Journal of Mines, Metals and Fuels, *70(10) : 157-160 ; 2022. DOI: 10.18311/jmmf/2022/32302*

Print ISSN : 0022-2755

Journal of Mines, Metals and Fuels

Contents available at: www.informaticsjournals.com/index.php/jmmf

Jayanta Bhattacharya
Hony. Chief Editor

Discussion-Opinion-Editorial

Does Windfall Tax on OMCs Achieve the Goal it Attempts to Achieve? Often Not

The Background

Like many governments around the world, the Government of India recently imposed a windfall tax on all refineries, including SEZ refineries, on the export of diesel, petrol and air turbine fuel. Besides, it also imposed a cess on domestic crude output. Analysts said the development is a setback for refiners as they cut FY23 earnings estimates steeply; it would mean lower investment in exploration and expansion. The tax could potentially be used to offset Oil Marketing Companies (OMC) losses on auto fuel, analysts said. The government has raised export duties on diesel by Rs. 13 a litre and on petrol by Rs. 6 a litre. It has also raised the export duty on ATF by Rs. 1 per litre. The government said Indian exporters would have to sell 50 per cent of petrol in the domestic market on the total shipping bill, while they have to sell 30 per cent of diesel in the domestic market on the total shipping bill. In addition, a cess of Rs. 23,250 per tonne was imposed on crude produced domestically. Morgan Stanley said a higher cess on domestic crude production of $40 a barrel for ONGC and OIL was a negative surprise and should imply downside risks for the sector over the medium term. It impacts ONGC and Oil India earnings for F23 by 36 per cent and 24 per cent, the brokerage said. The windfall tax on oil produced within India and fuel exported overseas will make up for more than three-fourths of the revenue that the government lost when it cut excise duty on petrol and diesel to cool soaring inflation, industry sources said. India on July 1 joined a select league of nations globally that have taxed windfall gains accruing to oil companies from soaring energy prices. The government slapped a Rs. 6 per litre tax on the export of petrol and jet fuel (ATF) and Rs. 13 a litre on the export of diesel, effective July 1, 2022. Additionally, a tax of Rs. 23,250 per tonne was levied on crude oil produced domestically.

The windfall tax on oil produced within India and fuel exported overseas will make up more than three-fourths of the revenue that the government lost when it cut excise duty on petrol and diesel to cool soaring inflation, industry sources said. India on July 1 joined a select league of nations globally that have taxed windfall gains accruing to oil companies from soaring energy prices.

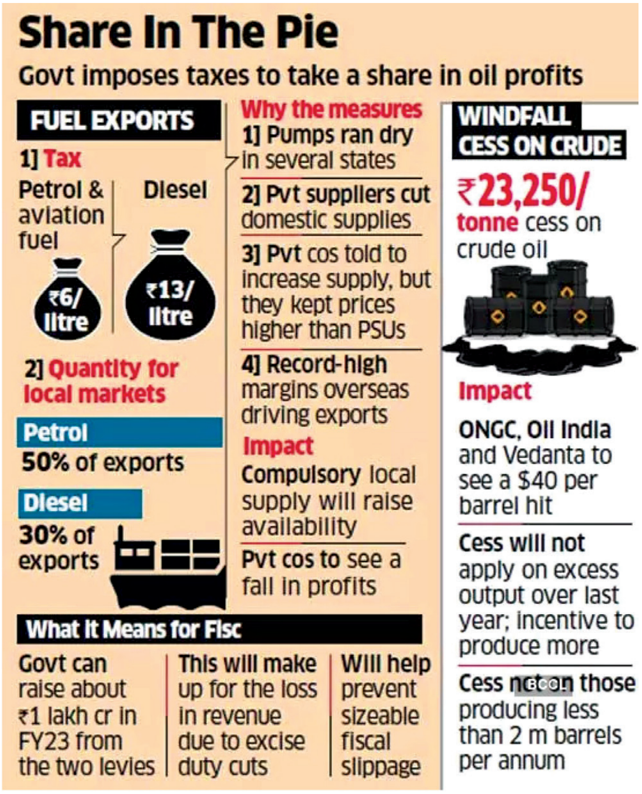


Figure 1. Outline of the tax.

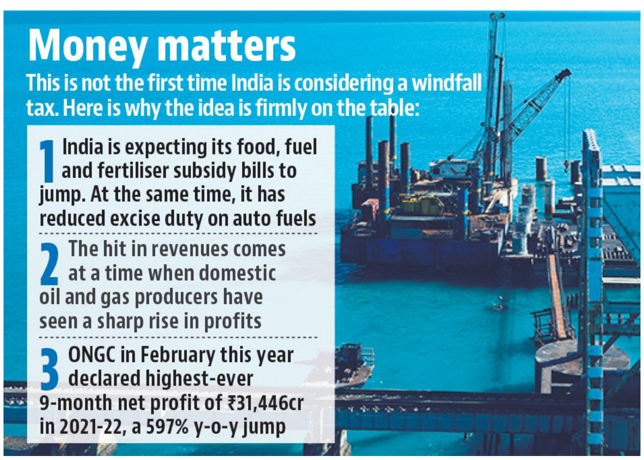


Figure 2. The prelude to the tax.

