companies they invest their money in.**

This report presents the analytical framework and techniques to fix loopholes and reduce tax regulation abuse. A separate report, "Protection against derivative abuse" presents how a simple technique can stop illegal use of derivatives while protecting legal use. The report "An extended country by country reporting standard" presents how very compact reporting in the notes to the financial statements can entirely change the way investors are able to monitor their investments to the benefit of themselves and society at large.

We will now return to the task at hand of presenting a framework within which tax systems can be tested and tried whether they are optimal or not.

# 4. A framework for analyzing resource tax systems

## 4.1 Tax systems by design

When it comes to optimal tax systems we have to distinguish between two set of tax regulation in two legal system traditions:

	BUSINESS CONTINUATION	BUSINESS DISCONTINUATION
	Less challenging for a tax administration	More challenging for a tax administration
CIVIL LAW-based  Less challenging for a tax administration	Income taxes comprehensive codification  Clear outcome in court due to most situations catered for	Capital gains taxes somewhat codified  Unclear outcome in court due to codification not complete
COMMON LAW-based  More challenging for a tax administration	Income tax statutes and some codification  Unclear outcome in court because of lack of precedents	Capital gains taxes for the main part statutes  Very unclear outcome in court due to severe lack of precedents

<sup>8</sup> Tax evasion is the illegal practice of misrepresenting taxable profits by under-reporting revenues or over-reporting costs or to wilfully create non-essential transactions or transaction elements to transfer taxable profits or taxable capital gains across a national border in order to avoid taxation (do not confuse with legal tax avoidance). Tax evasion can attract criminal charges and severe penalties in most jurisdictions.

<sup>9</sup> Tax avoidance is the term for using legal methods within a tax jurisdiction to minimize the taxes paid in any given year. Tax avoidance usually entails securing that all tax deductions and tax credits are utilized as well as securing that losses carry forward are utilized against taxable revenues before payable taxes are calculated. Tax avoidance is usually limited to using legal methods within a tax jurisdiction.

<sup>10</sup> According to the "2013 Index of Economic Freedom", The Heritage Foundation.

<sup>11</sup> "The cost of tax abuse", Tax Justice Network 2011

In order to analyze the effects of a tax system one must know the situation one is faced with, and the legal system that will have to deal with that situation. Business continuation is the regular situation in a company where the assets are used to produce revenue for the company while owned. Business discontinuation is the situation when a company realizes revenues through a one-time sale of parts of or the whole asset.

The experience from around the world is that business discontinuation is more challenging than business continuation as tax administrations have less experience with business discontinuations. Also, more money is involved in the transaction than in the average transaction, and hence more planning goes into business discontinuations from the tax payer.

The experience is also that due to the complexity of business and its taxation, countries based in common law traditions have difficulties handling extractive industries, where there are only a few multinational companies and few or no precedents to rely on in legal cases. Tax administrations have been reluctant to force issues to court in such countries as there is a general fear that due to imbalances between the internationally available legal resources of the multinational company and the in-country legal resources of the govern-

ment, the outcome is more likely to be in favor of the company than in favor of the government.

The table also indicates that the most problematic area is that of business discontinuation in common law countries, where the lack of situations from business discontinuation results in almost non-existent precedents. This combined with the short timeline of a court case and the general lack of tax competence with most judges (average number of tax cases is small compared to other type of cases) will usually lead to a higher risk for arbitrary results in common law based tax systems compared to civil law based tax systems.

Today there is generally not any pure common law systems left in the world. Common law systems have developed in the direction of a combination of statutes and codification. The principle that a government should anticipate all situations that can occur, before they occur, works in favor of continuing to codify more of the tax laws in common law based countries, particularly with respect to capital gains tax.

## 4.2 Challenges to tax systems

In "An extended country by country reporting standard"<sup>24</sup> we outlined six major instrument classes that create challenges when it comes to multinational companies. These were:

- Tax regulation abuse
- Derivatives abuse
- "Mark-to-Market" and Transactions outside the market
- Transfer mispricing
- Corrupt practices
- Criminal practices

Tax systems are challenged by these six areas due to that

- There is very little codification or precedents
- Codification or precedents are ambiguous
- Although the tax law codification or precedents may be unambiguous, there is still an information gap that needs to be bridged in order for tax administrations to prove to a court that the tax payer is at fault in the situation at hand

Corrupt practices and transfer mispricing has been on the radar for a long time, but others have gone quite unnoticed when one looks at tax cases around the world. Tax regulation abuse has, at least within tax administrations, become quite conspicuous although there is no global or country estimates for the loss of revenue from such abuse as compared to for example corruption or transfer mispricing. This may be because it often occurs combined with derivatives abuse, "mark-to-market" issues or transfer mispricing. Examples:

- If a company enters into a derivatives contract in a resource rich country that is designed to go with a loss in most situations, most tax administrations will accept that contract as legal as long as the company can claim that they are protected against getting very low revenues. However, most tax administrations would balk if they knew that in many cases the oil & gas or mining company will have entered into a back-to-back agreement or a completely separate agreement with the opposite effect in another country. The two agreements negate each other in the group. If one gives a profit, the other gives a loss and vice versa. The arrangement is however such that in the majority of the cases, a loss is created in the resource rich state and a profit is created in a tax haven, transferring a non-taxed profit (through deduction of the loss against other revenue) out of the resource rich country. This practice is

<sup>24</sup>Richard Murphy/Frian Aarsnes: "An extended country by country reporting standard". FWYP Norway, 2011. Available from [www.pwyp.no](http://www.pwyp.no).

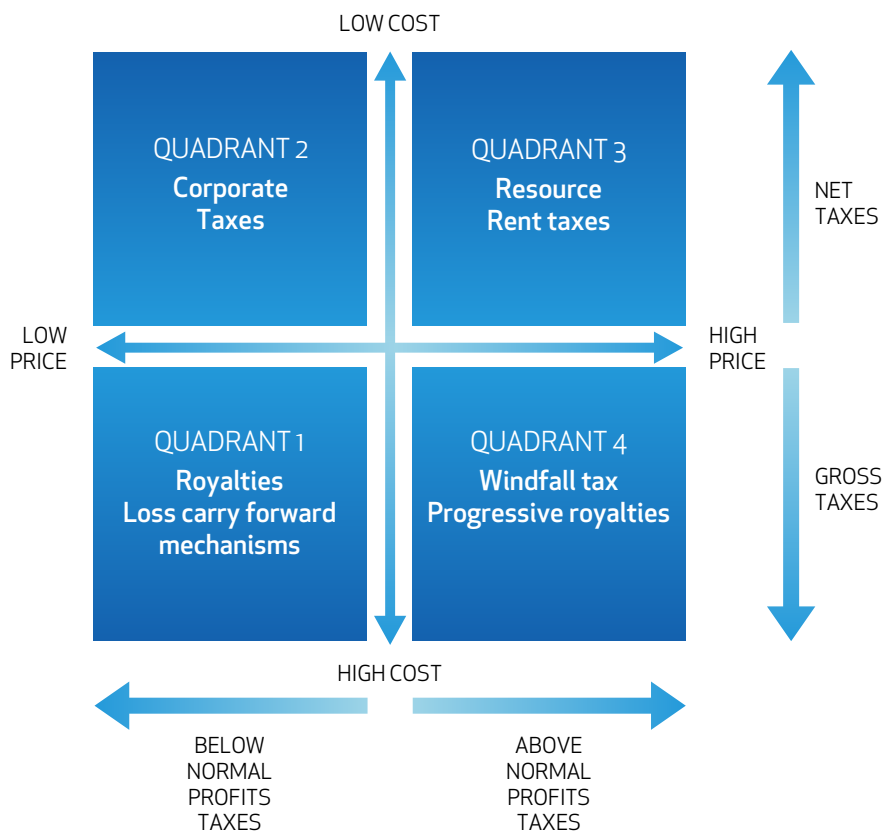
clearly tax evasion and would be illegal in most tax jurisdictions if the tax administration knew about the practice. The report "Protection against derivative abuse" addresses this with a simple, but very effective change in tax systems.<sup>25</sup>

- If a company hires an FPSO from an affiliated company in another country, most tax systems would accept that the rate is a "mark-to-market" rate that binds the rate to fluctuations in the oil price. The company would argue that the oil-indexed rate is good because it means that the rate (and thus the cost) goes down when oil prices go down, and it is only fair that the rate (and thus the cost) goes up when oil prices go up again. What a company is achieving with such an agreement is that it can transfer non-taxed profits out of the tax jurisdiction without tax administrations noticing in the beginning, and when they do notice, the previous year's treatment has usually created a precedence that is difficult to eliminate. The economic effect is that most of the oil & gas revenues are removed from taxation in the tax jurisdiction and only a smaller revenue on top of the oil-indexed FPSO-contract is left to tax. It is quite easy to avoid such situations as it is easy to codify in the tax law that FPSOs and other vessels utilized for running the installations on fields in a country needs to be owned within the country, or, if owned outside the country, that the company is only allowed a certain profit, for example 10%, on the FPSO and no oil-indexation of the rate is accepted.

