Taxing the miners' uncommonly large profit

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> *... those magnificent Dutch seamen who came here from 1606 on. They were looking for a land or a country which would be the source, as they put it so marvellously, of 'uncommonly large profit'*
>
> Manning Clark

Introduction

Almost the first action of the Gillard Government was to water down the Resource Super Profits Tax (RSPT), and to re-name it as a Minerals Resource Rent Tax (MRRT). While many design features of the RPST were retained, thresholds and rates were reduced, the tax is to be applied only to the iron ore and coal industries, and is to apply only to companies with profits above $50 million. The re-naming may not appear to be material, but it is a more formal term, "rent" being the word economists use to describe a profit arising from economic privilege.

In writing about this issue, I should declare a conflict of interest, because almost 20 percent of the value of shares in my self-managed superannuation fund is in mining companies. I was therefore looking forward to Government's original tax changes, because a higher tax on successful mining companies was to fund lower taxes on other companies. In terms of cash flow, my superannuation fund stood to benefit because the dividend yield on mining shares is very low (1.5 percent for my modest holding), while it is much higher (4.1 percent) for my industrial shares. Mining companies, being more expansionary than most other companies, retain a high proportion of their profits; in fact many pay no dividends.

Because my fund, like most others, is reasonably balanced, over the long term, when capital gains are included, the accumulation return with the RSPT may have been close to neutral, but those capital gains are a long time off. I could see no way, however, that I would be worse off.

The notion that superannuants would suffer – stated specifically on professionally made placards in choreographed demonstrations and implied in Minerals Council advertisements – was just one of the falsehoods of the hysterical campaign against the RSPT. The only people who might have a large proportion of their personal wealth in mining shares are mining company executives: perhaps these are the people whose interests those demonstrators really had in mind.

I should also declare a wider personal interest, which goes well beyond the paltry dividends and uncertain capital gains of my mining shares. Like 22 million other Australians I stand to benefit from the taxes paid by the corporate sector: that too is part of my dividend, and I am disappointed to find that part of my dividend has been scaled back.

Even more basically, I want to live in a country with a well-developed, broad economy. Many years ago, on an Australian Government posting, I lived in the Middle East, in the heart of the oil-rich sheikdoms – countries with huge financial wealth flowing into economies which, by most criteria, would be considered undeveloped. Because of these countries' high exchange rates, there was no way they could develop import-competing or export industries other than oil. There was extreme welfare dependence, with many able people in highly-paid make-work jobs – something like the old Soviet Union but with high incomes. Worse, from an economic perspective, the whole financial incentive structure was distorted: the returns to both capital and labour in the oil sector were so high as to kill enterprise in those parts of the economy which could show only more modest returns.

The foregoing lays out my personal interests. Some may call them prejudices, but whatever the case it behoves one to make such a declaration. I, like many other Australians, would have benefited, financially and in other ways, from the RSPT. I will still benefit from the amended version but I regret the missed opportunity for a more public dividend from mining.

To turn to a more detached analysis, I want to outline three aspects of the RSPT and of the MRRT, only the first of which has had a great deal of publicity. The other two have been largely pushed aside in the din of slanging matches and emotive television advertisements. These are:

- the impact of the taxes;
- the consequences if higher taxes retard the mining sector's expansion;
- the nature of the original RSPT proposal with its *de facto* public share in mining companies' fortunes.

Finally, I want to comment on the government's handling of the issue, which has been very poor by any criterion of good policy development.

1. Is it fair?

The industry's mathematical presentation of the RSPT was simple. The present company tax rate is 30 percent. Under the RSPT the base company tax was to fall to 28 percent, but on top of that there would be a 40 percent tax on the remaining 72 percent of earnings. In arithmetic:

$$0.28 + 0.4 \times 0.72 = 0.568$$ – or 57 percent rounded.

The main assumption in that simple equation was that *all* companies would be paying super profits on *all* their income. A profit becomes a "super profit", however, only after a threshold return on funds employed – 6 percent in the RSPT proposal. A mining company enjoying a high return would indeed have a *marginal* tax rate of 57 percent, but to reach an *average* tax rate of 57 percent it would have to have an infinite profit.

The new version raises the threshold from 6 percent return to 11 percent (linked to the long term bond rate), and reduces the rate from 40 percent to 22.5 percent, while reducing the cut in the general company tax rate. By the same formula the marginal rate would be:

$$0.29 + 0.225 \times 0.71 = 0.44975$$ – or 45 percent rounded.

