ACTU Submission to the Senate Select Committee on the Scrutiny of New Taxes

Inquiry into the Minerals Resource Rent Tax and expanded Petroleum Resource Rent Tax

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Introduction

The Australian Council of Trade Unions (ACTU) is the peak council for organised labour in Australia. Unions affiliated to the ACTU cover all sectors of the economy, across all states and territories, representing more than 1.8 million workers. The ACTU is an affiliate of the International Trade Union Confederation, a body established to promote and defend workers' rights and interests globally through international cooperation.

The ACTU welcomes the opportunity to make this submission to the Senate Select Committee on Scrutiny of New Taxes' Inquiry into the Minerals Resource Rent Tax and expanded Petroleum Resource Rent Tax.

Summary

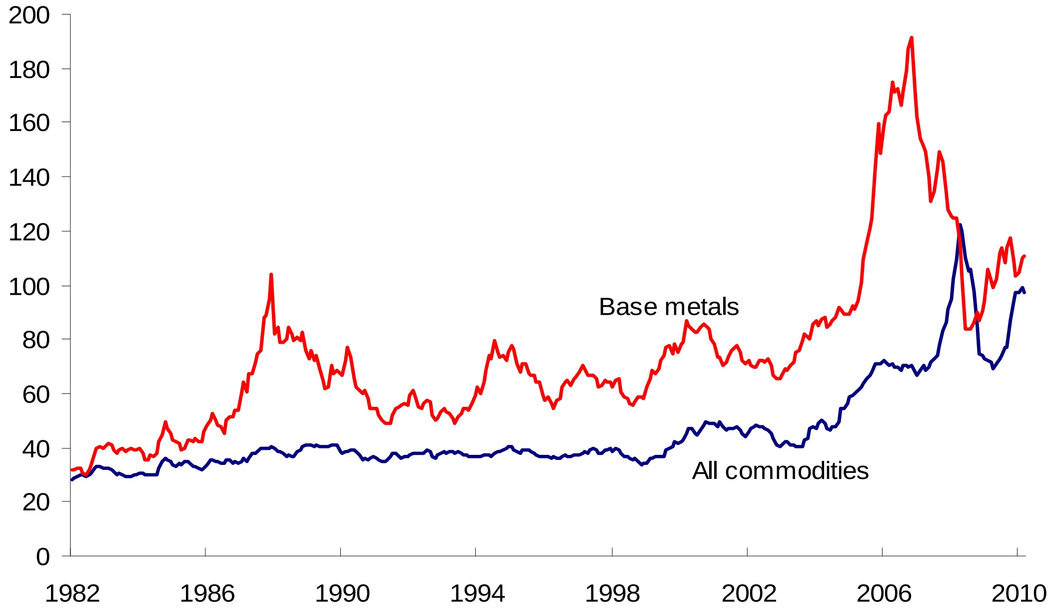
The ACTU supports the Australian Government's proposed Minerals Resource Rent Tax and expanded Petroleum Resource Rent Tax and strongly believes that both initiatives are highly positive developments for the nation. Resource rent taxation will return a fairer share of windfall gains to the owners of non-renewable resources, the Australian people, and will enable investment in the future via an increase in the Superannuation Guarantee. The MRRT regime may also help to reduce some of the negative effects of the mining boom on other sectors of the economy. The MRRT will be less distortionary than the present royalty system for iron ore and coal.

The Reform Context

The mid-2000s saw a massive surge in the price of commodities, driven by the rapid industrialisation of China and India. This surge is unprecedented and was unanticipated in size and scope. As a result, firms that export commodities have collected windfall profits.