The list goes on with respect to how many situations can create problems for a tax administration.

### 4.3 The Quadrant Cross<sup>26</sup>

The Quadrant Cross is used to identify all the situations that can occur in extractive indus-



<sup>25</sup>Friian Aarsnes: "Protection against derivative abuse". PWYP Norway, 2011. Available at [www.pwyp.no](http://www.pwyp.no)

<sup>26</sup>The Quadrant Cross is copyrighted to the author and any use or reference to the Quadrant Cross should be duly sourced "Source: Friian Aarsnes, 2008".

tries before they occur. Extractive industries are normally highly focused on the left-hand side of the figure, securing loss carry forwards and low taxation due to the risk of below normal to normal profits. It is thus usually the government alone that will have to initiate taxes that are based on normal to higher than normal profits.

All extractive companies know that if their resource is of some size, then they risk being in all four quadrants during the life of a field or a mine. The reason for this is:

- A company that establishes a mine or an oil or gas field will have large investments in the beginning, i.e. high cost (and low or no price due to start-up).

Alternative 1 – low prices at start-up:

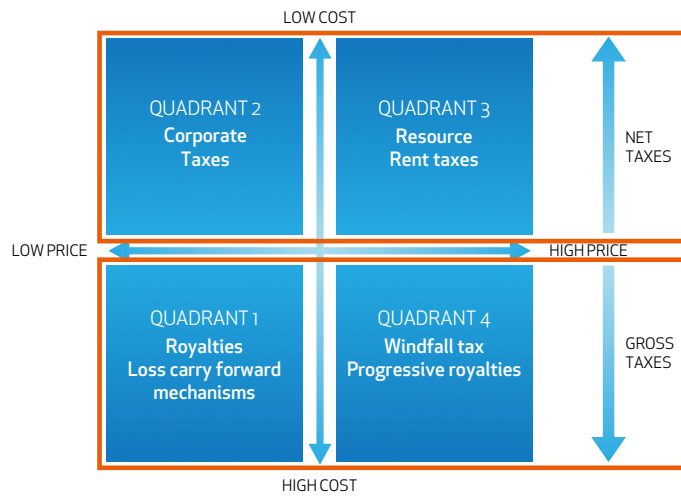
- If prices are low when they start the operation, they risk having losses carry forward in the start which they will want to bring forward against corporate taxes and potential resource rent taxes (quadrant 1).
- As they reach payback of the investment, the cost of operation is usually low per unit because the production is usually still high (quadrant 2).
- If prices were low in a historic perspective when they started operations, it is more likely that prices will increase than decrease further. Thus, an extractive company has substantial probability of creating higher than normal profits while still having lower costs during the life of the operation (quadrant 3).
- If prices increase and stay high, companies tend to want to invest more in order to get out more of the resources that are in the mine or the field. This normally creates a situation with high cost and high prices (quadrant 4).

Alternative 2 – high prices at start-up:

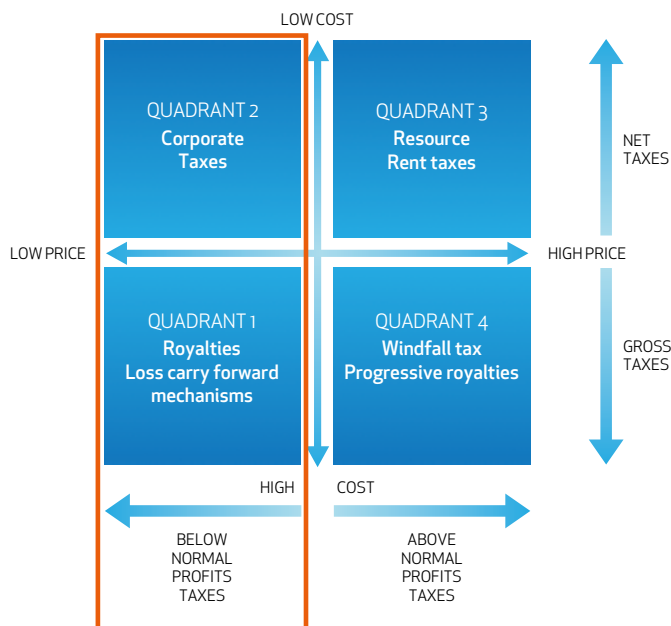
- If prices are high when they start operation, they will normally reach payback much earlier and will have an extensive period of very high profits but high cost in the beginning (quadrant 4)
- As payback is reached, the company moves from high cost to low cost while prices are still high (quadrant 3).
- If prices were high in a historic perspective when they started operations, it is more likely that prices will decrease rather than increasing further although this is also a possibility. Thus, sometime during the timeline, while the company still has rather low cost, there is a substantial risk that the profits will go from above normal to normal or below (quadrant 2).
- When production reaches its tail, the unit cost starts to rise significantly and if prices are still low, then there is a substantial risk of losses carry forward or downright closing down of operations (quadrant 1).

It is worth noting that when analyzing a country's tax system against the framework, it is important that one strictly adheres to the characteristics of each quadrant:

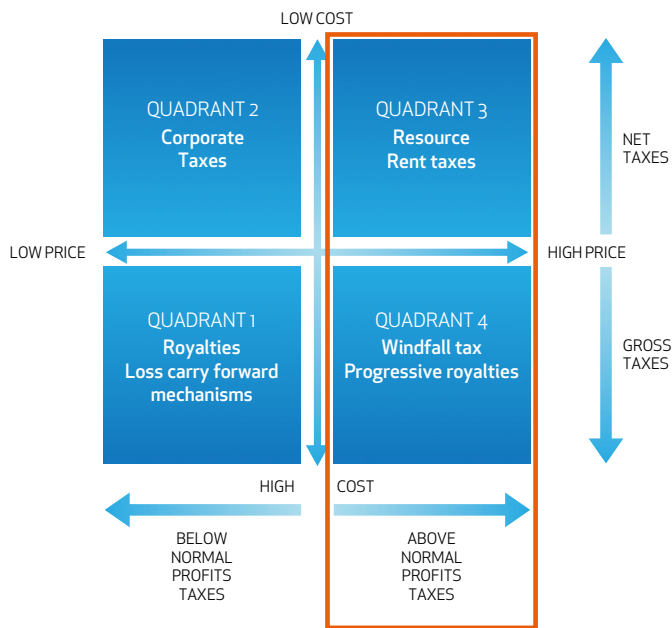
- Quadrant 1 and Quadrant 4 are thus strictly reserved for gross tax mechanisms while Quadrants 2 and 3 are strictly used for net tax mechanisms.



- Quadrants 1 and 2 cater to the below-normal to normal profits, and whereas Quadrant 2 tax mechanism is supposed to catch the largest revenue, Quadrant 1 is a "safety valve" for extremely low price levels.



- Quadrants 3 and 4 cater to the above normal profits, and whereas Quadrant 3 tax mechanism is supposed to catch the largest revenue, Quadrant 4 is a "safety valve" for extremely high price levels. There are examples of considerable confusion on these aspects, as politicians and bureaucrats in some countries have argued that their net tax mechanisms have qualities on par with gross tax quadrants (mainly quadrant 4). This is not the case and chapter 5 analyzes this further.



# 5. Analyzing the gaps in resource tax systems

## 5.1 Introduction

For the first time, this report provides the general public a complete framework for evaluating the tax systems used to tax multinational oil, gas and mining companies, thus making the public able to evaluate the efficiency, or inefficiency, of the tax system in a country or in a sector.

This report also provides governments with a complete and neutral framework that they can use to check, and fix, industry regulation for industries that move profits out of reach of taxation.

There are limitations to what the public can evaluate though. It is possible for the public to challenge governments where tax mechanisms are obviously lacking or where tax levels are obviously lower than other countries, but only someone with the adequate quantitative models can check whether a tax system (tax mechanisms and tax levels) is calibrated for optimum taxation or not. In the below discussion of each quadrant we will however go into a high-level discussion of what key elements each quadrant's tax mechanisms introduce, and how to combine them.