There was a great deal of argument about the fairness of the RSPT. It needs to be considered in the light of tax concessions presently applying to the mining industry, however. The industry has generous depreciation allowances, such as an immediate write-off of environmental protection and certain exploration activities, even if they are capital in nature. Mining operations benefit from the Fuel Tax Credits Program, which rebates the 38.1 cents per litre fuel excise; it is reasonable that mining companies should not have to pay a road user charge for stationery applications, but, to the extent that fuel excise is, *de-facto,* also an environmental tax, full exemption confers some level of privilege.

Another difficulty in making comparisons with other industries is that mining, being capital intensive, is far less burdened by state payroll taxes than more labour-intensive industries.

Because of these and other complexities neither the government nor the mining lobbies should have made categorical statements about comparative tax rates under the RSPT, but that didn't stop the industry from making outrageous claims. The miners criticised the Henry Review for using research showing that mining had a 7 percent lower tax rate than the "all industries" average, but any single figure comparison would be open to attack. And that's before there is any consideration of the value of minerals in the ground.

It is possible, however, to make some historical comparisons, and, as the Henry Review has pointed out, the combined Commonwealth and state (royalty) tax rate on resource profits has fallen from around 55 percent at the beginning of this decade to less than 20 percent in 2008-09. Even if one quibbles with the details, it is clear that the community dividend from the sector has not kept pace with the sector's profits.

The complexity of the RSPT and the MRRT made it hard for people to follow the debate, for these taxes operate in a different way to ordinary company tax. The threshold before the tax applies is treated as a "capital allowance". That is, a reasonable return on funds employed was assumed to be 6 percent under the RSPT and was raised to 11 percent under the MRRT. In accounting terms the capital allowance applies to all funds employed – debt plus equity. Established mining firms have reasonably high debt and pay very little interest on their debt, because much of it is interest-free trade finance. That means, to calculate their tax liability, they can make a larger tax-offsetting claim for a notional 11 percent capital cost than their actual interest outlay. The real profit threshold before the RSPT or the MRRT kicks in, therefore, is higher than 6 or 11percent.

Mining spokespeople did not point this out, nor did they point out that the new tax régime is designed to replace state royalties and that the base corporate tax on normal earnings was to fall.

In any event, the focus of the debate, which was about tax rates, was a distraction. From an investor perspective, what counts more than the rate of tax is the return on equity, and, using a model based on the capital structure typical of well-established mining companies, I have looked at the pre-tax return on equity and the post-tax return on equity under the existing régime, under the RSPT, and under the MRRT. The assumptions are that the company is 50-50 debt and equity financed, that its cost of debt capital is 2.0 percent, and that it has been paying 1.0 percent of its turnover in royalties (a conservative assumption). The results are shown in Table 1.

Table 1. Comparison of returns, pre and post-tax

Return on funds employed			
Pre-tax	Present régime	RSPT	MRRT
2.0%	0.5%	1.4%	1.4%
4.0%	3.3%	4.3%	4.3%
6.0%	6.1%	7.2%	7.1%
8.0%	8.9%	8.9%	9.9%
10.0%	11.7%	10.7%	12.8%
12.0%	14.5%	12.4%	15.3%
14.0%	17.3%	14.1%	17.5%
16.0%	20.1%	15.8%	19.7%
18.0%	22.9%	17.6%	21.9%
20.0%	25.7%	19.3%	24.1%

(The model is on the Web at

http://www.home.netspeed.com.au/mcau/academic/rsptmodel.xls

Readers can download it and enter their own assumptions.)

Under the RSPT proposals, up to a pre-tax return of about 8 percent, the return to investors would have been *higher* than at present, and for returns up to about 10 percent the additional tax burden would have been modest. Under the MRRT, the crossover point at which the tax burden becomes higher is around 15 percent.

To see those figures in context, over the 20 years to 2010, the average nominal return on Australian shares in all sectors has been just under 10 percent. By any reasonable criterion, above 10 percent we are entering the zone of “uncommonly high profit”.

Mining companies, however, claimed that the returns they would receive under the RSPT were absurdly low, well below their cost of capital (the weighted average of their cost of interest and equity finance).

