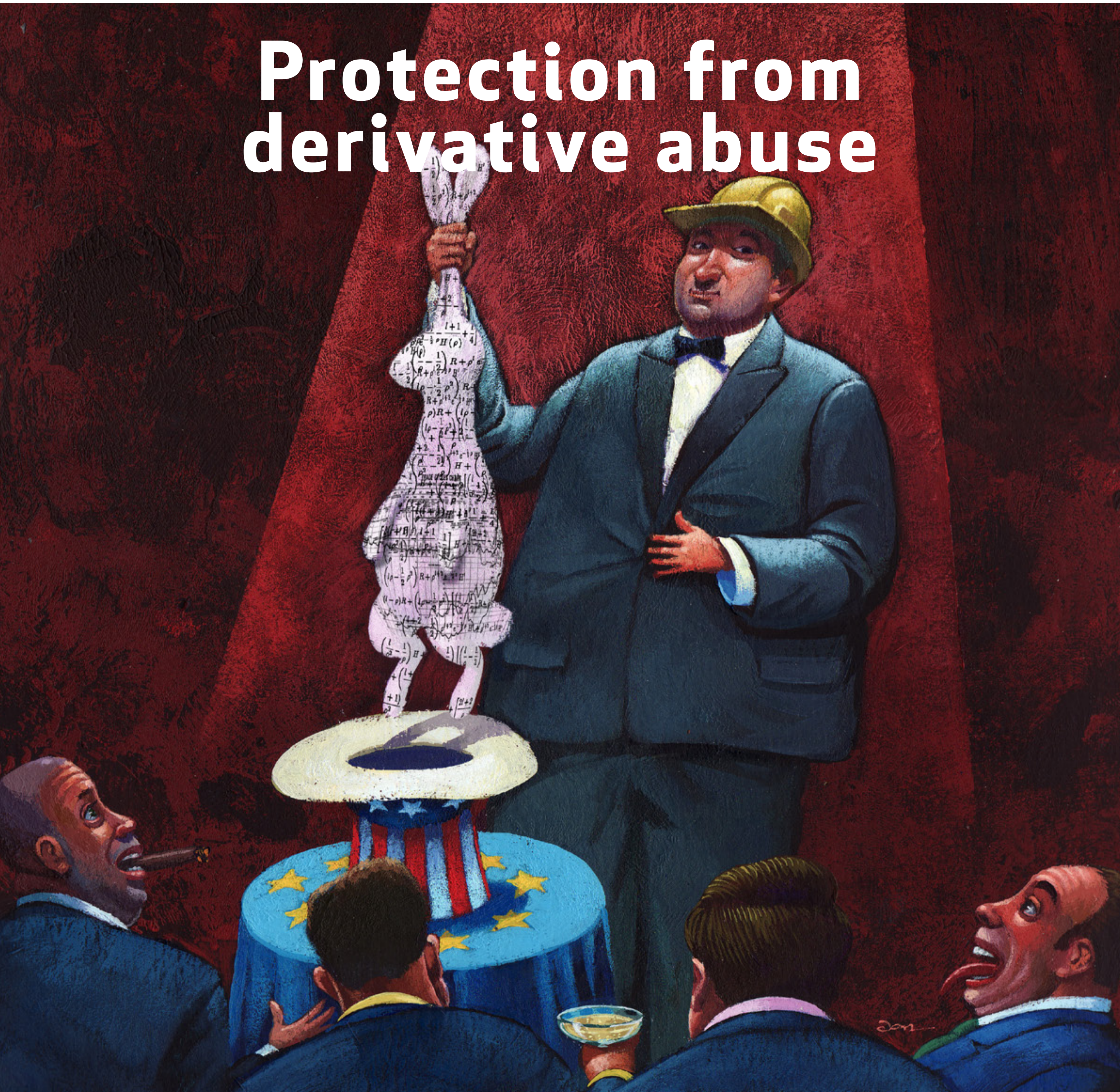
Publish What You Pay
NORWAY

BRIEFING

- Extractive companies abuse a financial instrument called derivatives in order to transfer revenues out of host countries – before the revenues are taxed.
- Poor host countries are tapped for their legitimate resources and lose billions of US Dollars. These countries often lack the transparency or capacity to uncover the derivative abuse.
- One simple policy proposal enacted on a national level can stop the abuse of derivatives, while still protecting proper use of these instruments.