This report does not advocate maximum taxation. Rather it advocates that there needs to be a balance in resource taxation which protects the private sector against high taxation when revenues and profits are small, but at the same time protects the funding of the public sector when revenues and profits are higher. This will secure that companies are confident that they will reach payback on their investment, but also that companies have to respect the social contract between the private sector and the public sector, that governments need funding and that extractive companies will have to participate in that funding when their profits are normal or above normal. Balancing the taxation of extractive industries this way will in the long run create a society which creates the highest prosperity with the least cost. This is what we in this report call optimum (resource) taxation, and we believe this report can lead to that:

- Closure of loopholes in tax systems creating opportunity for tax evasion can be closed
- Companies see the long-term benefit to investors of paying optimum taxes
- Governments see the long-term benefits of creating tax systems with no loopholes and lower tax rates to promote tax payer trust and cooperation as well as lower costs

A closure of loopholes, though, requires that governments and society knows about them. It will be outside the scope of this report to do a full evaluation of everything that can go wrong in a tax system, but before we discuss the content of each quadrant, we will place the Quadrant Cross in a larger context and provide some insights into some pre-requisites necessary in order to move towards optimal taxation.



## 5.2 Pre-requisites for optimum taxation

### 5.2.1 Understanding investor behavior

It is essential for a country to understand investor behavior in order to create the correct fiscal framework for optimal taxation. These are the major items that a multinational extraction companies will look for:

- prospectivity, see 5.2.2
- predictability, see 5.2.3
- at least one way to bring after-tax profits back to the home country, see 5.2.4
- investment priorities, see 5.2.5, 5.2.6 and 5.2.7
- taxation mechanisms, see 5.2.8
- depreciation and other deductions, see 5.2.9
- investment incentives, see 5.2.10
- free carried interest and government participation, see 5.2.11
- discontinuation opportunities, see 5.2.12

A multinational extraction company will, in addition to this, look for advantageous tax systems, but not necessarily in the way governments are thinking of advantageous. However, the country in question should never go down the road of using its tax system to compete with other countries. The country needs to be secure in the knowledge that their resources can only be extracted to the extent that the extractive companies establish a business within the country. The resource is thus locked to the country. However, this does not mean that the country should go in the other direction and level exorbitant taxes on the resource, which is happening in some countries with production sharing agreements (PSAs). There needs to be a balance and, more often than not, this balance is not optimal in most resource-rich countries today.

### 5.2.2 Prospectivity

Prospectivity is the likelihood that an extractive company will find resources if it undertakes exploration activities in a country. Prospectivity means a certain probability that commercially attractive resources are likely to be discovered, either due to large volumes, high grades or high prices. There are no other reasons for an extractive company to enter a country - period.

What the country needs to know is that the extractive company cannot get access to the resource unless the country actually gives the company the access. This is one of the reasons why a country should set up its regulation in law prior to inviting extractive companies, and not negotiate agreements with individual companies before the country actually knows its prospectivity. One way of knowing its prospectivity is to engage a team of geologists to create (or update) a map of potential prospects for various resources (oil, gas, minerals, metals, gemstones etc).

It is necessary to distinguish between operations onshore and offshore. Operations onshore are to a much higher degree a first come-first served principle which essentially lends itself to a monopolistic access to resources. Monopolistic behavior should essentially mean a higher degree of regulation and taxation, but often the opposite is happening. Mining companies and onshore oil & gas companies have less regulation and taxation than operations offshore.

Operations offshore (up to today oil & gas) are much more open for having seismic activities done by the authorities and thus that access to acreage is much more competitive and less monopolistic.

Prospectivity may change. Volumes do not change and neither do grades, but prices change. A resource that was not commercial previously can become highly valuable if prices change significantly. Prices may change because demand increases above world supply, or world supply may fall below demand due to that some non-renewable resources may be exhausted. This means that a country should not take at face value an extractive company's view that a resource is marginally economical. That may be the case today, but it may change in the future, and a government should get informed views on the assumed global supply versus demand in the estimated production period in order to be knowledgeable about the potential value. First and foremost, it is imperative that a country foresee that prices may change significantly during the production period and have the optimal regulation in place for all situations that can occur, before they occur. While a company typically would value a resource based on a (low) flat prices or price curve, a country should in contrast test the same resource using business cycle prices, or at least estimate what the resource would be worth should prices rise very high.

Recommendation: High prospectivity allows a country to place itself in the higher end of benchmarked countries ... and vice versa.

### 5.2.3 Predictability

An extractive company that invests billions of dollars in a country obviously wants security that their investment is not at risk. Many countries have responded by giving companies agreements with long stabilization clauses, sometimes to the end of the production period. This is absolutely not necessary. To the extent that a company wants a stabilization clause, it should only be given until the company has received payback on its original investment, possibly until a minimum return has been achieved. Payback should always be measured against the original capex and opex presented to the authorities when a project is approved. Preferably a country does not need to give a stabilization clause at all. To the extent that a stabilization clause is given, it should be treated as an insurance policy. If somebody gets insurance, they pay an insurance premium. If someone asks for a stabilization clause, they should pay a premium for that. One solution that has been used by at least one country is to demand a higher corporate tax in order to give such stabilization clauses (for example increasing the corporate tax rate by 5%).

Extending stabilization clauses can be avoided if

- A country takes time to get its legislation in place before it starts to invite (further) companies.
- Fiscal mechanisms are entered into law and made non-negotiable.

If terms are entered into law and made non-negotiable, it is much easier for companies to evaluate the terms and determine whether they are attractive enough, given the country's prospectivity.

If a country allows negotiations it must be prepared for that the companies will negotiate the best possible deal for themselves in order to have the best position possible relative to its competitors. This will usually not be to benefit of the country, hence getting its regula-

tion into non-negotiable law is the best course a country can take in order not to lose value from its resources.

Recommendation: The more predictable a tax system is, the higher a country can place itself among benchmarked countries ... and vice versa.

#### 5.2.4 Withholding tax on dividends

An extractive company that wants to carry out an investment needs at least one road whereby it can get returns out of a country if it puts money into the country. This road should be that there should be no withholding taxes on dividends that go directly back to the country where the company has its head office (unless the head office is in a tax haven). There should be withholding tax on dividends if the investment is routed through other countries, and the withholding tax should be at its maximum level if the investment is routed through a tax haven, i.e. that the company in a country is directly owned out of a tax haven. This way investors will be economically motivated to invest out of their home countries and not by utilizing treaty shopping or tax havens to create diversions in the investment flow.

It is absolutely essential that there is no withholding tax on dividends as long as the investments go directly from home country to host country. If not, the risk increases that:

- a country gets the initial investment, but that further investment in the country by the same company is limited to reinvesting profits from its first operation. Having no withholding tax on dividends for investments directly between home country and host country means that there are no arbitrary limitations on the amount of investment a company may inject into a country
- a country gets the investment, but in the case of investments via a tax haven, the country has a substantial risk that it has invited a company that will utilize the tax haven to move non-taxed profits out of the country or create a zero-tax reinvestment loop in the country and in other countries

A country that has withholding tax on dividends can create an exception for dividends that go directly back to the country where the ultimate owners have their head office. Such a rule also secures that several owners can own the same company. This will be important with respect to regulation with respect to business discontinuation and capital gains.

Recommendation: Remove withholding tax on dividends that go directly to a company's headquarter country, but retain withholding tax on all other dividends, particularly if the dividends are routed towards and through a tax haven. This recommendation does not affect any other withholding taxes.

#### 5.2.5 Investment priorities - exploration

A country needs to understand how an investor usually commits to an investment. When the investor is satisfied with prospectivity and predictability (if not they will seek some kind of insurance that they have predictability) and that there is a road to get after-tax profits out of the country (if not they will seek some kind of insurance that they will be able to seek compensation (exception from withholding tax, higher after-tax returns etc)), they will look into possible investment scenarios.

The first investment is the exploration phase. A country could consider reimbursement mechanisms equivalent to the marginal tax rate of its net tax mechanisms (quadrant 2 and

3) until a company has done its first commercial discovery or discoveries above a certain level in order to level the playing field among the companies. After that, the need for reimbursement has mainly disappeared, and it is enough that exploration costs are deductible from the revenues from its other operations, or that the company gets investment credits on further exploration that they can use as deductions towards revenues when further resources are developed. This way the company is guaranteed payback on their exploration on par with a tax deduction, while the country is guaranteed early taxes from the first development, as further exploration has to be a deduction against the second development (the company will have to use after-tax revenues to do further exploration).

Recommendation: A country that allows deduction for exploration costs can increase the taxation relative to their benchmarks, particularly if the first exploration is combined with a reimbursement mechanism. Countries disallowing exploration expenses should essentially have lower taxation relative to their benchmarks.

### 5.2.6 Investment priorities – development

When evaluating a commercial development, an extractive company will almost always follow the following investigation path: :

1. The Investment Decision: Evaluate the commercial development on a stand-alone basis with all necessary operations within the country
2. The Financing Decision: Evaluate whether the economics can be improved by placing some of the elements of the development outside the country (for example in tax havens)
3. The Transaction Decisions: Evaluate whether the economics can be improved by influencing individual transactions through transfer pricing, derivatives, reorganizations etc.