That may be so, but the question it begs is whether mining firms and their investors have become conditioned, over 40 years of Australian mining booms, to expect high returns. Over time, what lesser mortals may consider to be an “uncommonly large profit” may have become the norm for mining companies. Are they unaware of the tough reality of competitive markets in which most other businesses operate?

It has been common to hear mining companies referring to “hurdle rates” – the rate a new project must achieve – of 12, 15 or even 18 percent. While such figures include some buffer for risk, they are extraordinarily high. In the more mundane world of competitive small business, an inflation-indexed return of 6 percent would surely be considered a reasonable return and a return of 11 percent would be considered sheer luxury.

Were those pearl-draped demonstrators holding their designer placards out of touch with the real economy? Has mining distorted our notion of what constitutes a reasonable return to capital? Has the mining sector distorted our capital and labour markets? These questions are addressed in the next section.

2. What are the economic consequences of higher mining taxes?

Even if the Government believes increasing the tax on mining firms will dampen mining activity, it hasn't said so. The Treasury Secretary, however, in speaking about the RSPT, referred to problems such as the "Dutch disease", the "Stolper-Samuelson effect" (a distortion of capital/labour ratios in the economy), and a "three speed" economy. If the RSPT were simply a public revenue mechanism which had no effect on mining activity there would be little point in mentioning these effects, because they all refer to the way a small but highly profitable export sector distorts resource allocation in the rest of the economy.

In their public statements various spokespeople for the mining industry predicted dire consequences if the RSPT went ahead, but it's hard to ascertain how much is bluff, and even if predicted projects do not go ahead, there are many possible reasons for cancellation.

In a politically charged atmosphere it would be very hard for the Government to suggest that higher taxes will affect the decisions of mining companies. Similarly it would be in keeping with reactions to every other economic reform if the affected industry were to overstate its consequences. The debate, if we can use a such a term with its inference of rational discussion, was little different from the heated debates which accompanied tariff reductions, the GST and other reforms.

Even if the Government doesn't want to state it explicitly, there is a strong case for slowing down the expansion of the mining sector. It has been a magnet drawing capital and labour from other sectors, and in doing so is contributing to a distorted economic structure.

When one sector of an economy offers much higher returns than others, it attracts investment funds which may have gone into those other sectors. When an investor can obtain a return of 12 or 15 percent from mining, other businesses find it hard to get funds for ventures with lower returns. Economists may suggest that in time markets will respond adequately: once all demand from the mining sector is satisfied other ventures will get their share, at a lower return, but capital markets do not behave according to such textbook models. A high cost of capital means firms under-invest in technologies which would improve labour productivity: in other words, our labour productivity suffers because of the capital demands of the mining sector. Another effect is that a high commercial cost of finance flows directly and indirectly (through developers' capital costs) into the cost of housing finance.

Similarly a profitable mining sector attracts labour from other sectors. Unless we liberalise immigration even further, or allow many more foreign workers to come on temporary visas (assuming there is world supply of suitable labour), the mining sector will continue to bid up labour costs in many trades. Only geographic bottlenecks, such as housing in remote areas, protect us from an even greater flight of skilled and semi-skilled people to the mining sector.

A pervasive effect of a mining boom is its influence on exchange rates. When our exchange rate is raised, trade-exposed industries suffer. Costs of a high exchange rate are borne by import-competing industries, particularly manufacturing, and by export industries, such as tourism, education services and agriculture. A high exchange rate is attractive to people buying foreign cars or travelling overseas, but the costs are diffuse throughout the economy.

Another distortion is created by Australia's geography, for our mineral resources are concentrated in two states: Western Australia and Queensland can be booming while New

South Wales is in recession, making it politically hard for the Government and the Reserve Bank to manage monetary and fiscal policy.

Some economists argue that so long as income is flowing into the country, there are net benefits. If truck drivers and welders can earn $120 000 working in the Pilbara, or if shareholders in mining companies make high capital gains, income can be re-distributed through the tax and welfare systems. Indeed, over the last thirty years, Australia has seen a widening of private incomes (income before taxes and welfare payments) which have been brought back to some degree of equity with welfare payments, such as family allowances.

The point has some validity, but even a generous welfare system cannot compensate for the benefits people gain from being able to earn income from their own skills and enterprise. As Voltaire reminded us “work saves us from three great evils: boredom, vice and need”; of those three evils redistributive welfare can cover only one.

