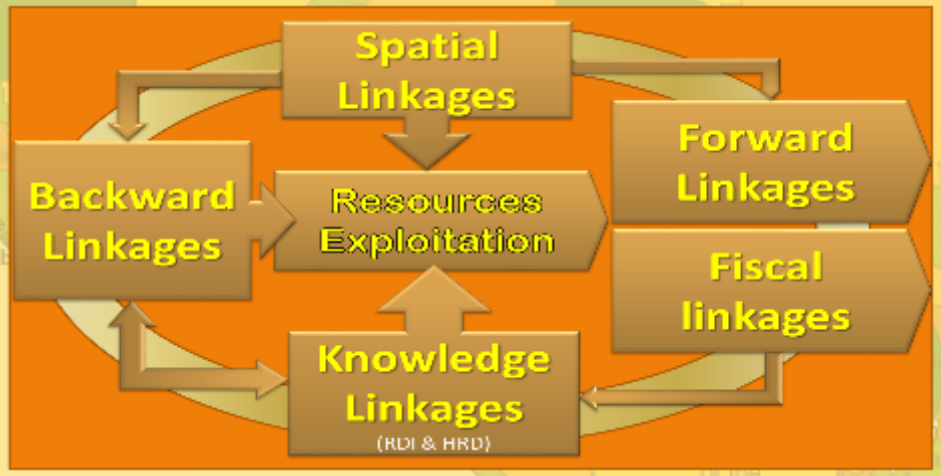
# Transfer Pricing in the Extractive Industries




## Constraints to Resource-Based Industrialisation

**Paul Jourdan**
**Aporde, Joburg, Sept. 2015**










# Beyond a hole in the ground: Resource Sustainability?

## *Optimising the developmental impact of Africa's mineral assets!*

## Transfer [mis] Pricing

# AU: Africa Mining Vision (AMV) 2009

***"Equitable and optimal exploitation of mineral resources to underpin broad-based sustainable growth and socio-economic development"***

**This shared vision will comprise: A knowledge-driven African mining sector that catalyses & contributes to the broad-based growth & development of, and is fully integrated into, a single African market through:**

- Downstream linkages into mineral beneficiation and manufacturing;
- Up-stream linkages into mining capital goods, consumables & services industries;
- Side-stream linkages into infrastructure (power, logistics; communications, water) and skills & technology development;
- Mutually beneficial partnerships between the state, the private sector, civil society, local communities and other stakeholders;
- A comprehensive knowledge of its mineral endowment.

***"Obtaining an adequate share of mineral revenue and utilizing it in an equitable manner is crucial. An efficient and transparent fiscal regime should catalyse social, physical and knowledge infrastructure development."***










# Fiscal Regime: Sustainability in Mining?

***Mining exploits FINITE national resources and accordingly <u>can never, in itself, be sustainable</u> in the longer term!***

However, **Hartwick's rule** for sustainability prescribes reinvesting resource rents, thus keeping the value of net investments equal to zero. **Hartwick's rule** defines the amount of investment in produced capital (buildings, roads, knowledge stocks, etc.) that is needed to exactly offset declining stocks of non-renewable resources. This investment is undertaken so that the standard of living does not fall as society moves into the indefinite future.

Solow argues that, given a degree of substitutability between produced capital and natural resources, one way to design a sustainable consumption program for an economy is to accumulate produced capital sufficiently rapidly so that the pinch from the shrinking exhaustible resource stock is precisely countered by the services from the enlarged produced capital stock.

The difference between total investment in some kinds of capital and total disinvestment in other types of capital has been labelled **"genuine savings"**. A positive value for genuine savings has been linked to the possibility of long-run economic sustainability – inter-generational equity.

***Is Africa achieving GENUINE SAVINGS?***

***Severely Compromised by Transfer [mis]Pricing***



# Resource-based Industrialisation?

## *Equitable Growth and Development (G&D)*

## *3 broad trajectories:*

### 1. "Normal" Regimes

(Most of Europe & Developmental states- PRC, Japan, Malaysia, et al)

***Mainly indigenous capital***

Strong Linkages dev.:

- >Fiscal (often thru' equity)
- >>Downstream VA
- >>Upstream (inputs)
- >Knowledge (STEM, RDI)
- Spatial (infrastructure)

***Indigenous Development***

**Inter-generational Equity**

**High G&D (Growth & Development) and high industrialisation**

### 2. Post-Colonial Regimes

(Most 3rd World states: ex-Euro-Imperial) WB "Free Mining" FIFA

***Mainly FDI (tax havens)***

Poor linkages dev.:

- << Fiscal take (leakage)
- << Downstream VA
- < Upstream (inputs)
- << Knowledge (STEM, RDI)
- Poor Spatial (infrastructure)

***Low Indigenous Development***

**Inter-generational *Inequity***

**Low G&D, low skills/RDI and negligible industrialisation**

### 3. Conquistador Regimes

(Euro-Settler Colonies: US, Oz, Canada, L.America, etc) FIFA

***Settler Capital & FDI***

Mixed linkages dev.: (> *for invasions from N.Europe)*

- ~<Fiscal and <SMCs (ideological)
- ~Downstream VA
- >Upstream (inputs)
- >>Knowledge– imports/settlers
- >Spatial (infrastructure)

***Indigenous wipe-out***

**Inter-generational *Settler* Equity (indigenous marginal-isation & extermination)**

**Med-high G&D and indust.**

# Resource-based Industrialisation?

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- << Downstream VA
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- >Knowledge – imports/settlers
- >Spatial (infrastructure)

*Indigenous wipe-out*

**African States broadly are on the #2 Post-Colonial (net dis-savings) trajectory – dominated by FDI and concomitant *rampant transfer pricing***

***Need to move to trajectory #1 – "Normal" Mineral Regimes***

**Inter-generational Equity**
**High G&D (Growth & Development) and high industrialisation**

**Inter-generational *Inequity***
**Low G&D, low skills/RDI and negligible industrialisation**

**Inter-generational *Settler* Equity (indigenous marginal-isation & extermination)**
**Med-high G&D and indust.**

# Resources Policy Must Optimise the Seminal Resources Linkages

## Maximise the 5 resource *linkages*

*Use depleting assets to underpin growth in sustainable sectors*

**1. FISCAL:** Capture & invest of resource rents (RRT) in long-term economic physical & human infra (inter-generational equity)

**2. SPATIAL**
Puts in critical infra-structure to realise other economic potential & could stimulate LED

**3. BACKWARD**
Inputs: Capital goods, consumables, services, (also export)

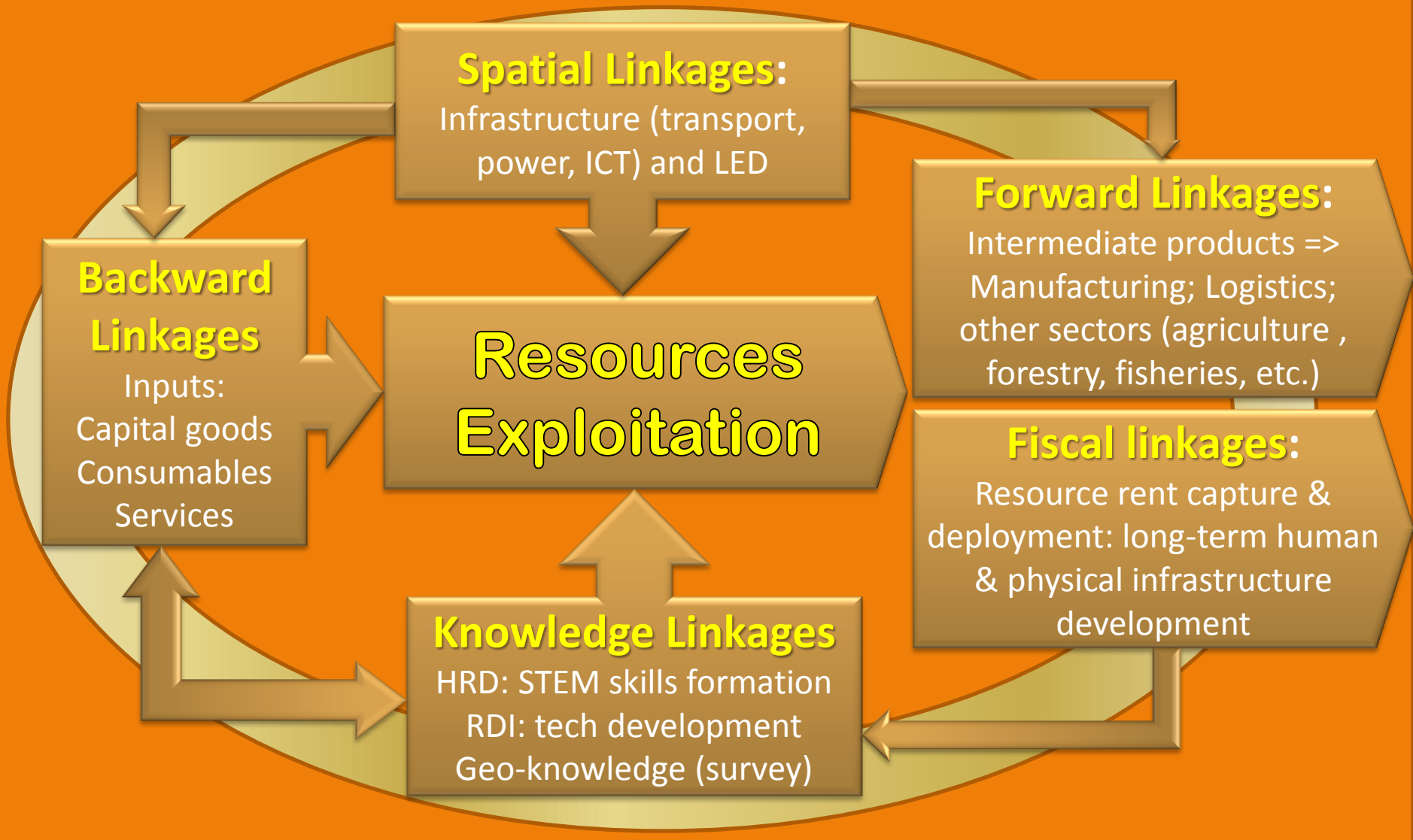
**4. KNOWLEDGE**
Linkages (HRD & R&D):
"Nursery" for new tech clusters, adaptable to other sectors