A government should always know that once a company wants to sit down and negotiate with a government, the company has essentially said yes internally to the first decision (the investment decision). Any concessions from the country beyond the country's standard terms is icing on the cake for the companies (assuming that the standard terms have been calibrated and are shown to be acceptable to companies given the country's prospectivity).

Recommendation: Establish terms for operating within the country in law, and do not allow a negotiation of fiscal terms.

### 5.2.7 Investment priorities – consequences of ring-fencing

Ring-fencing an investment is the same as not allowing investments from later developments to be deducted from revenues from earlier developments. This is essentially how investments are treated in the financial accounts, and it is also in line with how extraction companies are presenting projects to governments through feasibility studies. Governments are therefore approving projects as if they were ring-fenced, but the truth is often different. Many countries do not have ring-fencing of oil & gas or mining projects.

We do not specifically recommend ring-fencing, but we recommend that ring-fencing or no ring-fencing is taken into account when the tax system is calibrated and the marginal tax rate is set and effective tax rates are evaluated. No ring-fencing usually means that the tax payers can tolerate higher tax levels, while ring-fencing usually means lower tax levels.

Recommendation: No ring-fencing will allow for increasing taxation relative to benchmarks, while ring-fencing would mean reduced taxation relative to benchmarks.

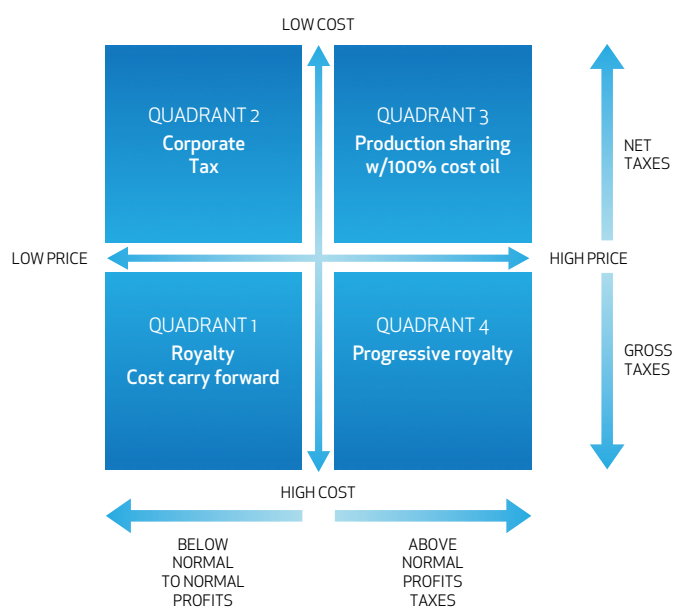
## 5.2.8 Taxation mechanisms

There are in essence three major classes of tax systems in the world:

- Royalty/tax systems where the main taxes are coming from non-profit tax mechanisms
- Production sharing systems where the main taxes are coming from production sharing
- Service contracts where the operator is given a small share of production or profits for servicing the field

Royalty/tax systems are the tax system that is used in most countries, closely followed by production sharing contracts. True service contract systems are rare and only used by a few countries. However, there is a number of countries that have hybrid systems with building blocks from two or all three systems.

The Quadrant Cross presented in chapter 4.3 is based on a royalty/tax system. The same Quadrant Cross for a PSA system with 100% Cost Oil could look like this:



However, as few production sharing agreements have 100% Cost Oil, production sharing tends to start while companies are still recouping cost, and production sharing is thus a mechanism that also catches revenues in Quadrant 1 (when there is no profit) and in Quadrant 2 (when there is normal profits). Countries with production sharing agreements thus have a tendency to have higher marginal tax rates than countries with royalty/tax systems.

If the predictability of the tax system (the trust in the country's ability to keep the tax system stable throughout the life cycle of the field or the mine) is high, most extraction companies would probably prefer a royalty/tax system, because payback is earlier in such systems.

It is outside the scope of this report to discuss all available tax mechanisms as there are hundreds of them, and they come in numerous forms and combinations. It is necessary to model them correctly and calibrate them in order to investigate a tax system up against its benchmarks. The major classes of tax mechanisms are:

- Gross tax mechanisms (addressed in the Quadrant Cross)
- Net tax mechanisms (addressed in the Quadrant Cross)
- Withholding taxes (will usually increase taxation)
- Investment incentives (will always reduce taxation significantly)
- Exemptions mechanisms (will always reduce taxation significantly)

The main problem in many countries is that although they tend to use a lot of different tax mechanisms, they does not have any clear roles in the tax system. These mechanisms tends to be combined with incentives and exemptions to such a degree that it is difficult to have any oversight over the consequences of the tax system. On top of this comes the added feature that many of the fiscal mechanisms used for extractive industries are buried in contracts that are kept secret by the government itself, making it almost impossible for the investor, media, civil society or, in many instances, government institutions themselves to get full insight into the taxation of these companies. Secrecy is a significant part of corruption, and in order to avoid any doubts, both governments and companies should openly state the terms of agreements they have entered into. As soon as a contract has been signed, it is in effect and there is no longer a need to keep the contract secret.

Another issue is that most governments are actually incompetent at being able to clearly explain the consequences of investments in extractive industries to the general population, and thus populations tend to underestimate the length of time involved before major revenues comes out of resource extraction. This creates unfulfilled expectations and social unrest, usually followed by elections where the parties in power are removed and replaced with the opposition.

In other instances, even governments are taken aback by the consequences of their own tax systems. This is particularly the case in countries with production sharing agreements. The shared production usually goes to a national oil company. If there are no mechanisms to bring the economic consequences of this shared production into the state budget, the national oil company will tend to grow out of all proportions, while the government remains underfunded. This is one reason why Hugo Chavez took control of the national oil company in Venezuela, and started to distribute funds out of the company. However, the best way is to secure one out of two roads for production sharing to reach the state budgets:

- Either the state establishes mechanisms whereby the national oil company is taxed, and the surplus that is not needed for reinvestments is paid as dividend to the owner (usually paid into accounts in the National Bank)
- Or the national oil company is only a custodian which receives its funds over the state budget, and that all revenues under the PSA agreements are moved in full to the state (usually to accounts in the National Bank).

Without such mechanisms the national oil companies will tend to become a state within the state and attract people that want the power and the money that follows. It is necessary to recognize these mechanisms, as they are closely linked to the political stability of countries.

## 5.2.9 Depreciation and other deductions

Depreciation is a method to distribute the cost of the investment across several years of revenue. Financial depreciation in extractive industries is normally done using a method called Unit-of-Production, which effectively distributes the investment across all the years with production. For tax depreciation it is normal to limit the depreciation to 4-8 years with a norm around 5 years using either a linear depreciation or a declining-balance method.

In sub-Saharan Africa, it is very common to have immediate deduction of the investment, creating a loss carry forward that means that no net taxes are paid before all the investment has been deducted. Such an immediate deduction usually means that the investment tolerates higher tax rates compared to benchmarking countries that utilizes tax depreciation over a number of years. This is an important point when calibrating the taxes.

It is usually recommended that all costs are fully deductible in the net profit taxes. However, should a country decide to limit certain costs from deductibility, it is necessary to ensure that this is factored into the equation when the various taxes are calibrated together.

Recommendation: 100% deductibility for investments will allow for increasing taxation relative to benchmarks, while long depreciation periods for tax purposes (6-8 years) would generally mean reduction tax level relative to benchmarks.

## 5.2.10 Investment incentives

100% immediate deductibility for investments is a powerful investment incentive in itself. Although, in countries with tax depreciation, it is also not uncommon to have some kind of investment incentive. Such investment incentives can take many different shapes and forms (termed good, bad or ugly depending on whether the characteristics of an incentive have mainly good properties, mainly bad properties or only bad properties (ugly) when looked upon from a government perspective):

- Reduced corporate income tax rate - bad
- Loss carry forwards - good
- Tax holidays - ugly
- Investment allowances - good
- Investment tax credits - good
- Reduced taxes on dividends and interest paid abroad
  - good if dividends to home country
- Preferential treatment of long-term capital gains - ugly
- Deductions for qualifying expenses - bad
- Zero or reduced tariffs - bad
- Employment-based deductions – depends on situation
- Tax credits for value addition - good
- Tax reductions/credits for foreign hard currency earnings - ugly
- Progressive tax systems (ROR-systems, R-factors) – depends on situation

Going through investment incentives is the content of a whole new report, but the above (good, bad, ugly) is at least a first indication to where countries should seek inspiration for finding good investment incentives.

Recommendation: Be careful to introduce investment incentives, and be absolutely sure that (1) it is needed, (2) that it is correctly calibrated and (3) that it can be repealed if viewed as undesirable in the future.

### 5.2.11 Free carried interest and government participation

Government participation is usually no problem as long as the government is carrying their own share of investments and costs. Then government participation works just like any other joint venture between private companies.