In any event, all countries find that the capacity of the tax and transfer system to reduce income disparities is limited. Taxes are needed for other purposes, particularly the provision of public goods such as health, education, defence, environmental protection and transport infrastructure.

Progressive taxes on labour as a means of redistributing income have probably gone about as far as they can go. In the early 1950s we had top marginal personal tax rates as high as 75 percent, but that was before people with high incomes were internationally mobile. A tax on resource rent brings progressivity into profits. Sixty years ago we taxed labour heavily because labour was immobile; resource rent taxes apply the same logic to mining. The Henry Review is about changing the tax base to less mobile resources, including minerals in the ground.

If higher taxes on mining do slow down the expansion of mining activity the resulting adjustment will be much more easily borne than the major industry re-structuring of the 1970s and 1980s associated with tariff reductions, which we came through successfully. In that re-structuring manufacturing lost 80 000 jobs, and its share of GDP fell from 25 percent to 18 percent. By contrast, the entire mining sector employs only 170 000 people, or 1.6 percent of total employment. And there is no serious talk about job losses in mining; the most extravagant claims about the RSPT were about mooted projects not going ahead. Even the Minerals Council was careful in its advertising, saying simply “it will affect jobs”. (Few people picked up this nuance: the impression created was that the RSPT would cause job losses.)

As a general point, in an economy approaching the zone economists call “full employment”, it is hard for any industry to claim that its projects have any virtue in terms of net job creation. All that can happen is for employment to shift between one industry and another. One could have re-framed the Mineral Council’s advertisements to say “if the RSPT goes ahead, we will stop taking workers out of other sectors of the economy”.

Similarly we are supposed to believe that there is some intrinsic benefit to investors in keeping mining activity in Australia. Undoubtedly industry lobbyists have overstated the attraction of other countries. In general, those countries which apply lower taxes to mining do so to compensate for other factors, including natural hazards, political instability, inadequate infrastructure and personal risks such as terrorism. Even if some expansion is in other countries, Australian equity holders in large companies such as BHP-Billiton and Rio Tinto will still benefit. Investors generally benefit from geographical diversification.

More basically, a decision not to go ahead with a mining project is not a permanent loss. The minerals remain in the ground for future use. (By contrast, loss of a project such as a corporate R&D facility or an aerospace operation is permanent; those chances are usually once off.) We are supposed to believe it is good if foreign investors can come and dig up our minerals, but it is undesirable if Australian investors get income from digging up other people's minerals. It's a difficult logic to follow.

There were other claims about "retrospectivity" and "sovereign risk". By the way some parties used the term "retrospectivity" all tax changes are retrospective. Their point was that a mining project is planned with a certain tax régime in mind, but so too are all investments in all sectors. The only way a country could avoid sovereign risk by these extreme interpretations would be to have tax rates hard wired in an immutable constitution.

Circumstances change, and undoubtedly those who planned the present projects did not factor in the recent high mineral prices, and, unless they were negligent in their project assessment, did factor in scenarios which allowed for some variations in taxes. In any event, a tax that is triggered only once a reasonable threshold is reached can hardly be called risky.

The most specious suggestion was that now is not the time to introduce a resource rent tax, because the future of the world economy is looking less bright than it did in early 2010. That conveniently overlooks the very nature of rent taxes; if prices or export volumes fall, profits will come back, and the rent tax will ease or will not apply at all. In fact, the companies would have the benefit of a lower corporate tax rate.