HRD, R&D

**5. FORWARD**
Value-addition: (beneficiation)
Export of resource-based articles

***If the linkages cannot be made, the people's resources would be best left unexploited- Need to maximise the developmental & inter-generational impact whilst still extant!***

# Inter-dependence of Mineral Linkages




***The realisation of all of these seminal linkages is severely constrained by transfer pricing, particularly the fiscal and backward linkages***










# Fiscal Linkages

## Rent Capture & Deployment into Other Forms of Capital

= ***net genuine savings***

= ***inter-generational equity (IGE)***

# *Why Have Special Natural Resources Taxation &/or State Equity?*

## *1. Because resources often embody Resource Rents*

**Resource rent** is a surplus value after all costs and normal returns have been accounted for, i.e. the difference between the price at which an output from a resource can be sold and its respective extraction and production costs, including a normal return. It can also be conceptualised as "abnormal", "unearned" or "supernormal" profit.

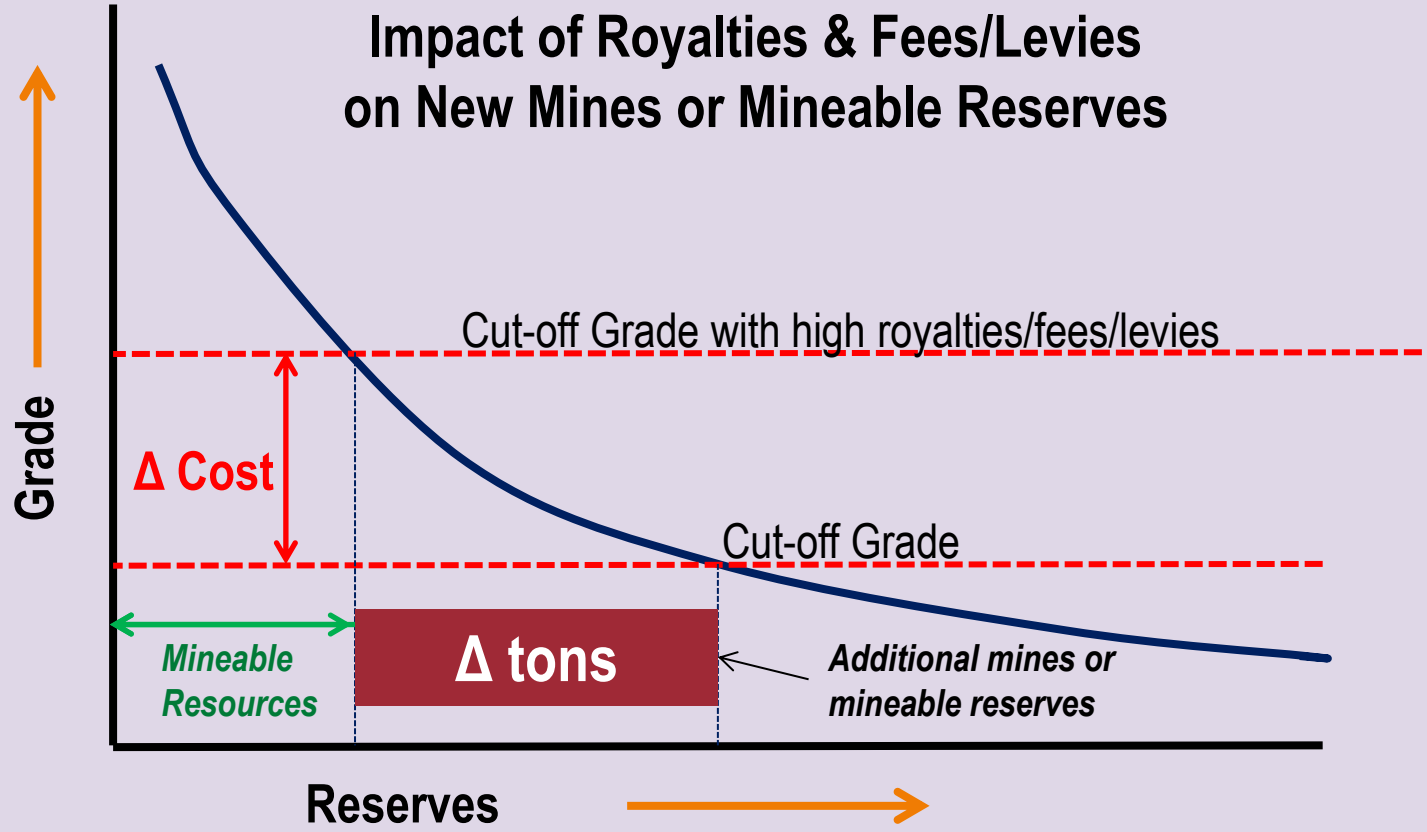
**Resource rents comprise both:**

- **Differential rent** (also called quality or Ricardian rent) arises because of differences in the quality (richness) of resources due to higher grade, higher yield, location etc. and
- **Scarcity rent** emanates from excess demand for (or restricted supply of) the resource (e.g. if the well-head cost of Saudi oil is $5/bbl and a "normal" return equates to a price of $6/bbl, but the market price is $60/bbl (scarcity), then the resource rent is $54/bbl)

## *2. Also, because the nation is steadily deprived of its asset as it is extracted – needs extra compensation to invest in the creation of new assets (royalties)*



***Royalties/fees are less vulnerable to transfer pricing, but add to costs, increase the cut-off grade, sterilise reserves and constrain new mines***