Some countries want to have a free carried interest, i.e. that the company in question effectively pays 100% of the investment, but only get  $(100 - \text{carry})\%$  of the revenues. This reduces significantly the project economics from an investor point of view, and it is recommended that any free carried interest is limited to maximum 10% in all cases, and preferably that the free carried interest is even below 10%. Free carried interest has, unlike general government participation, a significant impact on the calibration of taxes up against each other.

It is worth mentioning that, empirically, free carried interest has never given a country any major revenue. The reason for this is that a company usually has many different mechanisms whereby it can reduce the profits in the local company so that dividends to the carried interest are minimized. Government participation, and close monitoring, is therefore generally to be preferred compared to a free carried interest.

Recommendation: Government participation is a way to capture resource rent. Depending on the resource size, government participation can be quite significant. This is dependent on the government covering its share of investments and operating expenditures. The alternative, free carried interest, is not a mechanism that can be used indiscriminately, and should not go above 10% unless one is talking about very lucrative resources, and then only after very careful calibrations.

### 5.2.12 Business continuation versus business discontinuation

To the extent a company finds that it wants to discontinue its operations in a country, it needs to know that it is attractive to sell the operations to other companies. Thus there need to be clear rules on how capital gains are treated within the country.

The Quadrant Cross is only relevant for ongoing businesses, i.e. business continuation. For business discontinuation and capital gains, it is necessary that there are symmetrical rules for treatment of buyers and sellers:

- Non-taxable capital gains  
To the extent that sales value is based on capital gains is non-taxable, the purchase price should not be deductible for the buyer in future revenues. This is equivalent to the sales value/purchase price being determined based on after-tax cash flows.
- Taxable capital gains  
To the extent that the sales value is based on taxable capital gains, the sales value should be based on pre-tax cash flows and the purchase price should establish a new tax asset value with respect to tax depreciation.

In order to avoid the FPSO example in chapter 4.2, it is important that all assets that are being used for permanent operations have to be owned by companies within the country, and that ownership outside the country for these assets is permanently disallowed.



There also need to be rules with respect to whether sale of shares in the company or any of its owners will initiate a taxable transaction within the country. This is only relevant if the country in questions has chosen to have taxable capital gains.

Recommendation: there should be codification of tax rules in cases of business discontinuation, and care should be taken to clarify situations where assets are moved outside of a country in situations where they are sold. One should also clarify whether a sale of shares outside the country triggers approval and/or taxation within the country.

### 5.3 Quadrant 1 – losses and royalties

Quadrant 1 is based on the scenario that a company has high cost in a low price situation. This is often the case at the start-up of operations, and in very low price scenarios.

In this situation, it is important that the country in question have a loss carry forward mechanism that allows all the uncovered losses to be brought forward against future revenues. This is also the case in production sharing agreements where there is cost oil. Uncovered cost oil must be allowed carried forward unrestricted.

When prices are low, or unit costs are high relative to price, there will be very low or no profits. Thus, net taxes where deductions are allowed will not work in this quadrant. The only tax mechanisms that will work are gross tax mechanisms that are based on revenues, production or some other mechanism.

The most commonly used gross tax mechanism is royalties, and this tax mechanism can exemplify quadrant 1. All types of fees based on some metrics that are paid irrespective of profits or losses also fall within this quadrant.

Gross taxes should be deductible in net taxes in order to promote cost-consciousness. Companies should be allowed to deduct gross taxes from net taxes, and because of that the tax mechanisms chosen should encourage companies to get into a net tax paying position as fast as possible and stay there as long as possible. Thus, the part of the gross taxes that is "lost" in the deductibility should be gained because companies get to net tax-paying position earlier. Gross tax mechanisms in quadrant 1 should thus be so high that they hurt, but not so high that they discourage investments. In the case of royalties this would normally mean royalties in the range of 5-8% but not lower than 3% and not higher than 10%. This will have to be calibrated together with the net tax mechanisms and other gross taxes in order to check that the overall tax burden is not too high.

Recommendation for quadrant 1 is to at least have in place an adequate loss carry forward mechanism and a royalty mechanism that encourages companies to get faster into a net tax paying position.

### 5.4 Quadrant 2 – corporate taxes

Quadrant 2 is based on the normal situation that companies are presenting economics cases in the form of feasibility studies to the government of a country. This situation is characterized by relatively lower cost and lower prices. The economics of feasibility studies will normally be based on normal to low prices, and enough production length to secure the internal rate of return (IRR) that is high enough to meet the companies investment hurdle (RRR (required rate of return) or discount rate, often equal to the WACC (weighted average cost of capital)).

The RRR has been met when it is equal to the IRR that gives a project NPV (net present value) of zero. The RRR is sometimes equal to the equity owner (the private investors) required return, in which case RRR is the equity part of the WACC, and not the company's discount rate.

Technically a project with an NPV of zero is a viable project and the expectation is that a company should theoretically move forward with such a project. In many cases, companies require NPVs that are higher than zero. This can be the case when: (1) the company has more investment opportunities than they can process simultaneously, and they use a profitability index (PI) to rank the projects according to their NPV and continue developing the projects with the highest NPV; or (2) the companies are uncertain about their own discount rate or the RRR, and require a buffer to cover project uncertainties or country specific risk; or (3) the economic analysis is done at such an early stage with high uncertainty that the company expect that more detailed analysis will reveal potentially higher investments, which is the norm when moving from one stage in the investment process to another.

Quadrant 2 thus covers the normal situation that the extraction company foresees. This quadrant is most commonly covered by the net tax mechanism called Corporate Taxes. Corporate Taxes are the tax rate that the country in question has chosen to tax normal profits from other industries, and is thus the tax rate that most effectively taxes normal profits in extractive industries for that particular country. There is thus no need to adjust the corporate tax rate in the country to attract extraction companies. This is much better done by using investment stimuli like investment credits for the first billions invested in a country. It is important that investment stimuli is not given longer or higher than necessary, as this demands higher tax rates which, in the next run, reduces cost consciousness in the extraction companies.

Globally, there is tendency for the corporate tax rate to migrate towards 30% on average; higher for countries which give companies investment incentives and other additional deductions over and above full deduction for costs (like provision for abandonment etc), lower for countries which give companies full deduction for cash costs but which limits provisions for non-cash costs.

Recommendation for quadrant 2 is to utilize the country's general Corporate Tax rate also for extractive companies, but allowing deduction for all gross tax taxes from quadrant 1 and 4.

### **5.5 Quadrant 3 – resource rent taxes**

Quadrant 3 is based on the premise that a company has relatively low cost while prices are relative higher compared to the unit cost. This situation create higher than normal profits, and is a situation that has created a lot of research into tax mechanisms that are generally called resource rent taxes.

Resource rent taxes are net tax mechanisms that allows for deduction for cost and normally also deduction for all gross taxes, but it is a matter of calibration whether this deduction is needed. Some resource rent taxes are also deductible in the corporate tax, but this is more common in production sharing tax system than in general royalty/corporate tax system.

Among quadrant 3 taxes one will find:

- a. Royalty/corporate tax systems
  - Progressive corporate taxes without shields (only the threshold for progression)
  - Variable profit taxes with shields against taxing normal profits
  - Resource rent taxes without shields (only what is included in the tax basis)
  - Special resource taxes with shields against taxing normal profits
  - ROR (rate of return) taxes with or without R-factors shielding lower profits
- b. Production sharing tax systems
  - Sharing based on production tiers
  - sharing normally deductible in corporate taxes

The common denominator is that quadrant 3 taxes lift the taxes on extractive industries significantly above the royalty/corporate tax level. While royalty + corporate tax normally will have a marginal tax rate in the range of 30-35%, quadrant 3 taxes lift the marginal tax rate into the range 50-80% with the following normal ranges (final outcome depends on

- Oil --> 70-80% marginal tax rate
- Gas --> 65-75% marginal tax rate
- Mining --> 50-70% marginal tax rate

Countries with immediate deduction for investments and allowing provisions tend to be on the higher end of the range, while countries with depreciation and not allowing provisions tend to be on the lower end of the range. An exception here is Norway which has depreciation, does not allow provisions and still has a marginal tax rate approaching 80% for both oil and gas. Norway does have an investment uplift mechanism that imitates the economic effect of immediate deductions, but this mechanism has been watered down in later years. Below is a table with directional indication with respect to the various characteristics on where the marginal tax rate for quadrants 1-3 ought to be (where in the range above):

Factors influencing MRT down	Neutral	Factors influencing MRT up
Capital gains tax		No capital gains tax
Royalty/tax system benchmarks		Production Sharing Agreement benchmarks
Lower prospectivity		Higher prospectivity
Lower predictability		Higher predictability
High withholding tax on dividends	Zero withholding tax on dividends to home countries	Zero withholding tax on dividends to all countries
Low investment incentives		High investment incentives
Tax depreciation of investments		Immediate tax deduction of investments
Free carried interest	Government participation	No government interest

It is difficult to see why a country should not have a quadrant 3 or quadrant 4 tax on their resource industry, or preferably both of them. The reason for using both quadrants is that introducing a quadrant 4 tax will make it easier to correctly calibrate the quadrant 3 taxes and ensure that quadrant 3 taxes do not become overly burdensome for companies.