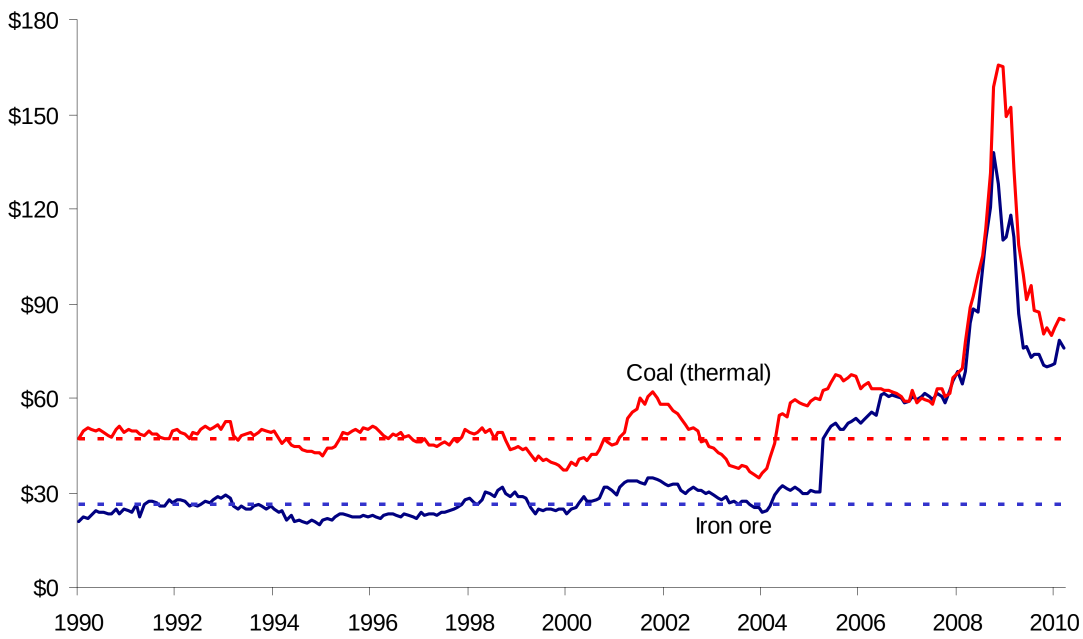
The scale of the price shock can be seen in the Reserve Bank of Australia's index of commodity prices.

Chart 1: RBA Index of Commodity Prices (AUD)[1]



The trend has been driven by massive increases in the price of certain commodities, notably iron ore and coal. The following chart shows the average export unit value of these two commodities in AUD per tonne, from 1990 to March 2010.

Chart 2: Average export unit value of iron ore and coal, 1990-2010[2]



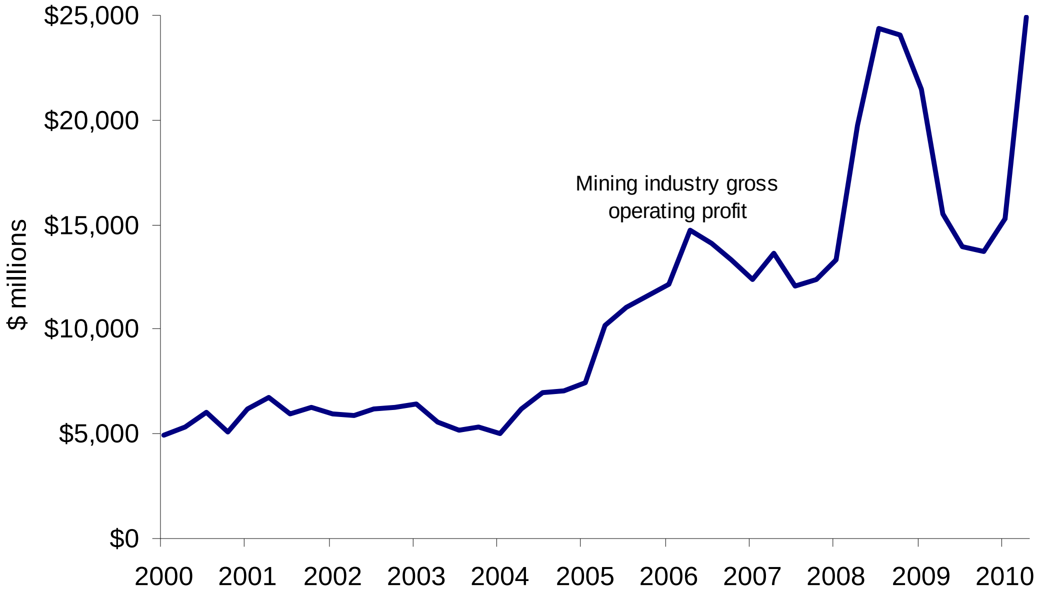
[1] Derived from Reserve Bank of Australia, Index of Commodity Prices (AUD) – RBA Statistical Tables – Table G5, available from: http://www.rba.gov.au/statistics/tables/index.html#prices_inflation [Accessed 13 October 2010].
[2] Australian Bureau of Agricultural and Resource Economics, Minerals statistics, Table 7. Available: http://www.abare.gov.au/publications_html/data/data/data.html. [Accessed 13 October 2010].