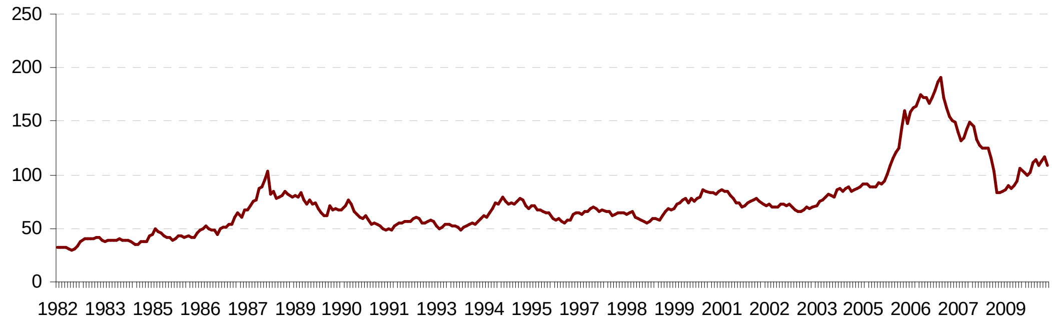
The Government did not enter this debate about economic structure, however. A kind explanation is that it is hard to explain macroeconomic concepts. A politically realistic explanation is that the Government knows that the Australian economy, because of its dependence on commodity exports to a small number of markets, is fragile. The present Government would like to claim that Australia's escape from the recent financial crisis is due to good management; similarly the previous Government would like to say Australia's strong fiscal position is due to good management, but the reality both parties are avoiding is that we have been living off our capital – our non-renewable mineral resources and the planet's atmosphere. We aren't all that much different from the Greeks and Spaniards; in fact, we are not much different from Nauru which went spectacularly broke once it dug up its last phosphate – it's just that we can postpone our day of reckoning.

3. The RSPT as "equity"

Sometimes an extreme statement contains grains of truth. In echoes of the Cold War era we heard Queensland mining magnate Clive Palmer and others using the term "communist" to describe the RSPT.

The claim had some relevance, for the RSPT would have put the government into a position with some of the benefits and risks of passive equity holders, because it contained

Figure 1. RBA Index of base metal prices $A -- even bumpier than the sheep's back



concessions for unsuccessful ventures, which would have received the capital allowance as a tax credit.

Naturally, large and successful companies do not welcome changes that may act to the advantage of their less established competitors, and even industry associations, which inevitably get more funding from larger companies, find it difficult to represent all interests. To misquote Margaret Thatcher, there is no such thing as an industry: there are only individual companies.

One benefit of such risk-sharing is that it is counter-cyclical. In boom times it would collect a lot of tax, and when the industry is in the doldrums it would provide tax credits. Because of the pro-cyclical nature of the commodity cycle (See Figure 1) the RSPT would smooth out that economic business cycle.

In the MRRT compensation for losses has been abandoned to pay for higher thresholds and lower rates, but there will still be some counter-cyclical benefits. Resource rent taxes are designed to overcome a problem with royalties levied on a unit basis, such as tonnes of ore or megajoules of energy content. In general, as a mine is developed, each additional unit of mineral becomes more costly to extract, as the mine becomes deeper and as lower grade ore is exploited. A resource rent tax, by definition, is designed to tax what, by an agreed standard, is the excess profit over what is considered to be a “normal” profit.

The proposal to compensate for losses had other virtues, including a leg up for small companies in gaining market share, thus reducing the concentration in the industry, but it represented a major break with the past. Mining has traditionally provided uncertain returns to investors, and, among some of the smaller companies at least, there is something of a gambler’s culture. Many investors buy shares in startup mining companies with the same attitudes as punters who place bets on horse races. Punters would hardly welcome a government intervention that taxed winners and used the proceeds to compensate losers. The “insurance” mentality that underlay the original tax may be at odds with the culture of the industry.

These basic issues of industry structure and *de-facto* equity never got discussed. The Government dropped the RSPT on to the policy agenda as a complete package, in a process bound to raise conflicting claims, misrepresentations and anger – a process which crowded out the possibility of serious discussion of principles.

4. Good policy, ghastly process

It would be a fair guess that few people, other than academic economists and those involved in the industry and government, understand the principles which underpin the RSPT, let alone its workings. Should governments become more involved in the fortunes of the mining industry? How should mining companies pay for the minerals they extract? Should we try to slow down the industry to protect Australia from the swings of commodity prices, and to keep a more balanced economic structure? How do we discount future costs and benefits; are we willing to defer realisation of part of our mineral wealth?

These questions of principle were not put to the community. The development of the RSPT compared poorly with the process which preceded the Hawke-Keating Government's reduction in industry assistance, which involved the traditional mechanisms of a Green Paper covering the issues, and a White Paper with proposed policies, interspersed with many other mechanisms of engagement, such as various reports by the Industries Assistance Commission (now the Productivity Commission).