Recommendation for quadrant 3 is that countries with extractive industries should consider quadrant 3 taxes unless it is obvious that the industry gives rise to only normal profits (like the mining industry in Sweden). To the extent that a country chooses to have quadrant 3 taxes, a country should choose a resource rent tax that fits with the legal system (civil law or common law) and the chosen tax system (royalty/tax system versus production sharing system). It is highly recommended that the chosen tax mechanism(s) are calibrated together with tax mechanisms from the other quadrants before implementation in law or agreement, as there is considerable experience around the world of countries not getting it right in the beginning.

### **5.6 Quadrant 4 – windfall taxes**

Quadrant 4 is a situation where prices are very high, while costs tend to be high for some companies but lower for other companies.

Quadrant 4 taxes are gross tax mechanisms just like quadrant 1 taxes. The reason for this is that quadrant 4 is supposed to be a safety valve against the effect of very high prices, and not a large revenue collector like quadrant 2 or quadrant 3 taxes over the life cycle of a mine or a field. In periods of very high prices, quadrant 4 taxes can be significant revenue collectors.

Typical quadrant 4 taxes are windfall tax and progressive royalties. Both these taxes are ideal under the “ability-to-pay” principle. The “ability-to-pay” principle implies that the taxes of a company should increase when the ability to pay increases, i.e. when prices or profits are way beyond expectations, and taxes should decrease when the ability to pay decreases, i.e. when prices or profits decreases.

The delineation between quadrant 3 tax mechanisms and quadrant 4 tax mechanisms is whether the taxes are linked to profits (which requires quadrant 3 taxes) or prices (which requires quadrant 4 taxes).

The benefit of quadrant 4 taxes is that they can function as a dual safety valve:

- When prices go very high, quadrant 4 taxes are ideal to tax the surplus. The criterion is that the threshold is high enough so that even high cost companies have normal profits before quadrant 4 taxes kick in. Only then is the “ability-to-pay”-principle adhered to.
- A correctly calibrated quadrant 4 tax allows a country to reduce the quadrant 3 taxes, thus increasing the cost consciousness of the companies by reducing the marginal tax rate in all situations except where prices go very high.

Therefore, a quadrant 4 tax is a tax with a threshold that is set so high that under no circumstances will companies assume such high prices for their businesses to return normal profits even in the highest cost company, and at the same time it is a tax that does not affect cost savings. The more a country can move in the direction from net quadrant 3 taxes to gross quadrant 4 taxes, the more of cost savings will a company keep themselves.

Recommendation for quadrant 4 is that countries where revenues from extractive industries are a significant part of the GDP should consider having quadrant 4 taxes in addition to quadrant 3 taxes to exert a downward pressure on cost levels of the industry. Any cost saving a company does is partly taxed with quadrant 2 and quadrant 3 tax mechanisms, while a cost saving is not affected by quadrant 4 tax mechanisms (the company retains the full effect of any cost saving).

## 5.7 Example: Analyzing a country

In order to show how a preliminary assessment can be done (a qualified assessment means that the tax system is analyzed in detail and calibrated correctly using models built to purpose). We will, for this purpose, analyze the Norwegian petroleum tax system ("allowing for" means relative to benchmark countries):

TAX SYSTEM CHARACTERISTIC	EFFECT ON MARGINAL TAX RATE
Main commodity oil, moving to gas in the future	Range: 65% to 80%, high end at the beginning (oil) lowering into the future (gas)
Quadrant 1 Taxes: None, royalty abolished	No effect after majority of companies entered into tax position, increased quadrant 3 taxes
Quadrant 1 Loss carry forward allowed without limitations	Allows for high-end marginal tax rate
Quadrant 2 Taxes: Corporate tax rate 28% (27%)	No effect, calibrated together with quadrant 3 taxes
Quadrant 3 Taxes: Special tax rate 50% (51%)	Q2 + Q3 taxes equals marginal tax rate of above 78% when combining with other taxes like CO2 taxes
Quadrant 4 Taxes: None	No effect
Prospectivity	High, allows for high-end marginal tax rate
Predictability	Generally high with exceptions, allows for medium to high-end marginal tax rate
Dividend withholding tax	Low to none, allows for high-end marginal tax rate
Investment priorities	Allows outside-Norway ownership, allows for high-end marginal tax rate (currently evaluating limitations on interest deductions, which will put pressure on high-end marginal tax rate)
Depreciation	4-year straight line, allows for medium-range marginal tax rate
Other deductions – all costs deductible and reimbursement of exploration costs if not in tax paying position	Allows for medium to high-end marginal tax rate
Investment incentive - uplift on capex	Allows for high-end marginal tax rate
Free-carried interest: No	Allows for high-end marginal tax rate
Paid government participation: Yes	Allows for medium to high-end marginal tax rate
Capital gains taxation: No	Allows for high-end marginal tax rate

The above analysis<sup>27</sup> is a good illustration of why Norway is able to keep a marginal tax rate above 78%, but it is expected that moving to more gas in the future, falling prospectivity over time (and thus field size), reduced value of uplift (recently introduced) potential limitations on interest deductions (proposed) will put pressure on Norway to move the marginal tax rate from the high-end into the medium-part of the range (70-75%) over the next 10-20 years.

<sup>27</sup>For the sake of good order, it is necessary to understand that the above analysis is only partial. There are other elements in the Norwegian tax system that has not been touched upon. The purpose of the analysis is to illustrate the major reasons why Norway can uphold a marginal tax rate close to 80% on its extractive industry.

## 6. The Case for Windfall Taxes

Windfall Taxes is a designation for Quadrant 4 taxes. Quadrant 4 taxes do not have any clear meaning outside of this report, though, hence the need to name these taxes with a meaningful name. While windfall taxes are one of the Quadrant 4 taxes, it is not the only one. The name windfall tax however conveys very well the meaning of these taxes.

In a world with normal flat prices, there will not be generated any revenue from a windfall tax. The reason for this is simply that a windfall tax is a safety valve that is there in the tax system to take care of the situation when prices do increase significantly. The point of the taxation lies directly in the name: it is taxing a windfall. A windfall is a sudden, unexpected piece of good fortune. When companies' present feasibility studies to a government they will never include windfall prices. This means that companies are not judging these prices as part of their normal profits. This includes high-cost companies. It must thus be clear that the prices that windfall taxes targets are above the price range that most extraction companies will include in their economic estimates.

In a world with volatile prices, or extended periods with high prices due to lack of supply relative to demand, a windfall tax can generate a substantial amount of revenue to a country without hurting the companies. Prices that are so high that they create super-profits even in the high cost companies are prices that can be taxed without fear of violating the "ability-to-pay" principle. A windfall tax will increase the pressure on the companies to reduce their cost, because they will keep more of a cost saving if a country has windfall taxes relative to a country without windfall taxes if the two countries have the same effective tax rate in high prices. As prices go lower the windfall tax will go away and thus become decision irrelevant from a cost reduction perspective, while in a country without windfall tax any cost reduction will also be taxed with resource rent taxes (quadrant 3 taxes).

A correctly calibrated windfall tax should thus be a benefit for companies, and will actually be better for lower-cost companies than higher-cost companies. The reason for this is the following:

- In countries which only have quadrant 3 taxes, it is with the exception of royalty and other quadrant 1 taxes only the profit of the company that is taxed. A company that manages its business well and is able to keep its costs down is hurt by countries only having quadrant 3 taxes. Quadrant 3 taxes thus hurt "the good guys".
- In countries which has reduced quadrant 3 taxes by introducing quadrant 4 taxes, the tax burden may be just as high or higher when prices are very high, but as soon as prices go below the threshold, taxes go immediately down to a level lower than the country which has only relied on quadrant 3 taxes. Who benefits from this? The companies that have the lowest cost because a company with low cost is able to keep more of its profits in a country with windfall taxes than in a country without windfall taxes, assuming that the effective tax rate is the same in the two countries in high prices. Quadrant 4 taxes thus help "the good guys". A high cost company will be able to have normal profits if the windfall tax is calibrated correctly, but it will have to pay more of its share under the "ability-to-pay" principle and is thus not so much a free-rider on the back of the lower-cost companies anymore.

