

# Taxation Mechanism of Fuel and Power Companies: Cross-Country Analysis of Reform Efficiency

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## Abstract

Global fuel and power industry is following the path of oil industry as their common root and strong interconnectedness exist. As a vital product in global market, fuel and energy have a great impact on economy of all countries. However, impact level is different in terms of taxation procedure and manner. Recent changes in global fuel and power market required immediate rethinking of taxation mechanism of fuel and power supply companies who are struggling to keep stable in market volatility and consequent fiscal imbalance. This article studies latest developments in fuel and power sector taxation and compares the impact and efficiency through cross-country analysis.

**Keywords:** fuel and power companies, taxation mechanism, fiscal revenue.

## 1. Introduction

The oil and gas industry, along with nearly all extraction industries, inherently provides substantial economic benefits due to its integrated supply chain, high wage jobs, and propensity to sell nationally and globally (Wobbekindand Lewandowski, 2015). High-income and highly demanded market profile of oil and gas companies not only keeps the economy stable but also strengthens the fiscal balance by generating revenues from excise and direct taxation. However, recent changes in global business environment began touching to the concept, as global oil market faced a strong and sudden long-term price reduction. Volatility in global energy market and shrinking consumption has been affecting the industry negatively. Large number of related business and systemically important corporations rooted from the stem of oil and gas companies, which have a considerable influence in macroeconomic stability in many countries. Power and energy industry is strongly based on the oil and gas sector and often moves in parallel in global scale sectoral trend. Therefore, current situation global oil market has a direct impact on fuel and energy market as an integral component and sub-sector.

The last decade is market with wide-amplitude fluctuations in oil prices and changeable market landscape. World economy barely recovered from global financial crisis and faced the new challenge – oil price shock. Harsh competition in the market took more aggressive character and oil-producer countries stoke to a competitive market share and production volume game in the context of sleeping market. This strict competition came extraordinarily expensive for some large oil producer economies. Too big to fail petroleum companies still coping for survive in the market. They have a large financial gap and an increasing volume of loss. The problem is even worse in economies with absolute dependence to oil revenues. Sudden and a sharp fall in oil prices led to huge fiscal gap in their budgets with a strong need for external financial support. Reduced revenues from oil, taxes from oil companies and their employees' income brought to serious lack of funding in a whole economy. Therefore, nowadays taxation policy of oil and gas industry, especially fuel and power companies remained as a hotly debated topic to be revised and adapted to a new rules of global oil market. This article studies the driving factors of change of taxation mechanism of fuel and power suppliers and proposes theoretically and empirically proven recommendations to revise and enhance taxation mechanism in accordance with current market profile.

## 2. Statement of Problem

Global fuel and energy market took its roots from oil markets which are highly vulnerable to non-cyclical financial and political risks in true manner. Therefore, fuel and power industry is always proved to be the most volatile market in condition of economic downturn. Price shocks in fuel and power markets call large fiscal challenges in global scope which last long and have significant negative implications. Some economies are fully dependent for fuel export revenue and their finance is totally built on fuel and power supply and consumption taxes. Recent oil price drop seriously hit the budget of several dependent economies due to extreme shortage of revenues from production and exports. Nowadays, they are attempting to cope with fiscal crisis and revising rebuilding fuel and power sector taxation mechanism. However, it does not mean that fuel and power industry taxation is important for only dependent and damaged countries. Any economy should revise and rethink the

applicability and relevance of current taxation mechanism of these most important commodities. This article deals with two key problems: (a) creation of flexible sector-specific tax mechanism which fits to all market cycles; and (b) relevance assessment of recent developments in fuel and power production companies in key fuel and power producer countries by comparative assessment.

