

Response to the discussion document dated 14 July 2006, prepared by the Task Team appointed by the Minister of Finance to consider possible reforms to the fiscal regime applicable to windfall profits in South Africa’s liquid fuel sector.

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Introduction

Having studied the discussion document in its entirety, we wish to comment specifically on the “Progressive Formula Tax” noted in section 9.7: *Request for comment on the fiscal measures identified in the TOR that the Task Team has been requested to consider.*

Progressive formula tax: Synthetic/alternative fuel production could be subject to a formula-based progressive profit tax, along similar lines to the South African gold mining tax formula. Such a formula has some advantages over a price or cost-based arrangement in that it avoids sharp tax thresholds and is linked directly to profitability. It can also provide for relief during periods of low commodity prices and low profitability.

The gold mining tax formula, which has been in use since 1936, has survived various efforts to abolish it, mainly because it enables marginal mines to survive in times of a low gold price and collects a progressively higher tax from richer mines. This formula conforms to the concepts of economic and resource rents as treated in the Discussion Document (DD).

In **Section 2** we discuss the importance of the liquid fuels industry, especially in light of the unique situation in South Africa where we have a synfuel industry producing a large portion of liquid fuel requirements at a considerably lower cost compared with other oil companies.

In **Section 3** we discuss the taxes levied on liquid fuels and the socio-economic effect these have on the poor.

In **Section 4** we deal specifically with Sasol, and using their latest financial statements, show how various formulas based on the gold mining formula would work in their case.

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In **Section 5** we discuss the philosophy of a progressive tax formula in relation to the taxation of economic and resource rentals and in **Section 6** give our views of the imposition of a windfall tax on Sasol and other oil companies.

2. The role and importance of the liquid fuel industry.

The DD points out (section 6) the vast importance of a liquid fuels industry in a non-oil producing country like South Africa, and how the synthetic fuel industry has played a major role in reducing the country's dependence on crude oil imports. This importance is underlined by the government's reluctance to de-regulate the oil and liquid fuel industry. This has resulted in a pump price of petrol and diesel that probably bears little resemblance to the actual cost of producing these fuels in South Africa, especially given the presence of the synfuels industry.

South Africa is in a unique situation in that Sasol produces about 23% of the country's liquid fuel requirements². This means that a large portion of the inland northern provinces' fuel requirements are met by Sasol. Yet inland consumers are burdened with an "imaginary" cost of shipping fuel "produced" at overseas refineries from the coast to inland sites. But with a fungible commodity like oil, chaos would probably ensue if refineries were allowed to sell refined product based on the actual cost plus shipping to the point of sale. It is unclear from the DD what a barrel of refined product costs Sasol (we believe it is currently around \$15 per barrel), but with a breakeven at between \$23 and \$28 for a barrel of crude, their costs must be considerably less than those of the crude oil refineries.

3. Taxes levied on liquid fuels

Another matter underlining the importance of the liquid fuel industry is the comparative ease with which the state is able to collect tax revenues on the sale of liquid fuels. According to the DD this amounted to R24 616bn in the 2004/05 fiscal year (general fuel levy, customs and excise duties and the road accident fund levy, but excluding VAT – page 25).

² Discussion Document, page 68

It is unclear whether VAT is levied before or after the imposition of the above levies, or what the VAT take is on liquid fuels in a fiscal period. Agriculture and mining enjoy rebates on (presumably) the general fuel levy, and this will affect the VAT if it is applied after the general fuel and other levies.

The DD states that the tax content of the fuel price in South Africa is about 40% and that this is relatively low compared with many other countries (page 65). However, it should be pointed out that the first ten countries (Turkey to Lithuania) with high fuel prices and tax takes of 100% or more are mainly small, developed countries with a variety of transport systems. Australia (next after Lithuania) also has a high fuel price and a tax take of about 100%, but in spite of being a very large country, the developed part of the country is probably less than 5% of the land mass. Most of the remaining countries are large, and with the exception of the USA and Canada, are developing countries with much lower tax takes. This is significant because for many of these countries private motor vehicles comprise the most important, if not the only means of transport. In South Africa, with a so-called “low” tax take on fuel, this tax still has an enormous effect on the living standards of the rural poor. Studies by the writers show that the prices of basic necessities in rural shops can be between 30% and 40% higher than in urban supermarkets. In addition, most rural people have to take taxis to the nearest town or village to purchase food and clothing, and fares include a large portion for fuel and vehicle taxes. The same studies have shown that the poorest of the rural poor subsisting on either social grants or piece-work wages, spend at least 10% of their incomes on VAT (some of their purchases are on non-vatable food and school fees).

Thus these indirect taxes compound upon each other, gathering more taxes until they reach their maximum effect on the lowest levels of society. It is little wonder that those who are able soon make their way to the metropolitan areas in search of riches and a better life, leaving only the elderly and very young in the remote rural areas. These are the real unintended consequences of fuel and other indirect taxes.