What Indian government has done is not one of a kind. In May, 22 the United Kingdom announced a windfall tax on energy companies that have been pocketing extraordinary profits as Russia's invasion of Ukraine drives up oil and gas prices. The decision followed similar moves by countries like Italy and Romania on power generators to ensure the industry shared the moolah it's been raking in as a result of the war. Others like the United States and the European Union are also contemplating a tax on the "war-fueled profits" of major energy firms.

Major oil and gas firms such as BP, Exxon and Shell have found themselves in the dock for reporting massive earnings amid the war that has caused food and energy prices to spiral,compounding consumer misery globally. There is a growing clamor that energy companies part with some of those profits to support efforts by governments, most of them saddled with pandemic-era debt, to help ease the burden on poor consumers.

"This is a very obvious moment for a windfall tax because you have an industry which is making what are clearly supernormal profits at a time when the ordinary people who are the consumers of that industry are facing very high costs," said Alex Cobham, chief executive of the Tax Justice Network. "So, doing a one-off redistribution of some of that excess profit in order to reduce the human costs of the price changes makes absolute sense".

What is windfall tax?

A windfall tax is a one-off tax on companies that have seen their profits surge extraordinarily, not because of any clever investment decision they've taken or an increase in efficiency or innovation, but simply because of favorable market conditions.

While an economically efficient way to tax companies that have fortuitously struck gold, windfall taxes are despised by the industry. The one-off taxes, which by definition are imposed retrospectively, are seen as arbitrary, fueling uncertainty among businesses about future taxes.

"I'm not a big fan of windfall taxes. It's better to say in advance how much tax you are going to levy in different circumstances and then do it rather than creating sudden one-off surprises in the tax system", Stuart Adam, senior economist at the Institute for Fiscal Studies in London, told DW.

Adam says windfall taxes are 'arguably' unfair to companies that have made investment decisions based on the existing tax system and are then retrospectively told to pay up more, creating an impression of ambiguity and randomness that can discourage investment.

"If you ask people in business or tax professionals what they look for in the tax system, usually at the top of that list is stability and certainty and predictability and windfall taxes move away from that", he said.

"Having said that, I can see the case for doing it. When something like the Russian invasion of Ukraine happens, you can argue that this isn't something we could legislate for in advance. So, it's fair to tax companies retrospectively because they've benefited from a windfall that they did nothing to earn", Adam said.

The German government, struggling to wean itself off Russian energy while looking to ease the impact of high energy prices on consumers, is also toying with the idea of windfall taxes on energy firms but so far remains split on the issue.

"Such concepts were already being discussed in the 1970s, but have never been implemented," Finance Minister Christian Lindner, who is also the chairman of the pro-business Free Democrats, said in May. "It cannot be clearly identified what an excess profit is or what impact would be associated with it".

What are the arguments favoring windfall tax?

It is generally agreed among economists that, in terms of economic efficiency, taxes should lead to only minimal changes in behavior, they should be seen to be 'fair' and they should have low collection costs.

A one-off windfall tax that is based on past behavior and is a response to an external event that was not foreseen has a strong case to be regarded as more economically efficient than, for example, an increase in the corporate tax rate that will apply for the next few years or an increase in personal income taxes that affect decisions about working time, spending and saving.

It is, of course, difficult to be certain that when any such tax is applied, it will be a one-off. But the history of the past half-century has shown that such taxes have not been frequently used. The timing of a windfall tax is also an important consideration. If, for example, the government announced today that it would be applying the tax at some point in the future, then companies could change their behavior and so reduce or negate the economic efficiency benefits of a windfall tax.

Windfall profits do not represent a reward for any factor of production or entrepreneurship. As a result, economists can argue that taxing them is fair, particularly relative to taxing, say, workers' income. The ideas of burden-sharing and fairness within society have been echoed in the debate on this issue.

Finally, a well-designed windfall tax is relatively easy to impose on firms, easy for firms to comply with, and hard to avoid. This results in a relatively predictable tax yield, which is particularly helpful if the funds received are aimed at a particular problem (such as helping to alleviate the burden of energy bills on struggling households).

What are the arguments against a windfall tax?

There are essentially four arguments against a windfall tax on oil and gas companies' profits.

1. Although a windfall tax may appear economically efficient in theory, in practice it may not be. The imposition of the tax may create uncertainty about the future tax regime (perhaps not only for oil and gas companies but for other companies – what's usually thought of as the 'thin edge of the wedge' argument) and, by so doing, reduce future investment spending by oil companies. But the economic evidence on this point is mixed. Some research points to the adverse effect of increased uncertainty on investment, but the energy sector is in many ways a special case and has particular tax incentives for investment already. In addition, the major UK oil companies operate globally and imposing a windfall tax in one jurisdiction may, over time, lead to changes in location to avoid such taxes.

2. Given the imperatives of combating climate change and providing energy security, the energy sector is particularly important. A reduction in profits (whether excess or not) might deter the pace of investment in renewable energy and slow the move toward increased energy security. In effect, imposing a windfall tax might result in some short-term gains, but this might be more than offset by longer-term losses.

