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PREPARED BY THE FISCAL AFFAIRS DEPARTMENT

BOARD PAPER ON THE TAXATION OF NATURAL RESOURCE RENTS

ISSUES FOR CONSULTATION

Motivation and scope

This paper will assess and highlight the potential for generation and taxation of resource revenues as an efficient and equitable source of additional revenue in many developing resource-rich economies—and suggest ways to realize it through better taxation of rents. The scope is revenue mobilization, including the growth of the tax base, rather than other fiscal aspects of the management of resource wealth (some of which will be handled in a companion paper on macro-economic frameworks for resource-rich countries). Among potential natural resources the focus is oil, gas and mining (extractive industries – EI). By "rent" is meant the intrinsic value of the resource in the ground once extracted; that is, the surplus after all costs of production including normal returns to capital are deducted. New discoveries in low-income countries (LICs) mean that EI offer potential for large, transformative projects; and in some advanced economies, more effective taxation of natural resources can contribute to sustainability needs and improvement of the wider tax system more generally. Technical assistance (TA) from the Fiscal Affairs Department (FAD) is increasingly occupied with the topic, including through a recently launched donor-supported topical trust fund on the topic.

Questions

The key characteristics of EI sectors include: volatility, uncertainty, presence of rents, asymmetry of information, time inconsistency, and exhaustibility. Only exhaustibility is unique to EI, but the magnitude of the other features is sufficiently great to bear upon tax policy for the sectors. Efficient resource extraction requires the granting of monopoly rights over defined resources, thus enshrining the potential for rents. Ability to capture these rents for public use, however, is constrained by features such as the pricing of output (including the charges for downstream infrastructure), fiscal decentralization of resource revenues, environmental costs, and any weaknesses in macro-fiscal management. ***From your experience, which of these characteristics have an important bearing on suitable tax design?***

Resource-rich countries vary widely by type of resource, stage of resource development, institutional structure and skills, and income level. No "one size" in fiscal regimes for EI sectors will fit all, but there are principles and approaches that probably do have wide application. More specifically, tax policy prescriptions need to take account of specific circumstances – notably the relative ability of a government to bear risk. ***From your experience, what should be the key principles guiding public policy in this area?***

Limited evidence on the relative profitability of EI companies, and on tax take from estimated rents, will be considered. Although not yielding strong global comparisons, the evidence points to some country examples where potential for increased revenue yield from EI sectors is apparent, and to some EI companies where the accumulation of cash balances or share valuations suggest the resources in their portfolios may be under-taxed. ***Please provide your views (and any evidence) on the actual and desirable extent to which rents in the EI sector are currently taxed.***

Evidence so far suggests that, on average, mining companies and mining projects are no less profitable than their oil and gas counterparts. ***Is this also your experience, from your own observations?***

Much of the literature, and practice in countries that successfully tax EI, indicates that taxes that directly target rents promote efficiency in both investment and revenue maximization. A strong body of opinion, however, argues that gross revenue-based measures (royalties) should be more emphasized – both because they charge the opportunity cost of the resource, and because they are easier for institutionally-weak governments to collect. The paper will examine these arguments and is likely to make a case for a package in which the balance of rent taxation between gross levies and resource rent taxes (in one form or another) will vary according to objectives and circumstances. ***What is your view on the appropriate mix between royalty-type and rent-based taxes, and how does it depend on country's circumstances?***

Administration of EI fiscal regimes need not be especially difficult; it is sometimes made so by exceptional ways in which EI sectors are taxed. Where EI dominate the economy, poor administration can seriously damage government revenue and the flow of investment; but the design and implementation of EI tax regimes are often major, though underrated, causes of administrative weakness. Rent taxes are not as hard to administer, nor royalties so simple, as is sometimes argued. ***What is your view of this assessment? Please make observations from your experience.***

Taxation of EI is linked to the manner in which mineral rights are granted. Auctions provide a complement to taxes for capturing rents; systems without auctions run the risk of taxing rents insufficiently if the tax regime does not include a progressive rent tax. In some cases, governments may benefit from separating exploration from extraction – for example, by auctioning known deposits to the highest bidder. ***Please comment on these observations, and your experience of different methods of awarding mineral or petroleum rights.***

Taxation may be more efficient if fiscal regimes are perceived as stable and credible. (Though there may be a counter-case for presuming periodic revisions or renegotiations.) ***Are regimes set out in general legislation preferable to imposition by contract? When are bilateral negotiations or renegotiations warranted?***

Finally, the paper will outline how the adequacy of rent taxes can be assessed in different contexts. While there is no universally appropriate level of "government take", countries can assess whether their rent receipts are adequate or can be improved. Critical here is the framework for fiscal transparency, for which good practice will be outlined. ***How should one assess the appropriateness of taxation in different country contexts?***

Your views on any other relevant aspect of the topic not included in this preliminary outline of the paper are also welcome too. We greatly appreciate your input to our deliberations on this important topic.

The deadline for comments will be April 27, 2012, but comments received in advance of that date will be more than welcome.