If a government is to undertake economic reform, it should start with a public debate about principles. Once there is some agreement on principles, technical design work can proceed. Ideally, in this case, this technical design should have been through an open process such as a Productivity Commission inquiry. That would have seen the theoretical models of resource rent taxes being compared with the evidence presented by interested parties. Of course the evidence would have had its biases, but it would have uncovered issues in practical design, such as the treatment of Onesteel's use of low quality iron ore. Furthermore, the Productivity Commission has the research capacity to do reasonably sound comparisons of international, historical and intersectoral tax comparisons. Such comparisons may not have generated a single bottom line, but they would have produced a much lower range of dispute than we had.

Rather than pursuing such a path, the Government was enslaved by the traditional budgetary process of secrecy to the date of announcement. Also, it should be remembered that the RSPT emerged from the Henry Review, which argues a clear case for the RSPT, but the Government announced its decisions on the Review at the same time as it was released, and confirmed these decisions just a few weeks later in its Budget.

Worse, the Government called the RSPT a "super profits" tax rather than a "rent" tax – the term used in the Henry Review. The term "super profit" can imply that the Government is considering attacking all high profits, while the term "rent" refers specifically to profit arising from entrenched privilege – low-cost minerals in this case. In being too lazy to explain the economics of the tax, the Government unnecessarily scared the horses.

The Government was criticised for breaking its own guidelines in embarking on an advertising campaign, but, having come to the point that the miners were bound to mount a strident and hysterical campaign, the Government had little choice other than to respond. Those who suggest that the Government was improper in using public funds in its response ignore the fact that the mining industry spent a large sum – possibly as much as $100 million – on advertising criticising the RSPT, and because such expenditure is tax deductible, something in the order of $30 million of public money has been spent by the industry, without an iota of public scrutiny. As voters we can easily find out how much of our money was spent on the Government campaign; by contrast as shareholders the mining companies treat us with contempt: what have we sacrificed in dividends to pay for these advertisements? Also, it will not be until January 2011 or 2012 that we know what the industry spent on political donations and what pledges it made to political parties, almost certainly the huge portion of which would have gone to Coalition parties. It should be remembered that the Government's promises on paid government advertising were part of a package which included reforms on political donations – a reform package that was lost in the Senate on a combined vote of the Coalition parties and Family First Senator Fielding.

The Government's public response, however, was pitiful. Rather than explaining the RSPT and its justification – which the Henry Review did in 350 words and one graph – it used the patronising language of political spin.

The blame for poor process does not lie solely with the Government. The Opposition, rather than putting forward its own principles and constructive suggestions for reform, simply carped about a "big new tax". The Coalition parties, since the Abbott coup, have reverted to a tactic last used in the mid seventies, when they used their Senate numbers to render the country ungovernable, regardless of the consequences to the nation. It's an irresponsible but effective tactic, for it creates an atmosphere of chaos reflecting back on the Government, which can be characterised as incompetent and indecisive.

Rather than fighting back, however, the Government wilted under criticism. When an Opposition is behaving so badly, a government should differentiate itself by exposing the tactic and adhering to sound process itself. In yielding on the emissions trading scheme, on refugees, on electoral reform and many other issues it had demonstrated that it is weak on process and that it meekly gives in to bullying.

Those precedents boosted the confidence of the mining lobby which, for the last 100 years, has proven itself a very hard negotiator. Perhaps this Government has forgotten the bitter conflict in 1909 between the Fisher Government (a Labor Government with a Queensland Prime Minister), when in response to a national wage decision, BHP closed its mining operations for two years. Perhaps the Government failed to realise that the Liberal Party, so badly out of favour with the business community, was desperately seeking a sponsor to replenish its depleted coffers.

We have a resource rent tax, but it is badly watered down, and it has been negotiated only with the big corporations; it is far from clear whether it represents the interests of the whole industry (but in this regard the smaller companies are paying the price themselves for yielding to bullying.) High commodity prices and high demand will probably cover the revenue shortfalls in the concessions, but the MRRT will be much weaker than the RSPT in terms of bringing a fairer way to tax mining profits and in terms of re-structuring the Australian economy to become less dependent on resource exports.

Without structural reform Australia's long term future is bleak – like that of an oil sheikhdom when the wells run dry, or closer to home, Nauru when the phosphate ran out, with a landscape of big holes in the ground and fading memories of past prosperity.

(In the interests of conserving space, the first three paragraphs under the heading "Is it far?" were not published in *D!ssent*. I have added them back in order to save the reader from needing to look up sources.)