### 3. Literature Review

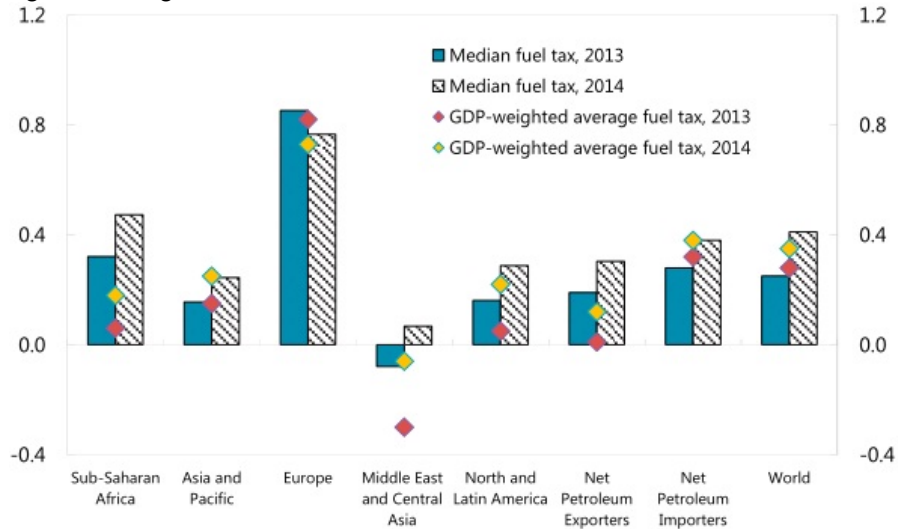
In the last couple of years global fuel and power industry faced several market related challenges derived from systemic and external factors. Subsequent slowdowns in oil price and inefficient negotiations for keeping the market share balance in the world market created a critical situation. Policymakers, business rounds and academia took immediate actions to tackle the issue as optimal as possible. Although a great deal of analytical reports, research and policy papers were announced, literature with relevant policy applications is still limited. Fiscal impacts are overinvestigated without any applicable insights of taxation mechanism enhancement.

Global Fiscal Watch (2015) analyzed the global oil market and fuel industry and found that Venezuela and Russia are a pair of countries who need a deep reform in taxation of petroleum companies. IMF experts (2012) revealed that oil-rich countries generate their 50 per cent of their budget revenues and these countries make of 20 per cent of total number IMF members. This trend keeps growing. In 2015 Husain, Arezki, Breuer, Haksar, Helbling, Medas and Sommer conducted a large scale study on fuel industry and its fiscal impact in the world. They found that lower global crude oil prices had not fully passed through to domestic retail prices. The extent to which domestic prices responded depends on price setting (market-based versus regulated), tax structure, and policy responses. Analysis of retail price data suggested that the median pass-through to gasoline and diesel prices was about 50 percent in the second half of 2014. There were also large differences within regions, partly reflecting discretionary policy responses to fiscal pressures or fuel pricing reforms. HM Treasury's investigations in 2014 suggested that there is a need for simplifying the fiscal regime to provide greater certainty, lower administrative burden, and fewer distortions, due to large investment capacity of British fuel industry. It means that in an unsound market condition fuel and power companies lost their income, so any increase in tax burdens for them creates more financial difficulties.

### 4. Taxation Mechanism and Tax Environment in Fuel and Power Enterprises: Best Practices and Development Horizons

Oil and gas extraction plays a dominant role as a source of export earnings and, to a lesser extent, employment in many developing countries. But the most important benefit for a country from development of the oil and gas sector is likely to be its fiscal role in generating tax and other revenue for the government (Sunley, Baunsgaard and Simard, 2002). The fiscal regime can be used to convert a government's policy into economic signals to the market, and influence investment decisions, provided that the framework is clear, is not changed retroactively, and does not discriminate among the actors (Tordo, 2007). Fiscal role of oil and gas, fuel and power industries is the central for financial stability of several economies, as it provides the largest share of revenue to the budget and foreign trade volume. Especially fuel and power companies provide a considerable part of government revenues in the form of tax and other mandatory payments. The fiscal regime for fuel and power industry of a country is a set of laws, regulations and agreements which deals with economic benefits derived from power and fuel production. Hence there is not any ideal taxation model, as each country has its own circumstance, needs and strategies in fuel and power supply. Therefore, taxation practices differ across countries additionally depending on the development level of business tax system and ownership structures. In developed economies corporate taxation system is prioritized, while in developing counterparts apply multiple non-unified taxation policy for enterprises (Figure 1). However, in both economies there are several mandatory fees and specific types of taxes in accordance with business sector and operating area. In the context of global fuel and power producing enterprises, special taxes on oil and gas mining, petroleum extracting, fuel and power producing companies are levied. Although petroleum, oil and gas, and hydrocarbons are not mineral resources, the term mineral rights is used to denote rights to exploit oil and gas resources from the underground to produce fuel. In some developed countries they pay resource rent payments and a large sum for official permission to start production. Moreover, fuel and power producing companies in resource rich countries are taxed with a particular rate of mandatory fee for the volume of production.