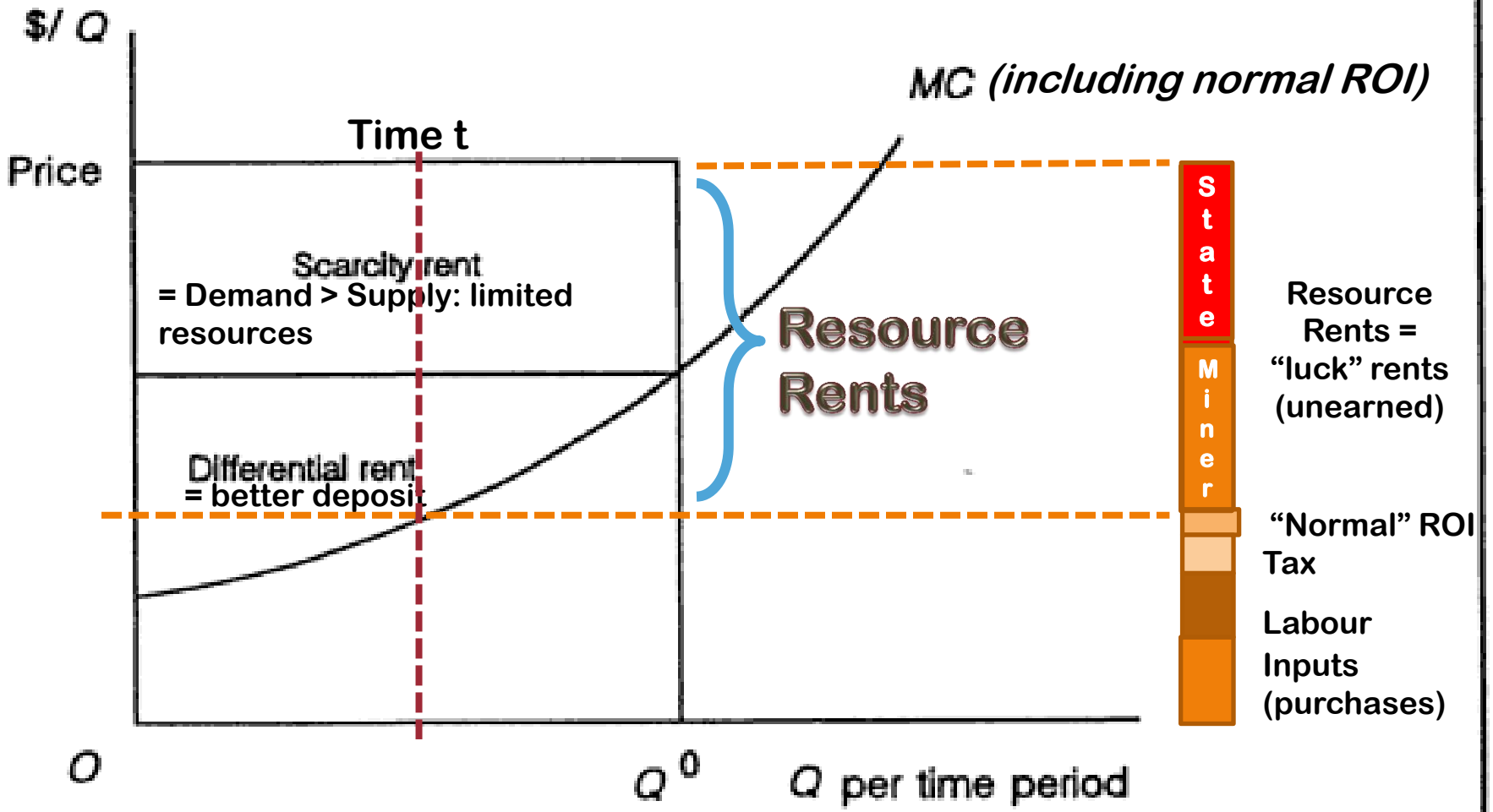



***Rather capture surplus: RRT or State Equity (after normal ROI) to fund a SWF (inter-generational) including a fiscal stabilisation, resources development and skills/tech funds***
***<u>But more prone to TRANSFER PRICING</u>***

*State free-carry conditions would also sterilise resources, but not if it only triggers in after a reasonable ROI has been made (equivalent to a RRT)*

# Resource Rents

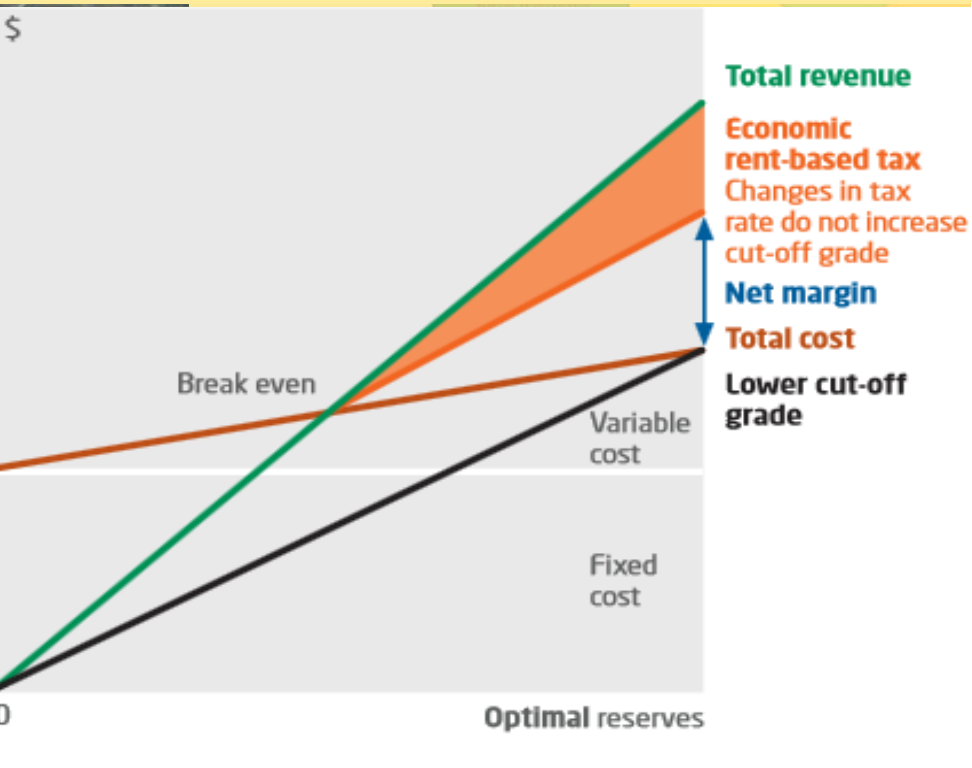
***Return on Investment (ROI) > costs including minimum return to effect the investment***



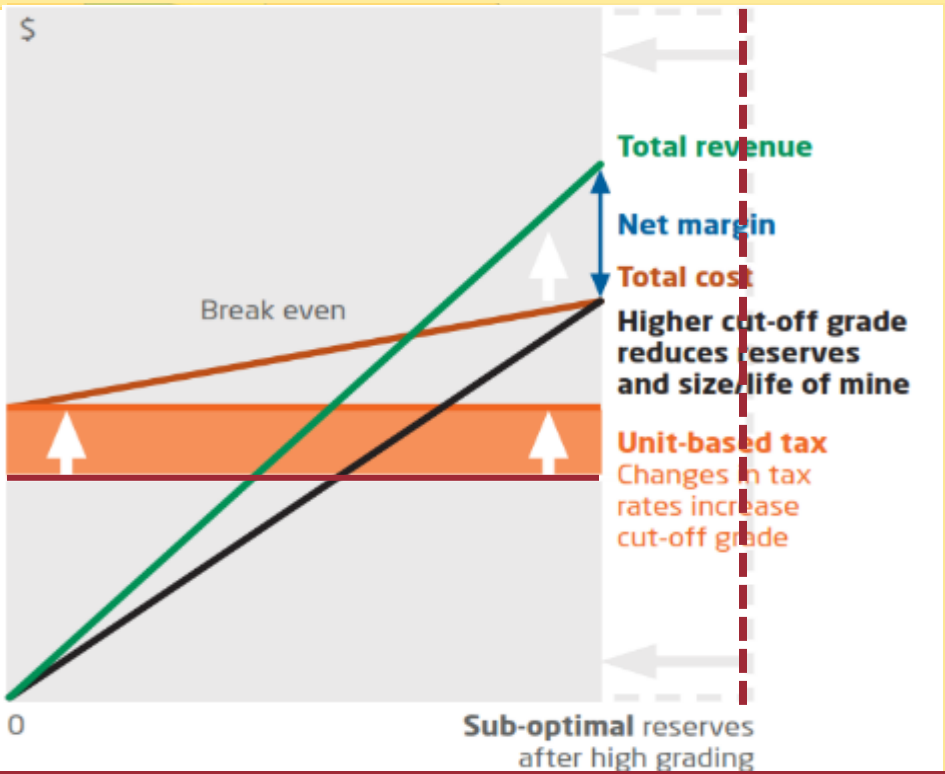

***Resource Rent Tax (RRT): 50% of ROI greater than Long Bond plus 7%?***
***NO IMPACT ON MARGINAL OR AVERAGE DEPOSITS!***

# Economic Rent or Unit-Based Tax?

**Economic Rent-based Tax – Economically efficient (RRT), but >TP**



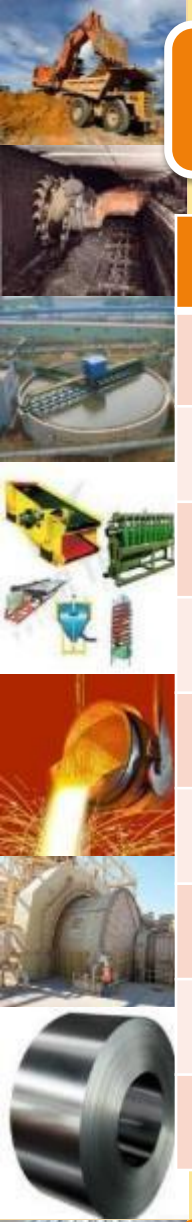

**Unit-based tax – Economically inefficient (Royalties), <TP**




*"an economic rent based tax is efficient in that changes in its rate do not alter the optimal level of mine reserves and total production. By contrast, changes in the rate of a unit-based, fixed tax will create the need for higher unit value of production to break even, thus reducing the size of economically exploitable reserves and the life of a mine to a lower, sub-optimal, hence economically inefficient level."*