4. Sasol

Sasol is the only company whose financial statements are available to the writers and we are using their income and value added statements for the three years to 30 June 2005

in order to illustrate a progressive formula tax that could be applied to Sasol and possibly to other oil companies.

Appendix 1 shows combined value added/income statements for the above three years. The format is one that the writers are working on in an attempt to incorporate value added information into an income statement that conforms to international financial reporting standards. All the numbers are taken from the Sasol financial statements and the only number that has had to be surmised is the amount for impairment of non-current assets.

In Appendix 1 we show how the gold-mining formula would work in Sasol's case, using both the profit to revenue and the EBITDA (earnings before interest, taxation, depreciation and amortisation) to revenue ratios. Some may complain that the EBITDA formula does not allow interest, depreciation and amortisation as a "tax deduction", but the point is that this is a formula for calculating a resource rental, not an income tax. In fact the formula may be wholly inappropriate: more study is probably needed to arrive at a proper basis for the calculation of a resource rental. (In this respect, we would draw the attention of the Task Team to a recent article in *Business Day* by Professor Joseph Stiglitz: "What is a fair share of state resources?" 22 June 2006.)

We have also shown a list of the total taxes paid by Sasol to the South African taxing authorities (taken from the statement of monetary exchanges with governments in the Sasol annual report). Some of these numbers may be considered to be controversial: for example, employees' tax is generally considered to be paid by the employee as a separate taxable entity. However, it can be shown that this tax comes out of the value added created by the business. Also Sasol, somewhat mischievously in our opinion, shows the payment of the fuel tax to government, without showing the amount collected from customers.

However, all this is an aside; the important fact is that Sasol (and most other companies) are paying considerably more tax than that shown in the income statement. We believe that this should be taken into account when considering a windfall tax.

5. Discussion of a progressive formula tax in relation to the taxation of economic rent and resource rentals

The ultimate aim of any business is to add value. In other words, to manufacture and sell a product, or to on-sell products, or to provide a service, where the selling price is more than the cost of such goods or services. This added value is then distributed to the three factors of production: labour (all the people employed in the business), in the form of wages; the providers of capital (owners and lenders), in the form of dividends and interest; and to “land”, represented by the government as the custodians and administrators of the country’s resources: land, mineral resources, water, air space, coastal waters and the electro-magnetic spectrum. The government, of course, collects taxes as its share of the value added.

These three “partners” in every business enterprise from a street hawker to a multi-billion company like Sasol, provide their unique contributions to the success of every business and no business can operate without all three factors of production.

Profit comes out of value added and is a concept that is important to the providers of capital. In terms of the capitalist paradigm, the providers of equity capital own and control the business; labour is merely a cost of production and taxation is considered to be an arbitrary and predatory impost that only has weight and force because of various acts of parliament. While the government is expected to provide various services to the businesses and citizens of a country, no-one directly relates such services to the tax they pay. In fact, taxation is seen by many as simply an exercise in wealth-distribution.

But these are only ideas and opinions in the same way that socialist, communist, fascist, or any economic theory are only ideas and opinions. A large amount of time is wasted in futile arguments about which system is right or wrong, or better or worse.

All these theories are imposed on the reality that business adds value using the contributions and services of the three factors of production. If a business has insufficient capital, under-skilled, lazy or corrupt staff, or the government is unable to provide an environment that is conducive to its business operations, it may struggle to optimise its added value and the distributions to the three factors of production. Here the providers of equity capital always seem hold to the short straw: lenders want their interest, workers their wages and the government their taxes, regardless of the difficulties the business may

be experiencing. But workers can be retrenched or fired and smart consultants can work out ways to reduce the tax liability, leaving the share due to the providers of equity capital more or less intact.

Taxation is universally despised because, as stated above, it is seen as arbitrary and predatory, and not adding any direct value to the business. While most business people accept the need for taxation they do not correlate any direct or indirect benefits for the amounts paid. Taxation on a company's profits plus the special tax on companies (STC) is generally recognised as the company's sole tax liability. However, as mentioned in the previous section, these taxes are certainly not the only taxes that a company pays. While income statements are only obliged to show company tax and STC, many companies are showing the full extent of taxation in a statement of monetary exchanges with government. In the income statement, most of the other taxes (such as employees' tax, property taxes and unrecovered VAT input taxes) are included in the relevant expenses.

Businesses and individuals use the resources that make up the patrimony of a country with the implicit blessing of the people of the country, represented by the government of the day. It is our vision that a way can be found to charge a rental on the use of such resources, in other words, a "resource rental" to ultimately replace taxation.

The discussion document refers to a "resource rental tax" in section 3.3.1 (page 15) as follows:

Direct tax (profit taxes)

- Resource rent tax – related to the economic rent generated by the difference between the market price and the cost of extraction (including a acceptable return on investment).