The dotted lines in the charts above show the average price for these two commodities over the period January 1990 to December 2003. The average price over this period for thermal coal was $47.22 per tonne. The price in November 2008 was $165.49 per tonne. The average price from 1990 to 2003 for iron ore was $26.24 per tonne. The price in October 2008 was $137.72. Although the price for each commodity fell during the global economic downturn, it has begun to rise again and remains 167% above the 1990-2003 average, in the case of iron ore, and 68.9% above the 1990-2003 average in the case of thermal coal.

The massive and largely unexpected price increases generated windfall gains for mining companies. These gains largely accrued to firms that had invested in projects at lower world commodity prices when the recent price rises were completely unforeseen. These gains therefore represent pure economic rents, in that they are above the returns that are required to induce and sustain the economic activity in question.

The scale of the mining industry's windfall gains can be seen in an examination of the industry's gross operating profits over the past decade.

Chart 3: Mining industry Gross Operating Profit 2000-2010 (Current Prices)[3]



[3] Australian Bureau of Statistics, *Business Indicators,* Cat. No. 5676.0, Table 11, seasonally adjusted.

As can be seen in the chart above, mining industry gross operating profit increased nearly five-fold in the period 2004-2008, from $5 billion to $24.4 billion.

In March 2004, gross operating profits in the mining industry represented 14.7% of total gross operating profits across all industries. By December 2008, this had reached 38.9%, before falling slightly during the global economic downturn. In June 2010, gross operating profits in the mining industry accounted for 36.4% of the economy-wide total. The scale of the industry's windfall gains is clear.

The Need for Improved Resource Taxation Arrangements

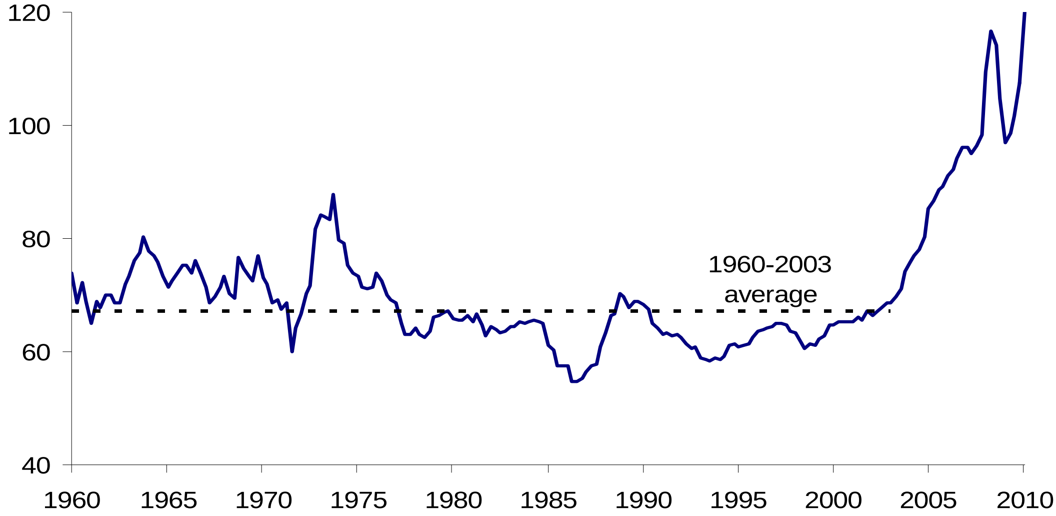
The mining industry's windfall profits have not been shared sufficiently with the ultimate owners of the resources being extracted: the Australian people. Resource taxation should be seen as the charge imposed by the owners of a factor of production; it thus differs in principle from other forms of business taxation such as the company income tax. It represents the price that firms pay in order to extract non-renewable resources that are owned by the people in common.