(Source: Guj P. 2012 IM4DC p6)

# RRT in Africa: Minimal RR Capture



| Country | Sector | Year/s | Type |
|---|---|---|---|
| Ghana | HCs | 1984 | contractual |
| Tanzania | HCs | 1984 | contractual |
| Ghana | Minerals | 1985-2003 | Law |
| Madagascar | HCs & Minerals | 1980s | Law |
| Namibia | HCs | 1993 | Law |
| Zimbabwe | Minerals | 1994 | Law |
| Angola | HCs | 1990s | contractual |
| Malawi | Minerals | 2006 | Law |
| Liberia | Minerals | 2008 | Law |

Adapted from Land B. 2010, p243

*Recent- Mozambique RRT for minerals: 20% on ROI>18%*

*Also, several African states have a "free-carry" which can equate to a RRT*










# Transfer Pricing – shifting surplus to lower tax jurisdictions (tax havens) through associated/related (A/R) companies

*Over-invoicing of costs:*

- *Interest – loans from A/R entities*
- *HQ costs*
- *Services – from A/R entities*
- *Goods – from A/R entities - no "fixed" price (brands, discounts, models, refurbished, et al)*
- *Etc.*

*Under-invoicing of revenues:*

- *Ores – no terminal price (different grades, contaminants, sizing, etc.)*
- *Concentrates - ditto*
- *Metals – terminal price, but hedging to associated/related entities*
- *Alloys – no terminal price (different grades, contaminants)*
- *Etc.*

# Ad valorem royalties on sales are usually easier to collect – the surplus declared for RRT/state equity and CIT can be dramatically reduced through *Transfer Pricing*








PROFIT

Transfer Pricing

Under-invoicing of sales

Over-invoicing of costs

Inputs, purchases

Finance charges

Labour

Profit transferred to a low tax jurisdiction

- Assess tax (costs) self-audit, (revenue >$200mn?)
- Assess not accepting FDI from tax havens

Africa is estimated to lose ~US$60 billion annually through illicit flows!

# Deployment of RRTs – SWF (IGE)










State

Miner

Resource Rents = "luck" rents (differential & scarcity rents)

"Normal" ROI

Tax

Labour

Inputs (purchases)

State RRT

STEM HRD, RDI (schools, Unis, technicians)

Resources Development Funds (geo-survey)

Fiscal Stability Funds

Infrastructure Funds

Sustainable Development - IGE



# Definitions

- **Trade mispricing – includes trade between unrelated or apparently unrelated parties. Over/under-invoicing of imports and exports; usually aimed at tax evasion.**
- **Transfer (mis)pricing – a category of trade mispricing; trade between companies of the same multinational group/subsidiaries is deliberately mispriced**
- **Illicit Financial Flows generally defined as a combination of:**

  **- Trade & Transfer Mispricing/Misinvoicing *(GFI uses GER)* and**

  **- Other unrecorded financial flows including proceeds of corruption, criminal activity *(GFI now uses HMN)***










# GFI IFF 2014 Study

There are two primary, detectable routes that illicit capital takes as it moves out of a country:

a) the deliberate misinvoicing of external trade transactions and

b) leakages from the balance of payments.

GFI measures trade misinvoicing using the Gross Excluding Reversals (GER) methodology.

This methodology, which draws upon the IMF Direction of Trade Statistics (DOTS) database in conjunction with its International Financial Statistics (IFS) database, estimates trade misinvoicing by looking for imbalances in reported export and import values between a country of interest and the world.