"Economic rent" is discussed in section 4.1 of the discussion document. The Pocket Economist (2000), however, describes it as "the difference between what a factor of production is paid and how much it would need to be paid to remain in its current use", a similar definition to the one given in a footnote on page 28.

In Sasol's case we understand this as follows: if Sasol can mine coal and turn it into a form of crude oil for a cost of say \$20 a barrel, when other refineries have to pay \$70, then Sasol's economic rent is \$50, given that the cost of converting crude into a petroleum product is similar for all refineries. This, as the Pocket Economist says, "is a

measure of market power”. In other words, Sasol, by virtue of its ownership of its technology, can bar all would-be competitors from entering its field.

Our view of a resource rental is that it should be charged on the use of all resources. Sasol, because there are two distinct stages of production, makes an interesting case study. In the first instance it is mining coal. Here the Mineral Royalty Bill specifically recognises South Africa’s “ownership” of its mineral resource patrimony and is looking for a resource rental (called a royalty) from anyone who wishes to extract, process and sell such minerals.

Recently, in terms of the Mineral Royalty Bill, a proposal has been made by Mr Rene Hochreiter, a highly rated mining analyst. He suggests a formula applicable to all mining operations that would replace the current proposal to apply a straight percentage on mining revenue. The formula, $Y = 10-100/X$, where Y = royalty payable as a percentage of profits, subject to a maximum of 5 %, and X = profit to revenue ratio, would give a nil royalty where $X = 10$ or less, rising progressively to 5% where X is between 10 and 20.

We support this proposal in respect of the Mineral Royalty Bill, and believe that the same principles could be used in the taxation/collection of resource rentals in all mining operations and in the fuel refining industry. We would go further: scrap all applicable taxes and raise the resource rental/royalty to a market level, i.e. to what the highest bidder would pay.

The second stage in the Sasol process is not so simple. Sasol is converting coal, firstly into a type of crude oil and then refining this into a petroleum product. It can do this at a much cheaper cost per barrel because it has exclusive use of a highly specialised and closely guarded technology. Is this technology a resource that “belongs” to the people of South Africa? To some extent our answer would be yes because this technology was initially bought and developed by a government-owned entity and even though Sasol is now privatised and has taken the technology further (e.g. GTL), it is allowed exclusive use of this technology in the same way as property owners are allowed exclusive use of their properties by virtue of registered title deeds. This is the source of Sasol’s original market power and its economic rent.

How this rent is calculated is another matter. In ideal circumstances where it could – and in our opinion, should – replace taxation, the formula-based resource rental may be a

useful starting point. If the formula were to be based on a value added to revenue ratio rather than a profit to revenue ratio, this may overcome the Mineral Royalty Bill's problem with mining companies that do not make a profit, and the resulting proposal in the Bill of an *ad valorem* royalty on revenue only. Using the Sasol income statements in appendix 1, we explore a few formulas using both the profit to revenue and the value added to revenue ratios.

The important aspect is that a resource rental concept is recognised in both the discussion document and the Mineral Royalty Bill. This concept now needs to be widened to include all resources that make up South Africa's patrimony.

6. Windfall taxes

From the above it may appear obvious that we are not in favour of a windfall tax mainly because it would add yet another tax to the whole panoply of taxes that already exist. However there are also other reasons for our opposition to this tax. If it were "backward-looking" it may result in long drawn-out and expensive court cases. The government says that the slate of past subsidies has never been cleared; Sasol says they have been fully repaid. It may be that only a court could give a judgement on this matter.

If the windfall tax were to be forward looking, Sasol and other parties affected by it would no doubt employ tax consultants to worm their way out of such taxes. The discussion document gives an illustration (page 33) of how this may have happened in the US: "The windfall tax brought in \$80 billion in gross revenues from 1980 to 1988, versus initial projections of \$393 billion when the bill was passed (Oberweis, 2006)". We would be extremely surprised if this was not mainly the work of tax consultants.

6. Conclusion

We present this response to the Task Team's discussion document, not with the aim of presenting a simple solution to this immensely complex problem, but rather in the hope of opening up the debate on the question of collection of rental on the nation's resources. We take our stand on the preamble to the constitution: "South Africa belongs to all who live in it..." This is not an idle political statement, but a fundamental statement of truth that all the natural resources of the country belong to the people. We all use these

resources to varying degrees and should all pay the rent concomitant with such use. Not only is this a matter of simple economic justice, but it would also directly relate the state's revenue to the value it adds to each business enterprise, and, in the case of individuals, to their usage of resources such as land. At the same time it would vastly reduce, if not eliminate, all the disincentivising, intrusive, and infinitely complex burdens that go with taxation.

The "Sasol" case puts this possibility into the arena of public debate: throwing yet more complex taxes at this problem is not the answer. What it does do is give us a window of opportunity to clear the maze of taxes that harm us all, especially the poorest of the poor.

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