Figure 1. Average fuel tax in around the world in 2013-2014, USD



Source: IMF, 2015.

In developing and transition economies tax system lacks in uniformity and simplicity. Therefore, large and small companies often are taxed with multiple taxes and levies. Unified and simplified taxation policy often poses difficulties for enterprises due to the existence of structural barriers in business regulation, entrepreneurship environment and forms of ownership. Therefore, fuel and oil companies in developing countries are levied different taxes such as resource tax, profit tax, special tax on turnover, diverse mandatory membership and union fees.

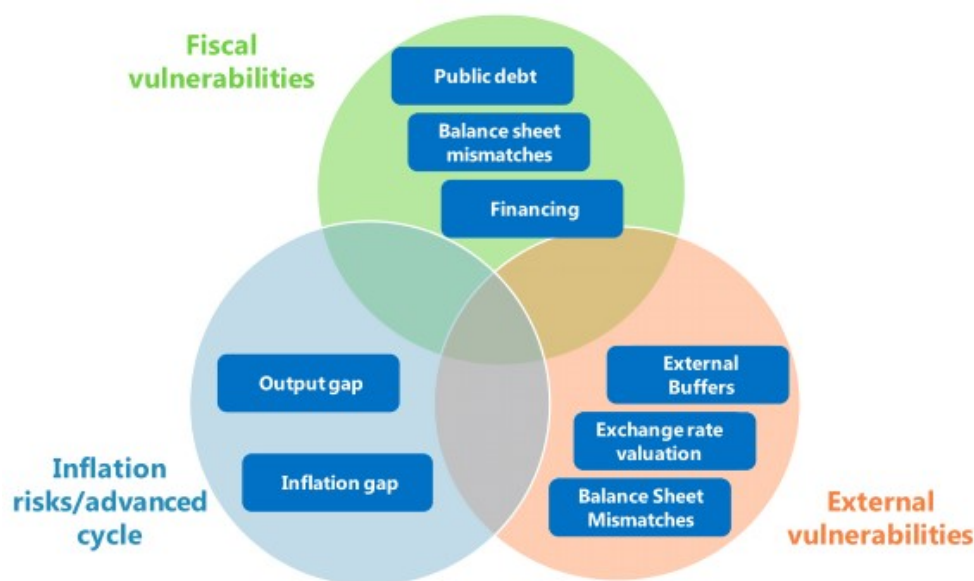
Fiscal system in large petrol producing countries embraces several elements which have commonness for all. Bonuses, corporate tax, royalties, production shares, surface fee, ring face corporation tax, environment fees, direct financial interest for the government are the commonly levied taxes and fees. Bonuses are levied in the forms of signature bonus, discovery bonus, first fuel sales, production sale, which can be classified as a regular and onetime. Royalties are shares of extracted fuel and power entitled to the host economy. Production shares are entitled only if there is a state-owned oil and gas company. Contractor and the state share the margin between cost oil and profit oil. Surface fees are paid on annual basis, depending on the area of oil mining and petrol extraction spot as shown in the license or lease agreement. Algeria, Angola, Benin, Brazil, Cameroon, Mauritania and Norway introduced this mandatory levy as a primary oil revenue. Moreover, there are some country specific taxes which make a significant contribution in tax revenues of state budget. In the United Kingdom petroleum producing companies introduced petroleum revenue tax at 50 per cent of received income and ring face corporation tax which takes 30 per cent of income. Norway adopted the same practice by levying up to 51 per cent of paid corporate tax and state's direct financial interest from oil producers of Norwegian continental shelves.