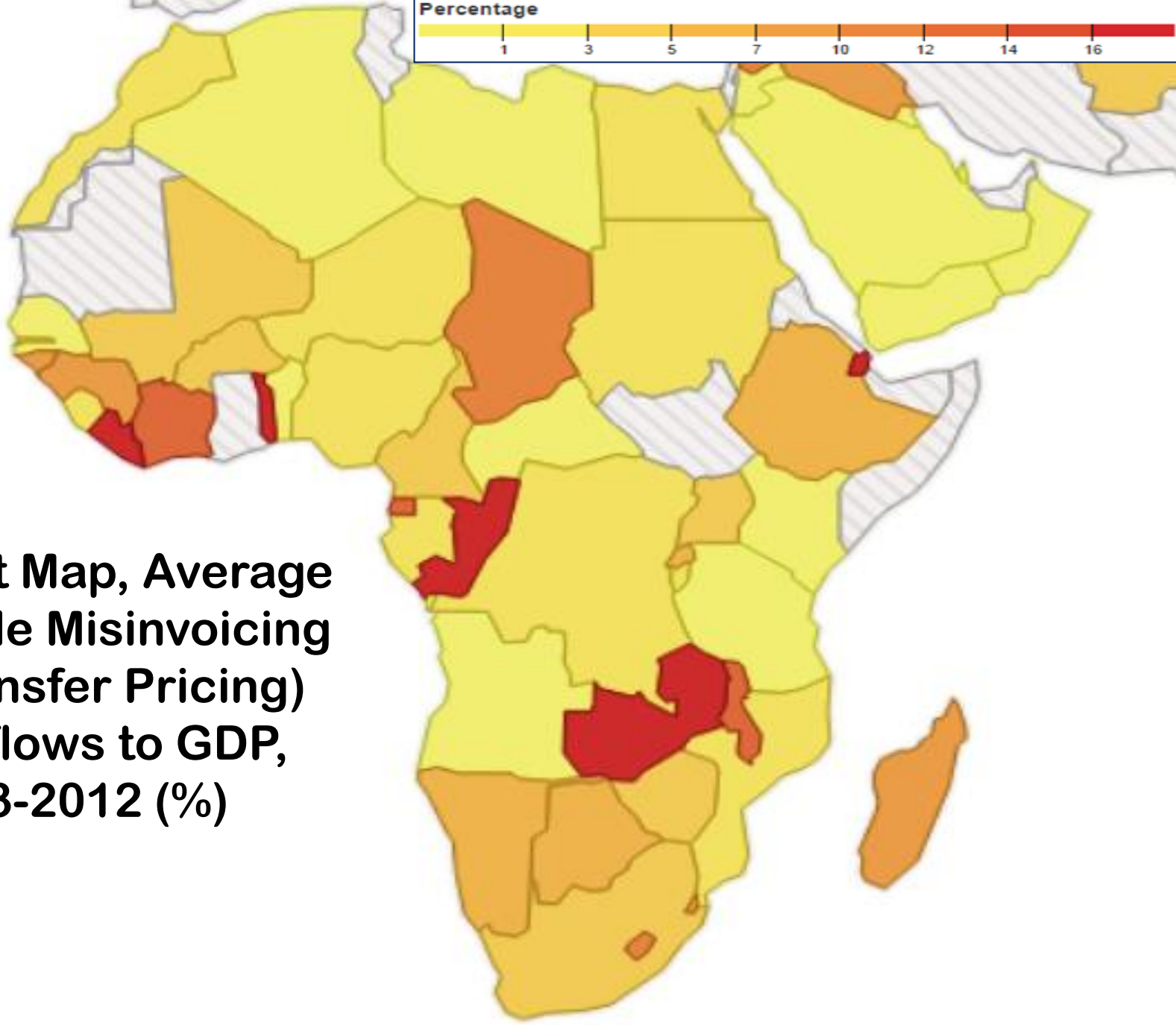








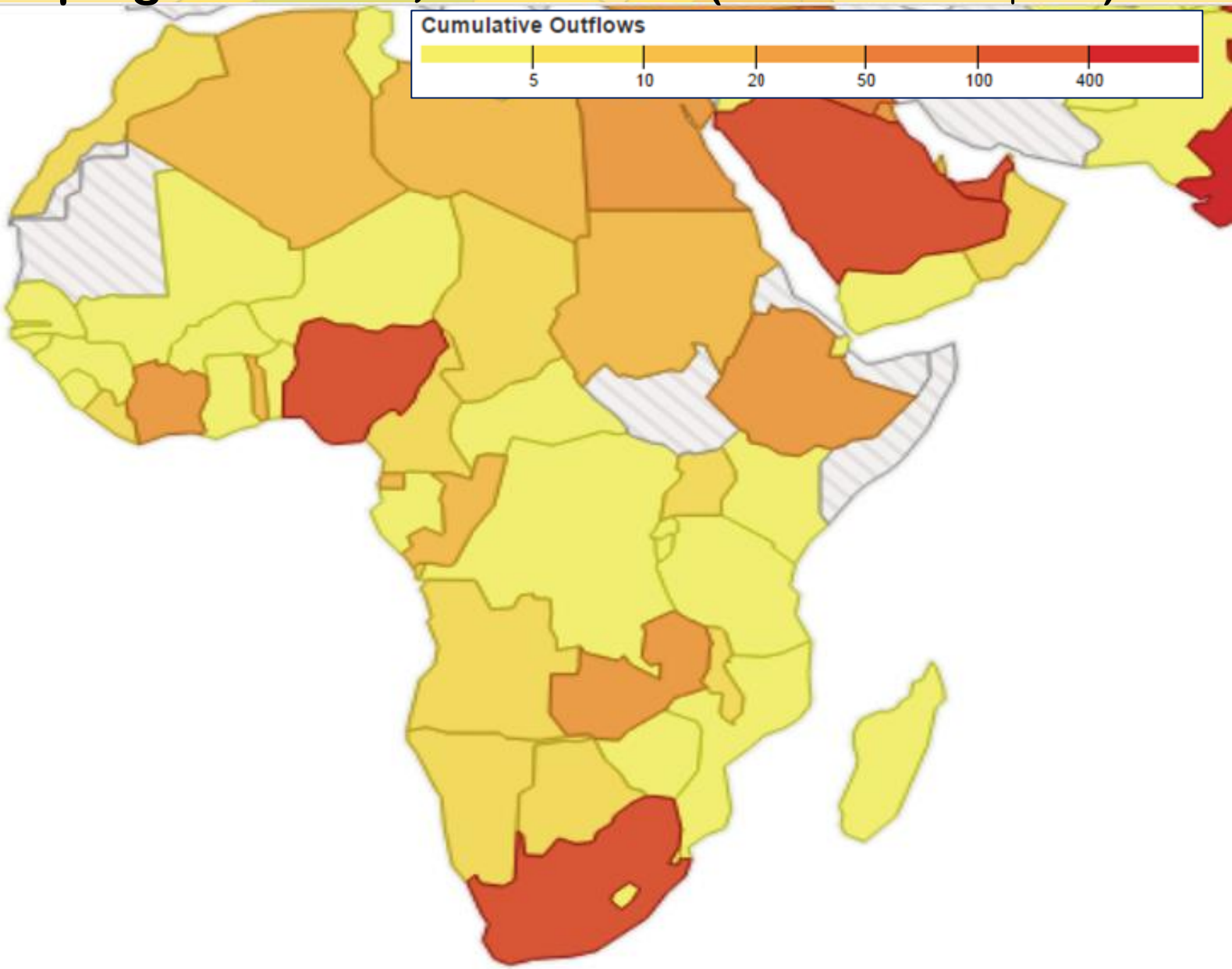

# Heat Map, Average Trade Misinvoicing (Transfer Pricing) Outflows to GDP, 2003-2012 (%)




*GFI 2014- IFF from Developing Countries 2003-2012*

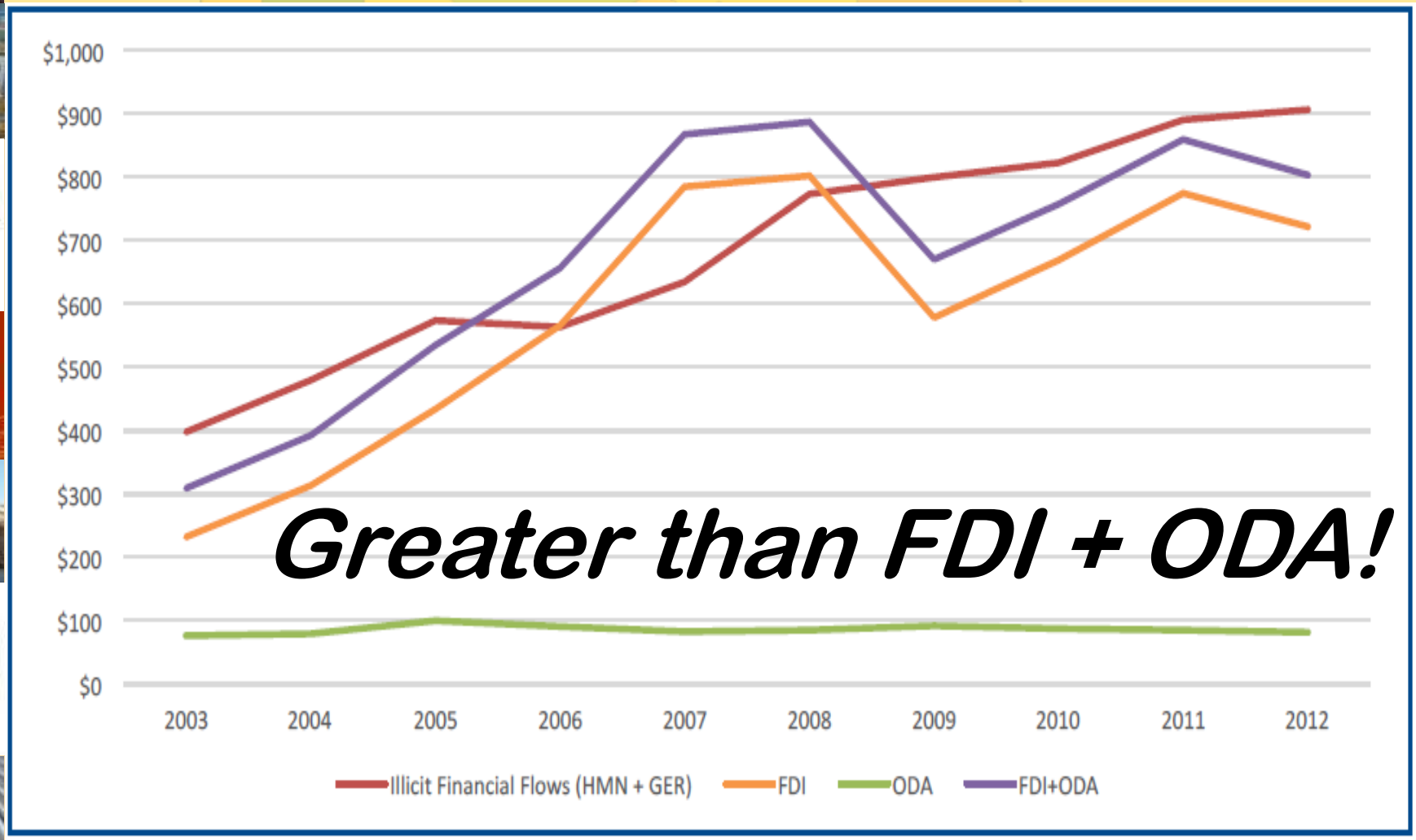
# Heat Map, Cumulative Illicit Financial Flows from Developing Countries, 2003-2012 (nominal US$ bn)






*GFI 2014- IFF from Developing Countries 2003-2012*

# Real Illicit Financial Flows, Official Development Assistance, & Foreign Direct Investment 2003-2012 (constant 2010 US$ bn)




*Sources: GFI (IFFs), World Bank (FDI), OECD/World Bank (ODA)*

## Illicit Financial Flows from Developing Countries, by Region, 2003-2012 (in billions of nominal U.S. dollars)

| Region | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | Cumulative |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Sub-Saharan Africa | 12.1 | 20.3 | 38.2 | 51.1 | 67.0 | 73.4 | 75.0 | 58.0 | 65.2 | 68.6 | 528.9 |
| Asia | 131.2 | 167.1 | 184.7 | 201.3 | 227.3 | 263.4 | 267.3 | 368.1 | 371.4 | 473.9 | 2,655.6 |
| Developing Europe | 68.1 | 73.9 | 85.9 | 95.9 | 131.7 | 168.1 | 175.1 | 170.3 | 250.9 | 166.5 | 1,386.4 |
| MENA | 6.0 | 22.7 | 57.8 | 51.1 | 42.6 | 131.8 | 118.6 | 74.2 | 109.2 | 113.4 | 727.4 |
| Western Hemisphere | 80.0 | 96.9 | 122.3 | 103.3 | 124.9 | 156.7 | 112.3 | 151.4 | 172.0 | 168.8 | 1,288.8 |
| All Developing Countries | 297.4 | 380.8 | 489.0 | 502.8 | 593.5 | 793.4 | 748.3 | 821.9 | 968.7 | 991.2 | 6,587.1 |