Protection from derivative abuse

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In the report "Protection from derivative abuse", **Publish What You Pay Norway** reveals the harmful use of the financial instrument called derivatives in the extractive industries.

THE PROBLEM

Today, trade with non-renewable natural resources like oil or minerals does not have to be connected to the physical and geographical extraction of them. Rather, much of todays trade is made through the use of financial instruments. Some of the most complicated financial instruments are derivatives, which are used extensively by companies in the extractive industries. The use is legal and can have positive effects. Unfortunately, derivatives can also be abused in order to move capital across countries and thereby evade tax. Most often these instruments are used for the companies' own benefit and at the expense of poor host countries where the resources are being extracted. By using derivatives, companies can transfer revenues out of the host countries before the revenues are taxed. This harmful use of the financial instrument of derivatives has up until now been underexposed. Yet, to illustrate the size of the problem, the global value behind all derivatives was more than ten times the world's gross domestic product in 2011.

THE CONSEQUENCES

The well-known investor Warren Buffet has termed derivatives as "financial weapons of mass destruction" that can harm the whole economic system. Extractive companies' abuse of derivatives harms both rich and poor countries. Derivatives are used to transfer untaxed money out of host countries (where the companies extract resources) and keep this money circulating within a multinational corporation without taxation, or without taking the money back to the home country (parent company jurisdiction). Poor developing countries are particularly vulnerable to this abuse: Tax revenues from the extraction of their natural resources might be the only financial basis of such a size that it can help fight poverty. Tax evasion, made possible by amongst other abuse of derivatives, taps host countries of their legitimate and strongly needed resources. Furthermore, few developing countries have the resources or capacity to uncover abuse of derivatives, as they are very complicated instruments. Lack of transparency in the extractive industries makes this task even more difficult.

"Derivatives are financial weapons of mass destruction that can harm the whole economic system..."

- Warren Buffet.

A SOLUTION

PWYP Norway outlines an effective policy proposal to hinder the abuse of derivatives and their harmful consequences: Countries can single out derivatives in a separate tax base. We call this "the separation method". The companies' income from derivative activities would thus be taxed separately from their income from extractive activities. This means that gains are taxed based on the general tax rate in the country, and losses can be used against current gains or carried forward and taken against future gains. This would limit the abuse of derivatives for transferring un-taxed funds from poor countries.

The method can be implemented unilaterally and is in line with how most countries have set up their tax systems, and with legislative systems in general. It fixes the market failure created by derivative abuse; while at the same time it does not discourage the proper use of these instruments.

Q&A

What is a derivative?

A derivative is a financial instrument that allows speculation on the future price of a product - without buying the actual product. The price is linked to the market place the product is derived from, but there is no physical delivery to back the transactions, only settlement of derivative contracts. A derivative has thus no value of its own.

How does it work?

Derivatives (like futures, options and swaps) were developed to allow investors "hedge" risks in financial markets - in effect buy insurance against market movements. Used correctly, hedging is a good instrument for securing profits in an uncertain world. Yet derivatives are unfortunately also an ideal instrument to move large amounts of pretax earnings from one tax jurisdiction to another. By entering into opposite derivative instruments at the "wrong" timing, it is possible for companies to create huge losses in jurisdictions with high tax, and equivalent profits in jurisdictions with low tax - thus being able to transfer huge amounts of untaxed funds legally out of a country.

Why should I read this report?

The report "Protection from derivative abuse" presents the various forms of derivatives, including their legitimate usage. Most importantly, it gives examples of how these instruments have been and can be abused in order to transfer funds across borders with the intention to avoid taxation on parts of the revenues from extraction activities. We reveal that the extractive industry is heavy users of this particular financial instrument. We also find that the global value behind all derivatives is a staggering ten times the world GDP. We show how some companies are using derivatives terminology on transactions that are not derivative at all, but are rather long-term contracts that are mispriced within the corporation. Finally, the report outlines two general methods that can be used by affected governments to avoid derivative abuse and their harmful consequences. Of these two, one is recommended: the separation method.

Download the full report for free at **www.pwyp.no**

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Do you want to see financial transparency and accountability in the extractive industries?

...

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Publish What You Pay NORWAY

PWYP Norway is the Norwegian chapter of a global network of more than 750 organizations from over 70 resource rich countries. We work to establish financial transparency and accountability in the extractive sector, so that countries can mobilise their own capital to promote a sustainable future, democracy, and human rights

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