### 5. Prerequisites of Improving Taxation Mechanism of Fuel and Power Companies in Interconnected Global Market

The optimal design of a tax system is a topic that has long fascinated economic theorists and flummoxed economic policymakers (Mankiw, Weinzierl, and Yagan, 2009). It is impossible to conceive a fiscal regime that meets all the required characteristics at all prices, at all times for all sizes of fields and cost structures likely to be encountered in a given basin (Nakhle, 2008). Fiscal regime for a particular sector or industry is of regular change, if it is a backbone for domestic economy. Any shifts in macroeconomic stability influences directly through all possible impact channels. In modern economic history of the world, global economy underwent numerous fiscal crisis rooted from sector-specific downfalls. However, as global economic linkages and transmission tools developed, sector-specific downfalls got modern face. Till 20<sup>th</sup> century, natural calamities (droughts, floods etc.) led imbalance in domestic economy and resulted in hunger, broken public budget and unemployment, while integrated economic relations created worldwide environment with cross-country pass-through effect from systemic faults in backbone sectors of individual economies. Ongoing oil price crisis hit main oil-exporting economies and brought serious economic implications like slowdown, fiscal imbalance, unemployment and

commodity market disorder. Economic tightening in these countries required to revise taxation policy of key enterprises and consumers. However, they presented easing in tax payment for main affected enterprises – oil mining, refinery, power and fuel production and distribution companies due to prolonged economic downturn. Taxation policy changes for power and fuel suppliers concentrated on tackling key issues of oil-dependent economies which have long term impact, especially fiscal vulnerabilities, inflation risk and other external shocks (Figure 2).

Figure 2. Impact channels of taxation mechanism improvement in power and fuel industry in oil dependent countries



Source: Author's modifications from Hussain et al., 2016.

In international perspective, countries and companies dependent on fuel and power industry revenues have already been significantly re-priced, especially those with existing vulnerabilities, but the impact may not yet have been fully felt. In particular, a number of fuel and power production companies accumulated sizable debt during the period of high fuel prices. Because the oil price drop is expected to have a large and long term impact in separate fuel and power markets, fuel exporters need fiscal adjustments to pay less taxes in condition of market size reduction. In these countries, exchange rate regime is lagging behind that fuel and power market policy should be tailored to domestic and international market cycles, inflation targets, and other external shocks. They can find the way for normalization through macroprudential policy revisions especial for fuel and power industry.

Fuel and power importers, in deciding how much of the windfall to save, should balance rebuilding policy space with managing domestic cyclical risks. Those with significant vulnerabilities should save much of the windfall, while those facing large output gaps should spend it. Countries should use this period as an opportunity to strengthen their monetary policy frameworks; evidence of second-round disinflationary effects could open space for reducing policy rates in some countries. Low fuel and energy prices provide a window of opportunity to undertake serious fuel pricing and taxation reform in both fuel-importing and exporting countries. The resulting stronger taxation mechanism creates condition for increasing priority expenditures and cutting distortionary taxes, thereby imparting a sustained boost to growth.

## 6. Conclusion

Global fuel and energy market has seen a weak positive impulse in short period by giving a spark of hope for fiscal revival in oil and gas exporting economies. Their prices provide an opportunity to increase domestic fuel and energy prices toward international levels and balance the fiscal stability by establishing a sound specific tax policy for fuel and energy sector companies. However, as discussed above, global scenario suggest that increase of taxes for fuel and oil producing companies eventually stimulates price growth despite low levels of competitive demand with a strong consideration of consumption, fiscal and environmental aspects. Following recommendations are proposed as a research result:

- 1) Fiscal policy strengthening. By revision of sector-specific tax policies, government tries to shorten

- fiscal vulnerabilities or to finance main expenditure priorities e.g. social or public investment. Restructuring of public budget in terms of sector-specific revenue sources enables higher societal impact and can be achieved through optimization of fuel and power production sector taxation mechanism (taxes on both producers and consumers).
- 2) New taxation mechanism for fuel and power suppliers may limit negative spillover between fiscal imbalance, dependency and fiscal inefficiency. Uzbekistan runs a favorable fuel and power taxation policy. However, real life examples can be seen in Venezuela, Russia and other oil exporting countries.
  - 3) New taxation mechanism should include pre-tax and post-tax fuel and power price subsidies, as all funds are paid and received through government budget. Revision of subsidy policy helps improve implicit and explicit fuel and power subsidy cost and its consistence with budget priorities and fiscal strategy.

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