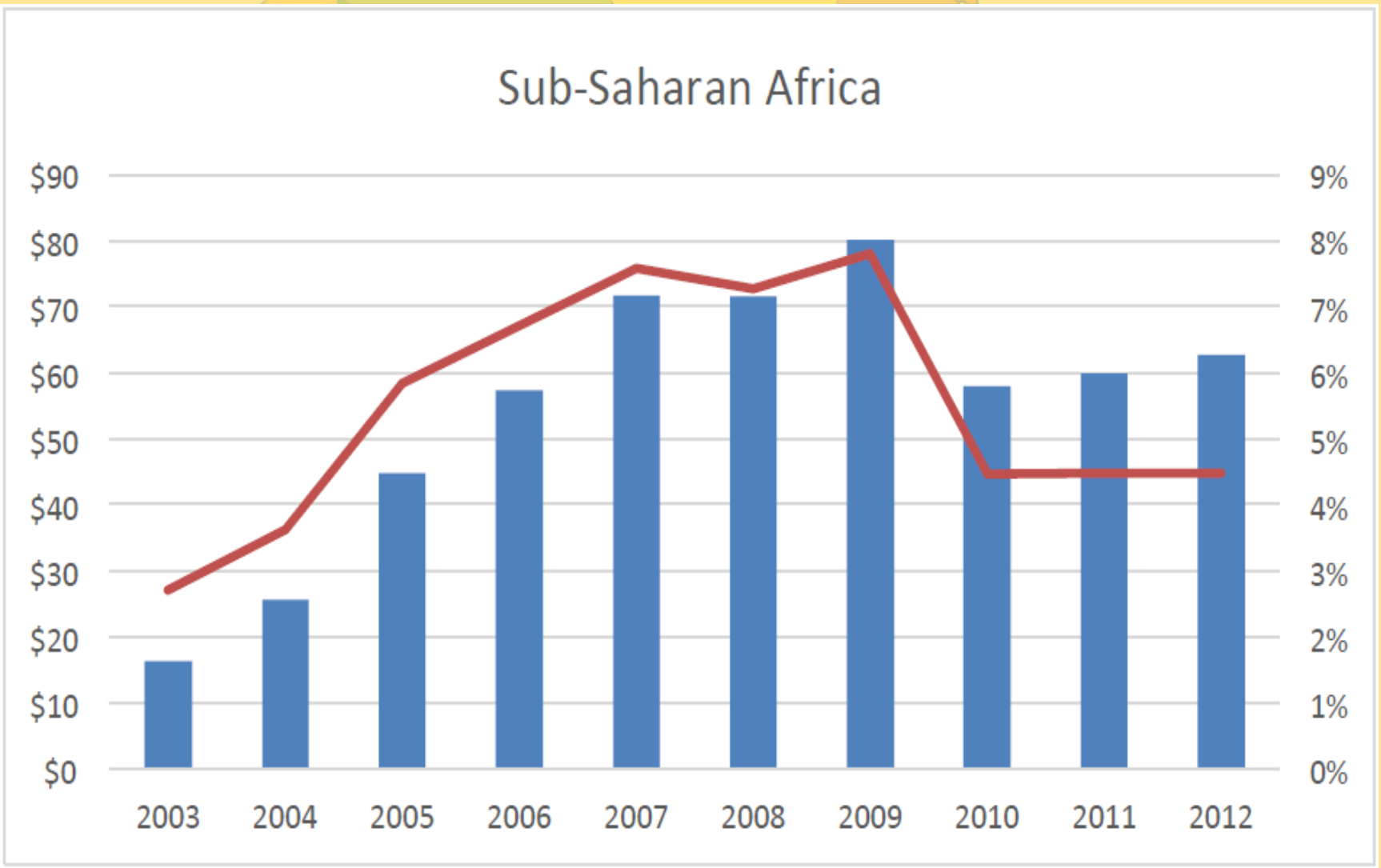
## Illicit Financial Flows from Developing Countries, by Component, 2003-2012 (in billions of nominal U.S. dollars)

| All Developing Countries | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | Cumulative |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Trade Misinvoicing Outflows (GER) | 257.5 | 347.1 | 369.2 | 412.4 | 495.5 | 594.1 | 514.5 | 594.3 | 786.7 | 729.9 | 5,101.1 |
| Illicit Hot Money Outflows (HMN) | 39.9 | 33.8 | 119.8 | 90.4 | 98.0 | 199.3 | 233.8 | 227.6 | 182.0 | 261.4 | 1,486.0 |
| Total | 297.4 | 380.8 | 489.0 | 502.8 | 593.5 | 793.4 | 748.3 | 821.9 | 968.7 | 991.2 | 6,587.1 |

*GFI 2014- IFF from Developing Countries 2003-2012*



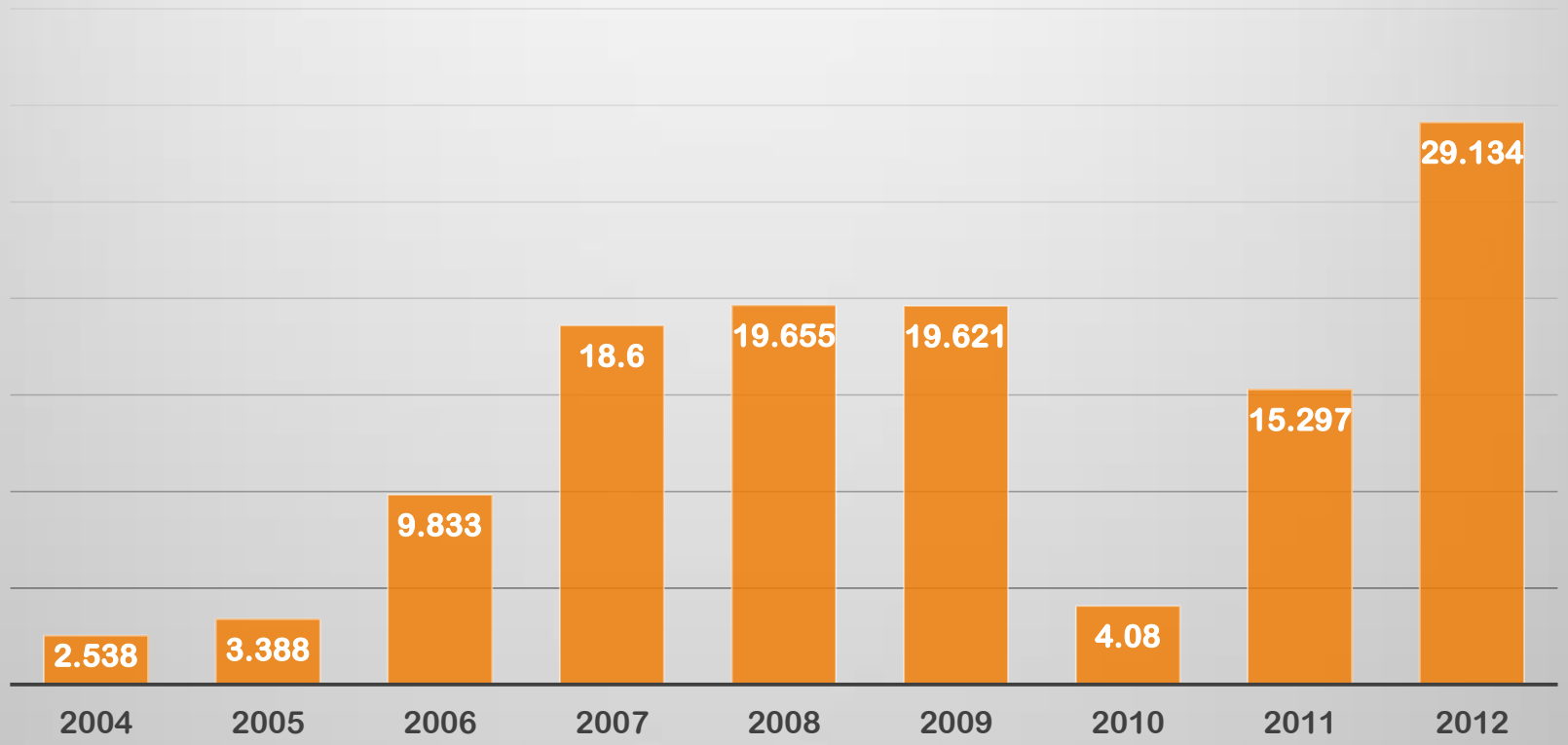
# Real Illicit Financial Flows & Illicit Financial Flows to GDP SSA, 2003-2012 (constant US$ bn, base year 2010, or in percent)




