

5 reasons why windfall profits tax is wrong

A **day** after Reliance Industries [Get Quote] chairman Mukesh Ambani met Prime Minister Manmohan Singh to forestall political attempts to throttle his oil refinery business, the petroleum ministry has come out with a **detailed** presentation to show that the demand for the windfall profits tax (WPT) on private [oil companies](#) is 'short-sighted populism' and 'bad economics.'

The ministry claims that WPT would neither help in reducing prices of petroleum products nor would it lead to any increase in output. WPT could lead to lower [investment](#) in the petroleum sector and undermine India's energy security, the presentation cautions.

Concerned that the WPT would make investment and production by the domestic [oil companies](#) more expensive, the ministry says these companies should be incentivised to go in for drilling and that any deterrent will slow down any research that could help make future energy in the country less expensive.

In a note, prepared in response to first the Left and now the Samajwadi Party leader Amar Singh's demand for windfall profits tax, the ministry has given five reasons why such a tax defies logic. These are:

* India is neither a major oil producer nor Indian companies have gained much from the rising global prices of oil.

* The government is bound by the contract of the production sharing agreement as part of the NELP (New Exploration Licensing Policy).

* As part of the profit sharing plan, the government is already a beneficiary of the rise in profits of oil companies, besides 35 per cent corporate tax on such profits.

* WPT on the basis of revenues in discovered blocks ignores the huge risks, investments and poor chances of discoveries.

* WPT will discourage [long-term investments](#) in oil industry.

The ministry points out that all over the world discerning opinion leaders see windfall profits tax as no more than a populist political tool designed to make people feel good.

The ministry's note asserted that the clamour in India for such a tax is based on the misleading logic that the rising prices of oil across the globe has helped the oil companies make profits far in excess of what they legitimately deserve.

What about the profit margins in other businesses during boom periods, the ministry asked, and

pointed out that nobody sought a windfall tax on India's software majors when they gained bumper profits from the upsurge in the global IT industry.

It said votaries of the windfall tax have chosen to ignore certain basic facts like the oil companies [pay tax](#) in all its myriad forms and the business being cyclical in nature has also seen these firms go through slumps.

It said the refining business that the votaries of WPT want to attack is also highly cyclical. As new capacity comes on-stream, refining margins decline precipitously. Not to be forgotten is the fact that the refining industry has to invest heavily in technology, upgradation and research to produce cleaner fuels, the note added.

The ministry pointed out that India has stagnated for decades in the production of oil and gas with 70 per cent of its requirements being met through imports and hence the government adopted a production sharing contract to attract investments. It includes royalty to the government and as such the government is getting higher royalty from increase in the oil and gas prices.

The ministry has also recalled how windfall profits tax has been a tried and failed concept in the United States that enacted such a tax in 1980, only to repeal it in 1988 because it was an administrative burden on the Internal Revenue Service, a compliance burden to the oil industry, and made the US more dependent on foreign oil as realised in hindsight.

"One of the unfortunate fallouts of WPT (in the US) was that it had the effect of reducing domestic supply of [crude oil](#) below what the supply would have been without the tax," the ministry noted, pointing out that WPT clamped as an [excise tax](#) would increase the production costs, reduce domestic [oil production](#) and increase the level of imports that are already as high as 70 per cent and are threatened to climb to 90 per cent by 2010.

"Moreover, to say that recent increased profits in the oil sector are a windfall is probably not fair. They are the reward for the risks the industry takes to provide petroleum products to consumers. When profits increase, the government revenues increase simultaneously because [income tax](#) -- federal, state and local -- is paid on higher profits. Thus, even without a windfall profits tax, the government's tax revenues would increase commensurate with any oil industry windfall."

The ministry also warns about the negative effects on the country if WPT is clamped -- like forcing companies to seriously look at [alternative investments](#), it jeopardises investments in high-risk exploration businesses.