Who benefits from the fact that companies have more left of a cost saving? In our opinion this benefits the entire world:

- Low cost companies benefits in that: (1) they keep more of their cost savings; and (2) they benefit from a downward pressure on costs from high cost companies
- High cost companies benefits in that: (1) they keep more of their cost savings; and (2) they also benefit from their own downward pressure on costs
- The world benefits from (1) lower pressure upwards on cost; (2) it becomes easier for supply to meet demand because more resources will be economical to extract
- Countries that have to import commodities will benefit because competition will raise global production, and slightly lower world prices
- Countries that export will, even with slightly lower world market prices, be protected because the margins of their industries will be the same because a slight fall in world prices (or slower growth in world prices) will be compensated by the cost of their industries becoming slightly lower.
- Investors win because more resources are economically viable and the investments that were economically viable before becomes more profitable (although part of it goes away in reduced world market prices, this part is regained by more resources becoming economically viable).

There is thus a win-win-win-win-win-win situation in establishing windfall taxes as part of an extractive industry tax system. The main factor in this equation is that with windfall taxes, there are stronger incentives for the company to reduce costs or slow down cost increases. This protects investor opportunities, company profits and country revenues. There is no tax other than windfall tax that has this characteristic. Windfall taxes have the inherent ability to rein in spiralling costs, and thus to reduce the need for high growth. With slower cost increase in the world, it is possible to earn healthy profits with lower growth, something that will put less pressure on global resources. Windfall taxes are thus a type of tax that can make capitalism a little bit more environmentally friendly without taking the "capital" out of capitalism.

Windfall taxes will ensure that a country's resources stay economically viable longer, and thus make sure that the country's resources can be harvested in a longer timeframe. A downward pressure on company costs will help to reduce the cost increases that countries see internally from extractive industries, or externally from import. This will help reduce costs also in countries without extractive industries.

It has been frequently argued<sup>28</sup> that the rapidly increasing derivatives market, which make it easier to buy commodity-based papers, have been driving up prices of everything from food to minerals & metals to oil & gas. This is, of course, not the only source for price increases, but in the period from 1990 till 2013 there has been an unprecedented price hike in commodity prices at the same time as there has been an unprecedented increase in paper trading in commodities. Prices are also costs, though. If food prices go up, there are not only people (investment banks like Goldman Sachs) that earn money from this, there is also a cost on the side of the countries and people who are consumers. Putting in place windfall taxes to tax price increases as the graphics show below would be an important strategy for countries with resources to take back some of the money these same countries have to use on imports without hurting their own companies because in accordance with the "ability-to-pay" principle it is when prices are the highest that the ability to pay is also highest. If prices are high, companies can afford paying windfall taxes; if prices are low, then countries can afford paying for their imports.

28 See for example "The Derivative Bubble: Speculating on Food Prices, Banking on Famine - Goldman Sachs Made \$400 Million Betting On Food Prices In 2012 While Hundreds Of Millions Starved". Michael Snyder, Global Research, January 24, 2013



Source: Global Research (<http://www.globalresearch.ca/the-derivative-bubble-speculating-on-food-prices-banking-on-famine/5320379>)

The nice thing about windfall taxes is that they directly tackle the problem. If two companies have the same profit, but one of the companies' profits comes from a large volume and the other companies' profits comes from high prices, it is fairly obvious which company has the largest ability to pay: the company with the lowest cost base, which is the company that has profited from high prices. That is exactly what "windfall" means - an unexpectedly positive outcome that was uncalculated and which has nothing to do with the company's underlying performance.

It is not, however, enough for a country just to introduce new windfall taxes. The overall tax level in the country needs to be calibrated, and quadrant 3 taxes need to be reduced in order for the country (and the world, the investors and the companies) to get the desired effect. Windfall taxes are not about increased taxes, but more optimum taxation in order to move cost-consciousness and decisions on cost savings in the right direction. Windfall taxes should not, and cannot, be viewed as a large revenue collector in the long run, but it can produce significant revenues in periods with very high prices (whether these are the result of derivative trading, or shortfall in supply versus demand, is irrelevant as long as the ultimate goal is price and cost reductions).

Why are windfall taxes not used more often? Mainly because nobody has been implementing windfall taxes correctly:

- The US had windfall tax in the period 1980 to 1988. However, there was a loss carry forward mechanism in the windfall tax, such that if prices were lower than the base price, the companies built up a loss carry forward which was used when prices went above the base price. Over time the loss carry forwards became so large that the windfall tax was seen as a source of minor revenue, and it was repealed.



- The US windfall tax had essentially a design flaw. Windfall tax is a gross tax, and should only be payable when even the high cost companies have a higher than normal profit. As a gross tax it should not have a loss carry forward mechanism attached to it. Had the US had the windfall tax enacted today, without the loss carry forward mechanism, the US economy would arguably have been in better shape than it is today, all other things equal.
- Mongolia introduced a windfall tax, the world's highest, in 2006 that was repealed in 2009. The windfall tax was introduced not as a safety valve to tax extremely high prices, but to tax copper concentrate and gold profits when their respective prices reach \$2,600 per ton and \$500 per troy ounce with a 68% levy. These prices are not particularly high, and the windfall tax was introduced in order to promote the companies to establish smelter capacity in Mongolia instead of exporting unprocessed produce. The purpose of the windfall tax was thus wrong and the chosen prices were far from windfall prices.
- Zambia introduced a windfall tax in 2008 that was repealed in 2009. This tax also had a design flaw. The tax rates were calibrated as if the windfall tax was going to be deductible, but the windfall tax was never made deductible. Thus the marginal tax rate went above 100%, a rate which everyone understands is unsustainable. The windfall tax had to be changed. Instead of making the existing windfall tax deductible, or calibrate the tax level of the windfall tax to match with it being non-deductible, it was repealed.

Therefore, there has been no country that has ever introduced true windfall taxes without design flaws, and these types of taxes (windfall tax, progressive royalties and the likes) have fallen out of favor, much to the advantage of multinational extraction companies, and to the disadvantage of countries.

The principles of a windfall tax, ref the Quadrant Cross, are however quite simple:

- Windfall taxes are gross taxes, and there should be no loss carry forward with these
- Windfall taxes are a safety valve, and the threshold should be set so high that even the highest cost extraction company within the country should be able to have normal profits before the windfall tax kicks in in order to adhere to the "ability-to-pay"-principle.
- Windfall taxes should only be introduced in industries that have demonstrated either volatile prices or consistently high prices in order not to introduce futile windfall taxes
- Windfall taxes should only be introduced for industries with potential for contributing a significant portion of a country's GDP. The reason for this is again not to introduce futile windfall taxes.
- Windfall taxes should only be introduced for main products, not for by-products, as the intention is to influence decision making, not to catch higher revenues (the revenues from windfall taxes should replace and compensate the reduced revenues from quadrant 3 taxes).

Following the above points, it is clear that it is only main products in major industries in resource rich countries that should consider windfall taxes. Which gross taxes to introduce, depends to some extent on the legal system:

- A true windfall tax fits best with a royalty/tax system
- Progressive royalties fits best with production sharing tax systems.

All other countries will probably be better off by having tax mechanisms from quadrant 1, 2 and 3. However, even having only these 3 types of tax mechanisms will demand a calibration in order to see that the elements are working together harmoniously and without any surprises in all the situations that can occur in the extractive industries.

All countries will however be able to benefit from using the methodological framework introduced in chapter 4.3 to evaluate their tax system to see whether they are capturing too little or too much in tax revenues from the industries in question. The final calibration is up to the government, but everybody can use the framework to see if their tax systems are generally in place or not.

A last word on production sharing agreements: The production sharing mechanisms with tranches for different production levels clearly falls within a progressive resource rent tax in quadrant 3. As a quadrant 3 tax it is vital to calibrate it together with the quadrant 1 and quadrant 2 mechanisms. Many countries have such high profit-sharing that they effectively make a lot of resources uneconomical to produce. Many countries could thus have had significantly higher extractive activity if there was less greed on the government side. This would have benefited the governments, the companies and the world economy as well. Less is sometimes more, especially when it comes to production sharing agreements.

## 7. Other ways to get to an optimal tax system

In chapter 5, we introduced a framework for analyzing a country's tax system in order to find out how a tax system works or not and how it can compare to other tax systems.

In chapter 6, we analyzed Quadrant 4 in particular and showed how gross taxes based on high prices (windfall taxes, progressive royalties etc.) could have a very significant role in a tax system to encourage high cost companies to reduce their costs. Otherwise, they would have to pay windfall taxes anyway in high prices, and that they thus can keep more of their cost savings if traditional net profit taxes are combined and calibrated with gross revenue taxes.