*GFI 2014- IFF from Developing Countries 2003-2012*

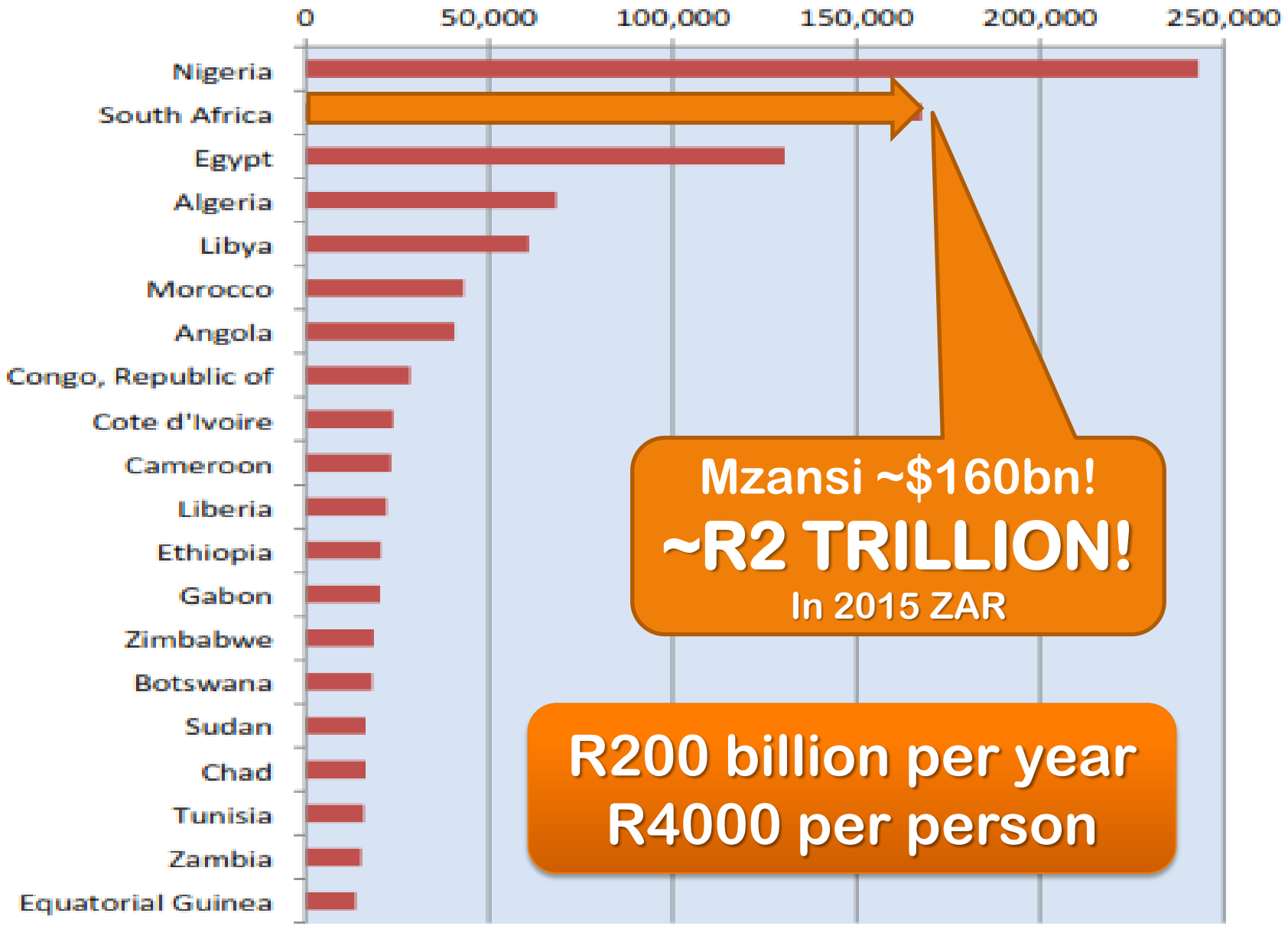


# IFF from South Africa in billion USD
# GFI 2014
# Cumulative 122 billion USD; Average 13.5 billion USD



# Top 20 Countries' Cumulative Non-normalized Illicit Financial Flows, 2000-2009 (GFI/AfDB, 2013)






**Mzansi ~$160bn!**

**~R2 TRILLION!**

**In 2015 ZAR**

**R200 billion per year**

**R4000 per person**

# Africa: Cumulative Real Net Resource Transfers, 1980-2009 (in millions of 2005 U.S. dollars, GFI/AfDB 2013)



From 1980-2009 Africa lost US$1.4 trillion through illicit financial flows ($140bn/an)

Tunisia 32787
Morocco 69561
Algeria -173711
Libya -222875
Egypt 4176
Mauritania 2774
Mali 13681
Niger 5701
Chad -3905
Sudan 22957
Eritrea 1372
Cape Verde 6514
Senegal 26089
Gambia -670
Burkina Faso 12515
Guinea -388
Nigeria -252357
Djibouti -2337
Guinea Bissau 1591
Sierra Leone 800
Liberia -12532
Côte d'Ivoire -23297
Benin 8748
Togo 4799
Ghana 33077
Cameroon -11773
Cent African Rep 1330
Ethiopia 18352
Somalia 4414
Uganda 21074
Kenya 35383
Rwanda 7270
Burundi 4477
Seychelles -1463
Gabon -34470
Congo -20850
Equatorial Guinea -1907
São Tomé and Príncipe 620
Dem. Rep. of Congo -1665
Tanzania 31591
Angola -45632
Zambia -651
Malawi 2440
Comoros 1167
Zimbabwe -11845
Namibia -7460
Botswana -30676
Mozambique 25427
Madagascar 8658
Mauritius -1486
Swaziland -1195
South Africa -183794
Lesotho 5216

**Millions of 2005 U.S. Dollars**

- > 26,000
- 17,286 to 26,000
- 8,572 to 17,286
- 0 to 8,572
- -8,856 to 0
- -17,570 to -8,856
- -26,284 to -17,570
- -98,342 to -26,284
- < -98,342

# The foreign capital (FDI) *"linkages trade-off"*

***In order to rapidly acquire the requisite capital, skills & technology, use FDI (rather than mainly relying on domestic capital). However, this could compromise the seminal resources linkages:***

1) **Fiscal linkages:** Foreign companies have ***more scope & incentive to transfer price*** (tax evasion), especially FDI from "tax havens";
2) **Backward linkages**: TNCs often have ***global purchasing strategies*** which are less likely to develop local suppliers; ***Imports facilitate TP (max returns)***
3) **Forward linkages**: TNCs tend to optimise their ***global processing facilities*** which can deny local downstream opportunities; ***Export ores/concs for TP***
4) **Knowledge linkages**: TNCs locate their ***high level HRD and tech development (RDI) in OECD countries***, thereby denying Africa the development of these critical linkages; ***Overseas RDI & HRD could also facilitate TP***
5) In the longer term there are clearly ***political downsides*** to national resources being dominated by foreign capital.

***Nevertheless, these threats can all be overcome with appropriate resources exploitation policies & strategies and the capacity to implement them!***

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4) Knowledge linkages: TNCs locate their *high level HRD and tech development (RDI) in OECD countries*, thereby denying Africa the development of these critical linkages; *Overseas RDI & HRD could also facilitate TP*
5) In the longer term there are clearly political domestic strategic resources being dominated by foreign capital.

