

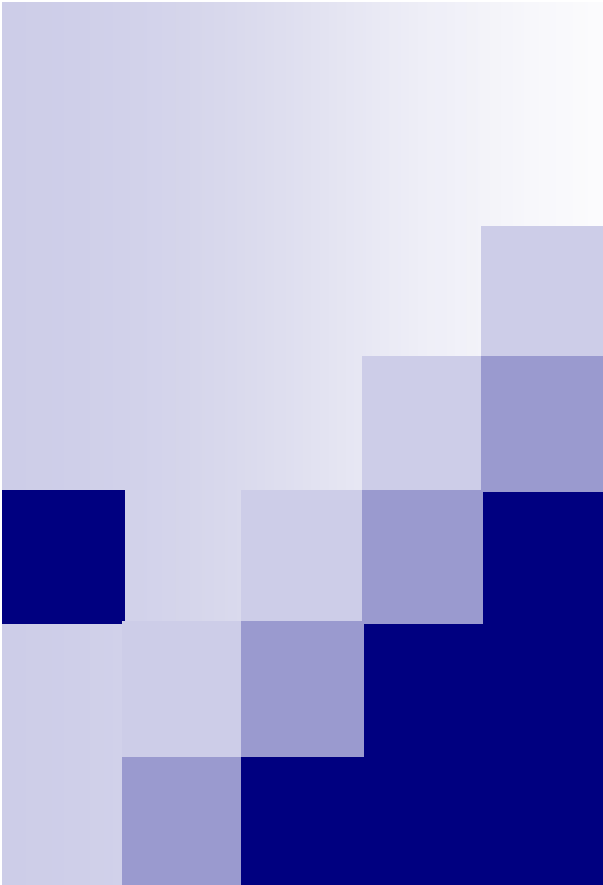


# Contractual Assurances of Fiscal Stability

Philip Daniel and Emil M. Sunley

September 19, 2008

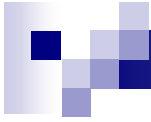
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# Contractual Assurances of Fiscal Stability

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IMF Conference on  
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# Outline

- What are fiscal stability assurances?
- Why should companies want them and governments grant them?
- Fiscal stability in context, framework and alternatives
- Two formulations
- Issues
- Invoking the fiscal stability clause
- Conclusion and issues for discussion



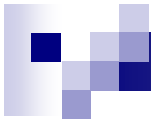
# Fiscal stability assurances

- The reason for:
  - The large size and the sunken nature of the initial investment
  - Long payback and profitability period
  - A lack of credibility that the host country will not change the fiscal rules—the “time inconsistency problem”
- But not all countries grant fiscal stability in their mining and petroleum agreements



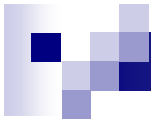
# Why should companies want them – and governments grant them?

- The time inconsistency problem in government policies:
  - Government announces a policy, and then finds it improves welfare to renege
  - Government loses credibility, leading to underinvestment
- Analogy with fiscal or monetary rules:
  - “Commitment”
  - “Signaling” – or
  - “Smokescreen”



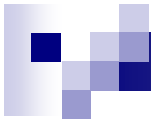
# Trade-off

- On the positive side:
  - Fiscal stability clauses can reduce the contractor's fiscal risk
  - A possible answer to the time inconsistency problem
- There is a cost:
  - Fiscal stability may come at the price of a lower take for the contractor, all other things equal



# Fiscal stability in context

- Overall “stabilization” – preserve economic and legal conditions at the date of the contract
- Legal authority for the assurance
- Make the contract a law (ratify by the legislature)?
- Other devices
  - Bilateral taxation treaties
  - Bilateral investment treaties.



# Two approaches to fiscal stability

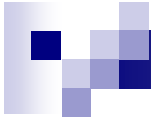
- Frozen law: fiscal stability guaranteed by reference to laws in force on the effective date of the agreement
  - May bestow unintended benefits
- Agree to negotiate to maintain economic equilibrium if there are any adverse changes
  - Should fiscal stability be a one-way bet?
  - Appropriate offsetting change will depend on assumptions regarding future revenues and costs.





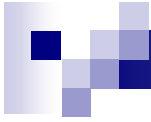
# Issues

- Unsustainable benefits
- The frozen or reference law
- The offsetting change
- The one-way bet
- Fiscal stability as an option



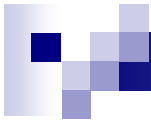
# Unsustainable benefits

- Zambia—0.6 percent royalty and 25 percent corporate tax rate
- Tanzania—income tax not due until project earned a 15 or higher rate of return
- Mongolia—income tax law defective
- Even with an assurance, terms may not survive if not robust or circumstances change.



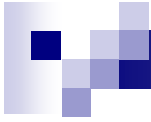
# Frozen or reference law

- May be difficult to determine just what was the law (including regulations and interpretations) when the agreement was signed



# Offsetting change

- Need to quantify the effect of the fiscal change
- Possible with assumptions regarding revenues, costs, and appropriate discount rate
- Offsetting change that is appropriate under one set of assumptions may be too generous or not generous enough under a different set of assumptions



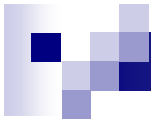
# One-way bet

- Contractors protected from adverse changes; benefit from favorable changes
- May make it difficult for a government to broaden its tax base and reduce tax rates



# Fiscal stability as an option

- Chile—contractor required to pay a higher tax in exchange for fiscal stability
  - 42 percent combined corporate income tax and withholding tax; regular corporate tax 35 percent
  - Contractors can waive fiscal stability but only one time



# Invoking fiscal stability clause

- Few examples where fiscal stability clauses invoked in arbitration or court proceedings
- Nuclear option—breakdown in relation between contractors and government
- Real benefit of fiscal stability clauses may be to sow the seed of doubt in the host government



# Fiscal stability and contract renegotiation

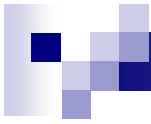
- Since 1999, 28 countries have changed their fiscal terms for petroleum to increase their share of profits or government take
- Fiscal stability clauses do not necessarily prevent renegotiation
- A robust fiscal regime that produces a reasonable sharing of risks and the economic rents will more likely ensure fiscal stability and reduce the pressure to renegotiate agreements





# A proposal

- Assurances of fiscal stability should be time-limited
- Cover capital recovery rules, income and withholding tax rates, royalty rates, and a maximum rate on import duties
- Changes in tax law that affect businesses generally and do not discriminate against mining or petroleum would apply
- But ... remember the “smokescreen”; use this alternative in context of building credibility.



# Issues for discussion

- What are the implications of the surge of mineral and petroleum prices for the design of fiscal regimes and the use of fiscal stability clauses?
- Are fiscal stability clauses in the best interest of shareholders?
- Should assurances of fiscal stability be limited in time and scope?