The outmoded and inefficient system of resource taxation that presently exists, State royalties, sees the rate paid by companies rise and fall with the quantity of production, but not (for the most part) with the price per unit of production. This is a major systemic design flaw in the present system of resource taxation.

A profits-based tax, such as the MRRT, corrects this flaw. Such a tax ensures that the dividend received by the owner of non-renewable resources rises and falls with the profits of mining companies, which are determined by both the price and quantity of extracted resources. This system is more equitable and also more efficient; it shares the windfall gains arising from exogenous price shocks with the owners of the primary factor of production, and has a less distortionary effect on the market.

There are other sound public policy reasons for moving from quantity-based resource royalties to a profits-based resource rent tax. The terms of trade shock experienced by Australia as a result of soaring commodity prices has caused the value of the Australian dollar to appreciate sharply relative to other currencies. The terms of trade and the value of the Australian dollar are shown in the charts below.

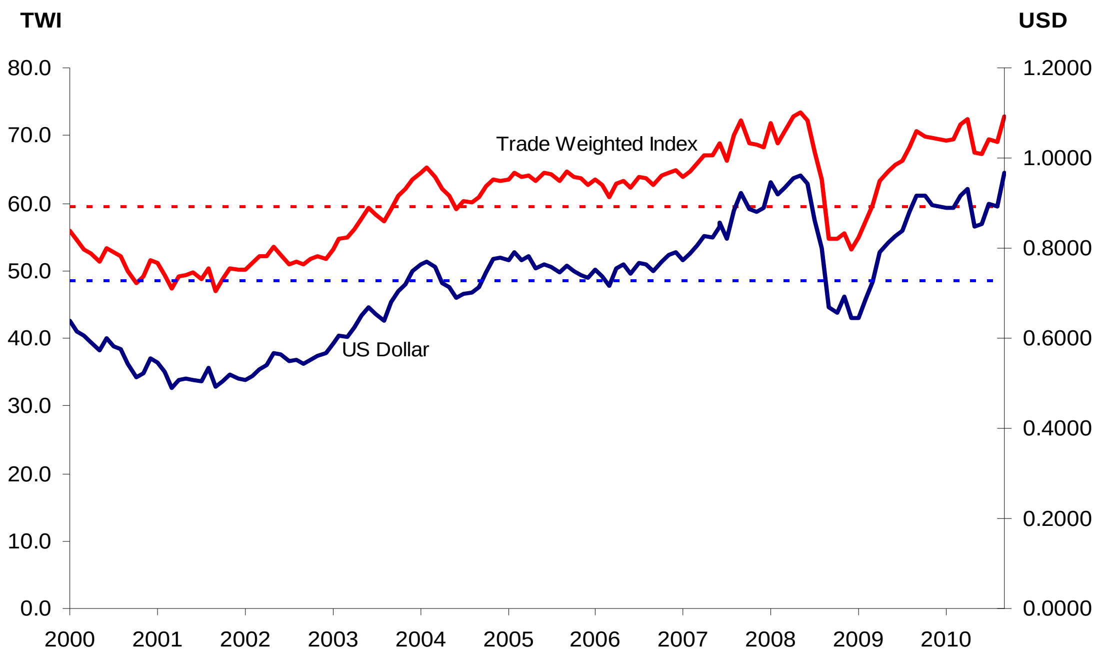
Chart 4: Terms of trade (Index) (2007-08=100)[4]



The value of the Australian dollar in US dollar terms rose above its post-1983 average in October 2004, and has been above that level for almost all of the period since that time. The Australian dollar has also appreciated sharply against the Trade Weighted Index of currencies. In the chart below, the dotted lines show the average exchange rate in USD and TWI terms since the Australian dollar was floated in December 1983.

[4] Derived from ABS National Accounts 5206.0 Table 1, Terms of Trade – Index – Seasonally adjusted.

Chart 5: AUD Exchange rates (US Dollar and Trade Weighted Index)[5]



The strong Australian dollar has the effect of reducing the competitiveness of non-resource export sectors, such as manufacturing, tourism and higher education. Increased real exchange rates also harm import-competing sectors, as Australian households and firms find it cheaper to acquire goods and services offshore.