3. Such taxes are asymmetric and judgmental. If oil prices were to collapse, oil company profits would do so too. Oil companies suffering a one-off tax now might then call for a one-off subsidy. There may have been calls for windfall taxes in the past, but if oil companies make losses due to falling global oil prices, there may be fewer calls to provide funds to support them. In addition, there is the question of how to determine that some particular level of profit is 'normal' and some higher level of profit is 'excessive'. In one sense that arbitrariness of the definition adds to the idea of economic efficiency – the company does not know beforehand what profit level will be judged to be excessive

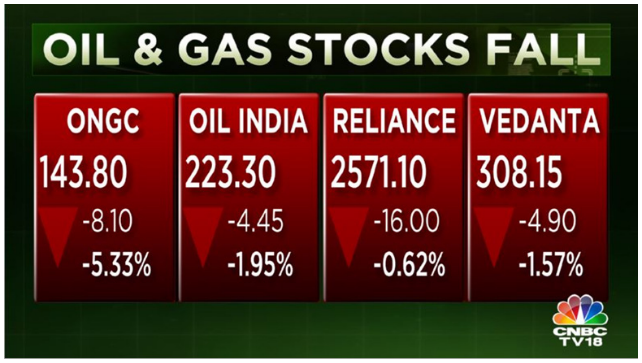
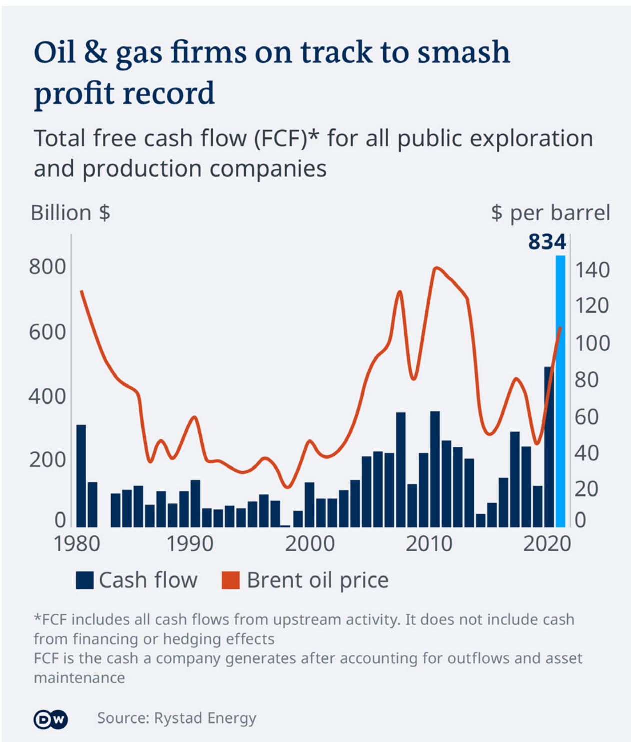


Figure 3. The impact of the announcement.



and so cannot adjust its behavior to that. But in another sense, it effectively means that the level of normal profit would be determined by the Chancellor.

4. Finally, the issue of taxing companies raises the broader issue of who is being taxed. A higher tax on company profits would mean, among other things, a lower dividend paid out by the company and potentially a lower share price than otherwise. This would lower the incomes (or wealth) of shareholders, and in the Indian share market, a large proportion of public shares are those of the OMCs and held by retail investors; this could have an adverse effect on the income of investors and mutual funds that depend on them. In essence, profits do go somewhere, and a windfall tax takes them from one group of households (in the case of OMCs, which are global in their shareholder bases, potentially some households in other countries as well as in India) and redistributes them to other households in the society. The efficiency of transfer remains a question, though.

Case of India

Domestic and global investors expect the sanctity of contracts and they should be able to work around it. Unless the government can assure the investors of the complete sanctity of contracts, it is not possible to attract much-needed investment. The proposed windfall taxes will surely override the terms how the government will deal with the sector in the short term and the sanctity of contracts will be violated. Given the poor prospecting scenario of India's sedimentary basins, uncertainty surrounding peak oil demand and finally the huge risk involved in exploration, any imposition of windfall tax would go against the government's own efforts to attract badly needed investment both domestic and foreign. Under the new Hydrocarbon Exploration Licensing Policy, not one foreign oil company participated. Now, with the Damocles sword of the windfall tax hanging over the oil industry, the chances of any foreign investment in India's exploration are likely to be even lower.

References

1. https://economictimes.indiatimes.com/news/economy/finance/windfall-tax-to-recoup-most-of-rs-1-lakh-cr-revenue-lost-in-excise-cuts/articleshow/92629748.cms
2. https://economictimes.indiatimes.com/markets/stocks/news/heres-how-windfall-tax-will-impact-reliance-ongc-and-oil-india/articleshow/92651665.cms
3. https://www.dw.com/en/why-single-out-energy-companies-for-windfall-tax/a-62060966
4. https://www.niesr.ac.uk/blog/windfall-tax-good-idea
5. https://www.deccanherald.com/opinion/panorama/windfall-tax-on-oil-medicine-worse-than-disease-676051.html