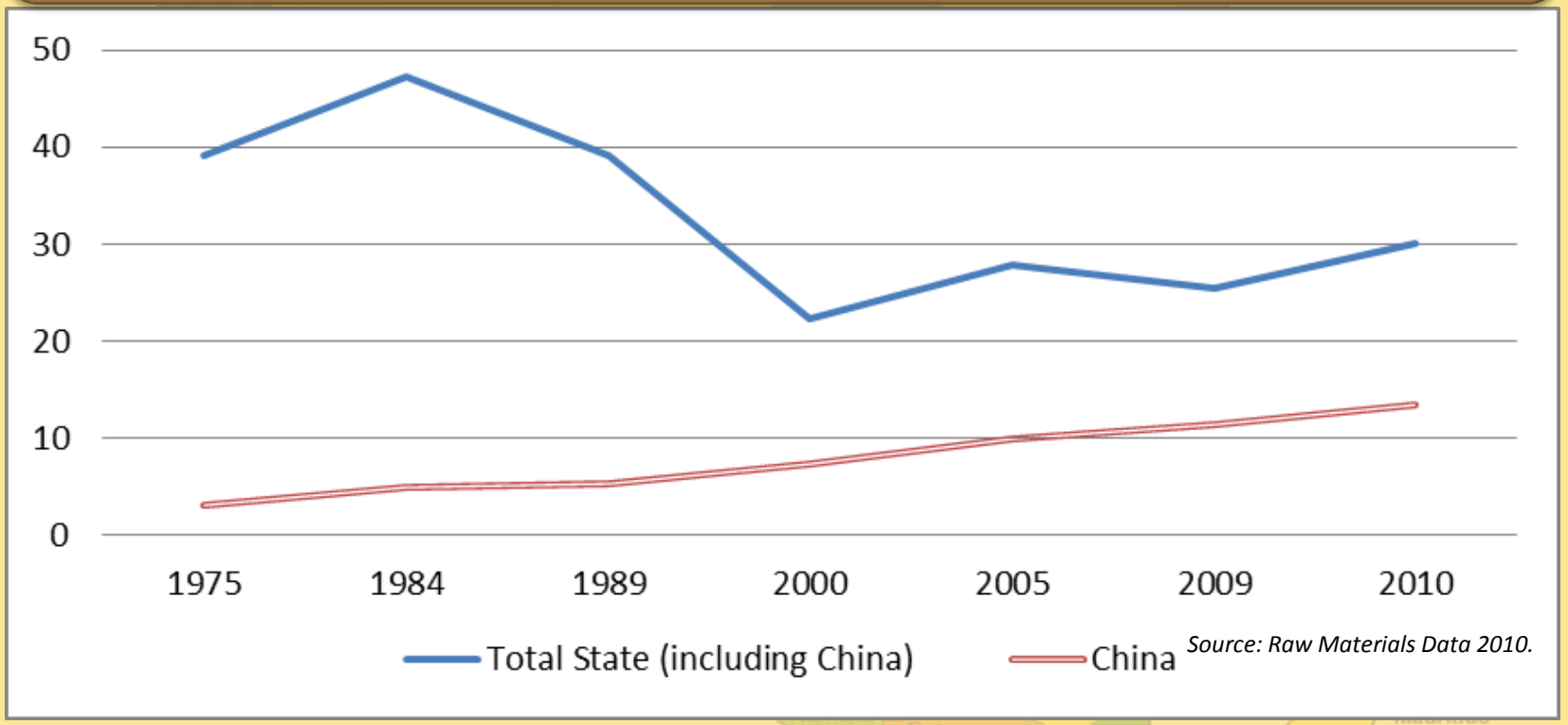
***We need to progressively "normalise" the African minerals development trajectory and optimise retention/reinvestment of the rents/surplus (minimise leakage)***

***Nevertheless, these [illegible] be overcome with appropriate resources exploitation policies & strategies and the capacity to implement them!***

# State Ownership - >RR and >oversight

## Global Mining Ownership

### Total State value at the mine stage (% of total value)




*Source: Raw Materials Data 2010.*

***Ex-China, no increase since 2000!***



# Global "Best Practice" in State Ownership

**The global data on the success/failures of State Mineral Companies (SMCs) shows both widespread failures and successes, though success does correlate with the overall level of economic development. The following key issues appear to be important for successful state mining companies:**

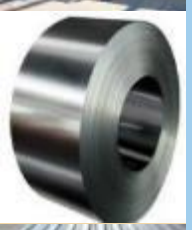
- ***Clear distinction between the state as an owner and a regulator;***
- ***Clear communication lines between owner and the company;***
- ***The company should not be part of the Treasury;***
- ***Full transparency;***
- ***Clear and transparent developmental goals;***
- ***Listing of the state owned company.***

*Source: ANC SIMS Report 2012*










African Mining Projects: 1376 mines and projects worth $130 to $300bn (less than 30% have value data)

Represents a huge market for inputs: > EU or PRC.

We need strategies to realise this market, starting with REC protocols

conceptual prefeasibility feasibility construction operating suspended closed n/a

# Realising the Regional Market AND Combating Bambazonke

## SADC e.g.- Regional Inputs (local content) & Indigenisation example
## Highest GDP/cap 50% eligible, lowest 90%

**e.g. SADC local content eligibility weighted by GDP/capita: Zambia (w/Africa 50% and indig. +10%. Ex-Seychelles)**

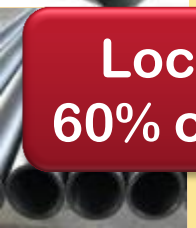
| Putative Local Content (goods & services) Calculation | | | | Regional (REC) GDP/cap weighted VA | | | | | | | | Eligible African Local Cont. (ex-Indig.) | % Af LC | Indigenous/BEE Indig/ BEE (weighted avg% equity?) | Eligible Local Content (national +10%) | Eligible Value as % of Total |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Purch-ase Value $mn | ZAM | e.g. Zim | e.g Tanz | e.g. RSA | e.g. Maur | e.g. Mal-awi | etc … | Afric a VA ex-REC | ex-Afric a VA | Total VA (check) | | | | | |
| Weighting | | 100% | 78% | 87% | 61% | 50% | 90% | etc. | 50% | 0% | | | | | 10% | |
| e.g. 1 Cap Goods | $110 | 20% | 5% | 0% | 22% | 15% | 1% | etc… | 10% | 27% | 100% | $42.20 | 38% | 50% | $44.31 | 40.3% |
| e.g. 2 Consumables | $50 | 70% | 7% | 1% | 14% | 0% | 0% | etc… | 5% | 3% | 100% | $39.69 | 79% | 55% | $41.87 | 83.7% |
| e.g. 3 Services | $135 | 22% | 45% | 2% | 11% | 5% | 3% | etc… | 10% | 2% | 100% | $100.93 | 75% | 70% | $107.99 | 80.0% |
| e.g. 4 Services | $100 | 81% | 0% | 0% | 5% | 5% | 0% | etc… | 0% | 9% | 100% | $83.50 | 84% | 85% | $90.60 | 90.6% |
| e.g. 5 Cap Goods | $97 | 10% | 21% | 0% | 35% | 12% | 7% | etc… | 10% | 5% | 100% | $48.37 | 50% | 30% | $49.82 | 51.4% |
| e.g. 6 Services | $15 | 90% | 0% | 0% | 5% | 0% | 5% | etc… | 0% | 0% | 100% | $14.63 | 98% | 100% | $16.10 | 107.3% |
| e.g. 7 Consumables | $43 | 40% | 0% | 8% | 45% | 6% | 4% | etc… | 3% | -6% | 100% | $24.42 | 57% | 35% | $25.27 | 58.8% |
| e.g. 8 Cap Goods | $23 | 5% | 0% | 0% | 0% | 0% | 0% | etc… | 0% | 95% | 100% | $1.15 | 5% | 35% | $1.19 | 5.2% |

# *Proposed Regional/Local Content (VA) Eligibility Weighting*









**Africa**

- 50% eligibility
- All states ex-SADC

**REC RMCs**

- 50% – 90%
- 1/GDP/cap

**Host RMC**

- 100%
- VA in host RMC

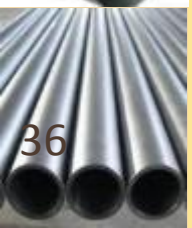
**Local/Regional content of 90% for services; 70% for consumables & 60% of capital goods would dramatically reduce over-invoicing of costs**

*RMC: Regional Member Country*







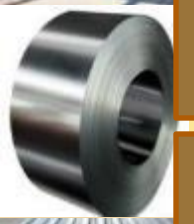



# Conclusions










# *Need "trade-offs" to optimise the resources regime for sustainable development*

***Domestic Capital v/s FDI***

Normal (domestic) resources exploitation is much more likely to make the linkages/industrialise.
However, FDI brings rapid capital, skills and technologies

Accept FDI, but phase in indigenisation and include linkages targets in resources licenses – *they won't happen through market forces alone!*

***Royalties v/s Rent-based revenue (RRT)***

Resource rent tax is least distortionary and more efficient, but royalties are easier to collect (more diff. to crook)
*(state free carry can equate to RRT)*

Apply both, but increase RRT & decrease royalties as state capacity (IRS) to collect is built (to limit transfer pricing)

***Public Tender v/s Free Access (FIFA)***

Public tender of mineral assets optimises impact on G&D, but FIFA is much easier!

Use a hybrid of tender for known assets and FIFA over unknown terrains. > tender with > invest in geo-survey










# Interventions could include:

- Progressively "Normalise" EI – domestic capital
- Capacitate IRS (agency);
- Forensic tax self-audit by forensic accounting company every 5 years (ops w/sales >$200mn);
- Limit thin capitalisation;
- Cap HQ and interest payments (% costs)
- WHT on interest & services?
- Introduce a RRT – ideal moment (low prices)
- Eschew FDI from tax havens (transfer pricing)
- Use APAs (advance pricing agreements) against marker price, e.g. Tuberao pellets for Fe ore;
- Ring-fence hedging in a separate a/c;
- Boost local/regional content and beneficiation with discounted credits for RMCs and Africa;
- Inter-African (REC) cooperation on EI taxation and transfer pricing.










# Thank you

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