This process, by which a booming export sector (mining) crowds out activity in other sectors through an appreciation of the real exchange rate, is known as the Gregory Thesis or Dutch Disease. It is sometimes referred to as a problem of a "two speed economy". Resource rent taxation can help to alleviate the pressures on non-resource export industries and import-competing industries. This is particularly the case where some of the proceeds of such a tax are used to assist other industries and where revenue is also used to divert funds from consumption to investment, such as through an increase in compulsory superannuation.

The "commodities super-cycle" driven by increased demand from China and India is expected to endure for decades. The 2010-11 Commonwealth Budget observed that "there are reasonable grounds – in particular, an expectation that global demand will continue to grow strongly for an extended period – to believe that the terms of trade

[5] Derived from RBA Exchange Rate Monthly Data. Available from: http://www.rba.gov.au/statistics/hist-exchange-rates/index.html. [Accessed 14/10/2010].

and mineral resource prices will be sustained at high levels for some time".[6] There are some signs that commodity prices may decline slightly from the record highs experienced in recent years as supply expands in other jurisdictions, but prices are expected to remain elevated well above historical levels. It is therefore prudent for the Commonwealth Government to plan for the nation's future with this central forecast in mind. Failure to implement an improved system of resource taxation now would leave Australia worse off in the coming years and decades.

The ACTU considers the new system of resource taxation is needed: on equity grounds, to deliver an appropriate return to the owners of Australia's non-renewable resources); on efficiency grounds, as rent taxes are less distortionary than royalties; on macroeconomic grounds, as the tax and its revenue can be used to ameliorate the negative effects of a mining boom on other industries and deliver a more balanced economy overall.

The MRRT

If a resource rent tax is well designed, the usual tax policy trade offs do not apply. Ross Garnaut and Anthony Clunies-Ross said this in 1983:

> *"Many people believe that the only important characteristic of a tax is how much it takes. This is far from true. The form of the tax may have extremely weighty effects in encouraging some activities or discouraging others. It is easy to assume, as governments often seem to have done in meeting the question of taxing mining companies, that there is a simple dilemma between heavy taxation, which discourages mining, and light taxation, which yields little in the way of revenue. On the contrary, provided that the form of the tax regime is chosen prudently, it is possible to improve the trade-off considerably..." [Taxation of Mineral Rents, 1983]*

KPMG Econtech modelling suggests that, of all existing taxes, the petroleum resource rent tax imposes the smallest marginal welfare loss on the economy, while royalties and crude oil excise impose the largest marginal welfare loss.[7] Taxes with a

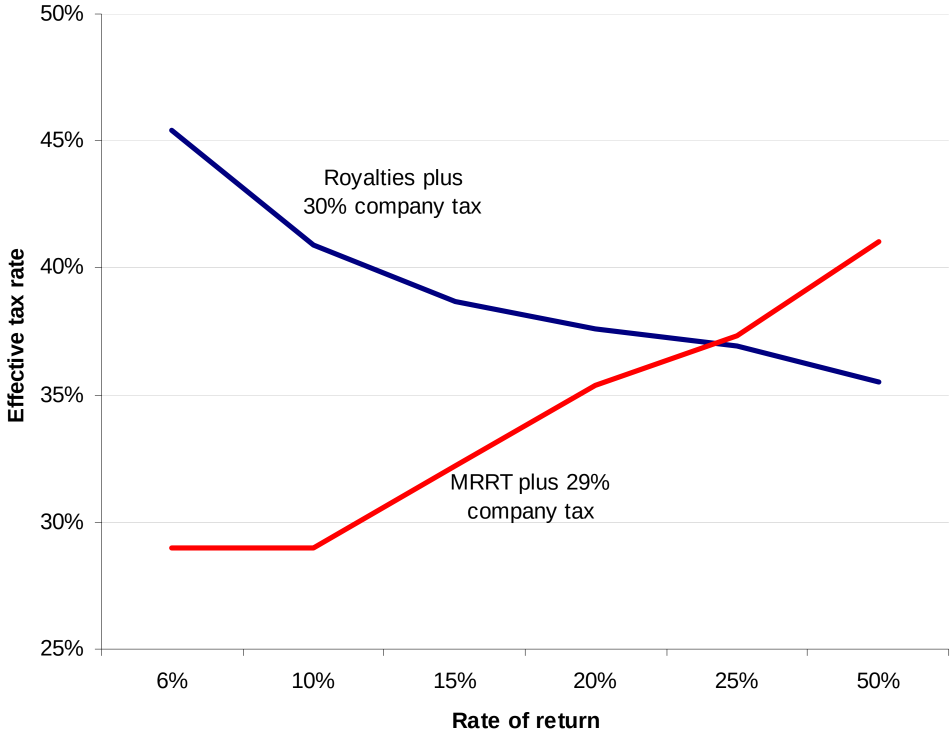
[6] Commonwealth of Australia 2010, *Budget 2010-11,* Budget paper no. 1, p.4-10.
[7] KPMG Econtech modeling cited in Australia's Future Tax System 2010, *Report to the Treasurer.*