There are other ways to optimize the tax system, and although this report cannot go into all of these, we will categorize these in order for governments and other constituents to investigate them should the need arise:

How to avoid reduced revenues – a short-list

- Always assume that a company will at least be able to sell their products at world market prices less net back cost between the production site and the market. In order to secure that the pricing is not affected negatively it is important that a country have thorough insight into world market prices and that they fully understand the net back cost. It is preferable if all gross taxes (royalty, windfall taxes, progressive royalties etc) can be based on world market prices less net back. It is also preferable that net taxes can be based on world market prices less net back, but here more care needs to be taken with respect to which mechanisms to use. It is outside of the scope of this report to go through all the mechanisms available.
- Follow up loss carry forwards as diligently as positive tax bases. The reason is that many companies will try to increase their loss carry forwards in order to avoid future taxes, and some countries are lax on companies while they are still in a loss carry forward position.
- In accordance with the recommendation in the report "Protection against derivatives abuse", introduce a law that moves all derivatives and quasi-derivatives into a separate tax base. This allows for the continued use of derivatives for true hedging, but will effectively negate any other uses of derivatives as it will not be economically attractive to accumulate losses within the country in question any more.
- Use withholding taxes to the country's advantage. Secure that companies always have one road to take taxed profits out of the country – this should be by keeping withholding taxes towards the ultimate home country at zero, while having withholding taxes to all other destinations, especially if the immediate mother company is located in a tax haven. In such case a full withholding tax on dividends should be upheld.
- Combining quadrant 4 taxes with quadrant 3 taxes will allow governments to increase taxes when prices are very high, while at the same time being able to lower the taxes somewhat when prices are low, medium or high.

How to avoid increased cost - a short-list:

- Ensure that assets used in extraction industries have to be owned within the country to avoid mark-to-market issues
- In accordance with the recommendation in the report "Protection against derivatives abuse," introduce a law that moves all derivatives and quasi-derivatives into a separate tax base. This allows for the continued use of derivatives for true hedging, but will effectively negate any other uses of derivatives as it will not be economically attractive to accumulate losses within the country in question any more. This is a measure used to protect against both reduced revenues, as well as increased cost due to the use of derivatives.
- Make it illegal in the tax law not to source rebates and kick-backs to the country that has supplied the basis for the rebate or kick-back. Monitor industry rebates on major imports, and secure that investigations are carried out to the extent that there are no rebates on imports where rebates are normal.
- If it takes a long time before companies enter tax paying position, evaluate whether changes to depreciation schedules or introducing ring-fence will achieve the desired effect. Be aware that the tax level should be lowered when introducing (length-ened) depreciation and ring-fencing. The tax system should be calibrated anew when mechanisms like this are changed.
- A country should consider withholding taxes on cash flows other than dividends going out of the country in order to minimize the risk of transfer mispricing, and to encourage the use of dividends directly to the (ultimate) home country.
- Combining quadrant 4 taxes with quadrant 3 taxes will allow governments to increase taxes when prices are very high, while at the same time being able to lower the taxes somewhat when prices are low, medium or high. When net profit taxes are reduced when prices are low, medium and high, then it becomes more attractive for the company to carry out cost savings, as they then will keep more of the tax saving.

These are just examples of how thinking around both protecting the revenue base and the cost base can lead to a much improved tax base. However, whenever a country increases its tax base, it should also consider lowering the tax level somewhat in return, in order to secure improved tax payer behavior. The goal is optimal taxation for the benefit of both the tax payer and the country, not maximal taxation that creates a lose-lose situation.

## 8. Lobbying

The extractive industries are clearly against quadrant 3 and particularly quadrant 4 taxes. The majority of producers in (everybody except the very highest cost producers) the world would however have benefited from introduction of quadrant 4 taxes since this would have:

- Moved some of the taxation to periods when the ability to pay were the greatest
- Moved some of the taxation over to gross taxes so that more of cost savings would be left with the companies, and so that good companies would keep more of their profits for reinvestments. When good companies reinvest, they tend to invest in other profitable operations, something that would benefit the world by lowering the cost (or the cost increases) somewhat. This is important in a world that has seen skyrocketing costs in the extractive industries

Reducing the cost spiral in the world today is one of the most important tasks for investors in the extraction companies. So is funding the societies through taxation, such that there are stable societies forming markets for the produce from the same companies. If windfall taxes can help in this area, then lobbying against it seems somewhat counterproductive for most extraction companies.

It is our view that governments should make up their own opinion with respect to which tax mechanisms a country should have when taxing extractive industries. This means that governments should essentially disregard lobby activities from the extractive industries with respect to the fiscal mechanisms chosen.

It is when the tax level is set that the industry should be heard. The reason for this is that in many cases, the industry knows better how their decisions will be influenced by the effective tax rate, which together with the marginal tax rate tells what incentives extraction companies have to explore and develop new resources.

## 9. Corruption

Corruption is still rampant in many countries. In some countries, it is institutionalized. More and more focus is, however, put on this problem, and many of the largest extraction companies have established strict rules about corruption. This has to be more than lip-service, though, in order for corruption to really go down. Investors, especially the large institutional investors that invests on behalf of a large amount of people instead of single investors, have a significant role in keeping the dialogue with the companies on this issue, and demand changes whenever circumstances show that companies are misbehaving and putting investor money at risk.

## 10. Arguments against windfall taxes – and our counterarguments

### a) Windfall taxes has never been used

Yes, windfall taxes have been used, amongst other in the US, but due to loss carry forward mechanism in the windfall tax (an absurdity in a gross tax), the accumulated loss carry forward was so large at one point that the US removed the tax altogether because it was estimated that it would never give raise to any taxes in the future. This happened when the oil prices had been flat for a long time, only broken by the occasional spike in the oil price.

### b) New countries that have tried windfall taxes have failed

It is correct that countries like Mongolia and Zambia which has tried windfall taxes after year 2000 has failed. However, this is due to design flaws in the windfall tax, not the windfall tax mechanism itself. With minor adjustments, Zambia would have had a windfall tax that would have worked, while the Mongolian windfall tax had the wrong intention and taxed normal prices.

### c) Windfall taxes lead to too high taxation

The intention of the windfall tax is NOT to increase taxation under normal prices. The windfall tax should be calibrated such that it does not lead to higher taxation under normal prices. Only when prices rise to very high levels should the windfall tax kick in. In fact, having a windfall tax in the tax system is a safety valve that allows a country to set quadrant 3 taxes (the resource rent taxes) a little bit lower than they else would have had. Resource rent taxes are calibrated to catch a significant part of the revenue when profits are high, not when prices are high. The difference is that if the resource rent tax is set too high, there is no incentive for the companies to save costs, because that only increases an already high taxation level. With windfall taxes, companies are allowed to keep more of their cost saving if the resource rent taxes are calibrated together with a windfall tax.

### d) Windfall taxes is not a progressive tax and is leading to different results for low cost and high cost producers

This is actually not an argument against the windfall tax but against the purpose of the windfall tax. The whole purpose of the windfall tax is to move part of the taxation away from profits and over to prices. Taxing only profits is wrong, because that actually penalizes the most cost efficient companies. Taxing only prices is also wrong, because that gives enormous benefits to the most cost efficient companies. However, combining taxation of profits with taxation of prices means that the burden of taxes is more evenly distributed between the companies, and it actually puts a downward pressure on the cost of the high cost producers. That is the intention of the tax. Why should low cost extraction operations tolerate that high cost extraction operations pay less taxes when prices are high?

Low cost extraction operations are actually a result of good management, a fact that should be rewarded. Windfall taxes are such a reward, by moving some of the taxation away from profits and over on prices when prices rise very high. If high cost companies take the pains to move in the direction of the low cost companies, they would also be rewarded by keeping more of their cost savings as windfall taxes are not affected by rising profits, only rising prices.

e) It is very difficult to calibrate windfall taxes correct

Yes and no. It is correct that windfall taxes are difficult to calibrate if the calibration is only done on the windfall tax. However, a correctly implemented windfall tax should be calibrated together with resource rent taxes in Quadrant 3. It is easier to calibrate quadrant 3 and quadrant 4 taxes together than each of them separately. When calibrated together, it is actually fairly easy to find the price level which one wants windfall taxes (or other Quadrant 4 taxes like progressive royalties) should kick in on.

f) It is possible to achieve the same result using only resource rent taxes

Actually, no. Resource rent taxes targets profits and profits alone. That means that cost-efficient operations with high profits will pay relatively more taxes than high-cost operations. This actually penalizes sound cost management. Combining resource rent taxes and windfall taxes, and calibrating them together, will introduce a reward for cost savings, in the sense that companies will be allowed keeping more of a cost saving in a system which has a windfall tax calibrated into it, as opposed to a system where resource rent taxes is supposed to capture the entire resource rent.











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Publish What You Pay Norway  
Brugata 1  
0186 Oslo  
Norway

[post@publishwhatyoupay.no](mailto:post@publishwhatyoupay.no)  
[www.publishwhatyoupay.no](http://www.publishwhatyoupay.no)

ISBN 978-82-93212-08-9

Publish What You Pay Norge © 2013