greater marginal welfare loss have a greater distortionary impact on economic activity.

The Minerals Resource Rent Tax package is both simple and well-designed, and will have little distorting impact on the structure and composition of the mining sector.

Resource companies that are not accruing economic rents will see their effective tax rates reduced by moving from the present system to the MRRT system. The chart below shows the effective rates paid by firms at different rates of return.

Chart 6: Effective tax rates under royalties and the MRRT[8]:



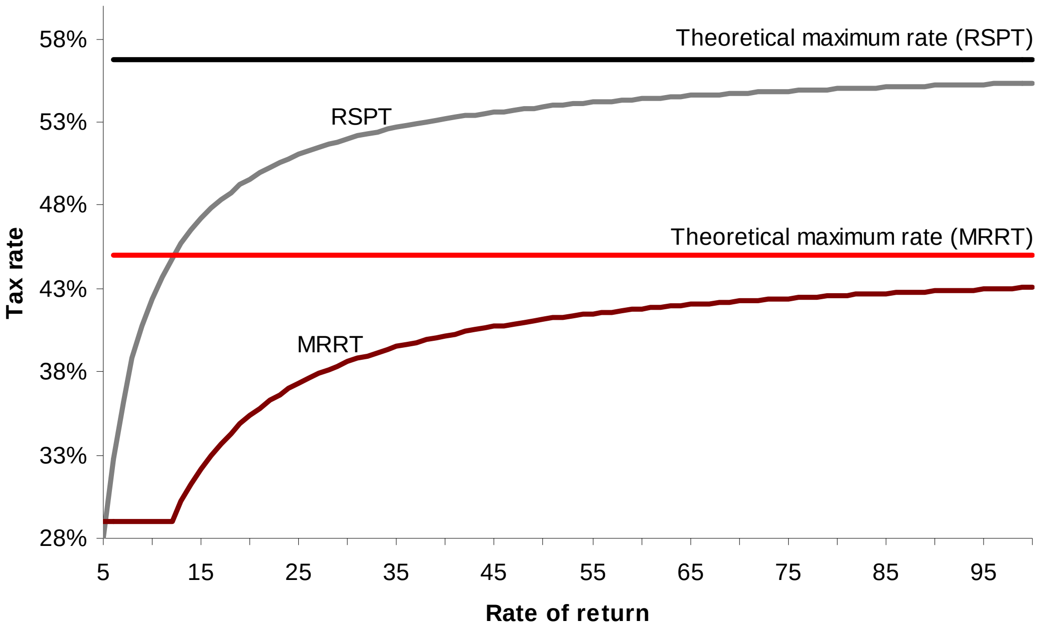
The MRRT also excludes companies with MRRT-assessable profits of less than $50 million per annum. New investment will attract an instant write off, which means that projects will not be liable for any MRRT until they have made enough profit to pay off their up-front investment. Unutilised losses will be carried forward at the long-term government bond rate plus 7 per cent, a sufficient margin to account for the risk that investors in mining projects face. Furthermore, the headline rate of the MRRT (30 per

[8] Effective tax rates for royalties plus 30% company income tax derived from Swan, W., *Economic Note No. 18,* 9 May 2010. Effective tax rates for MRRT plus 29% company income tax are ACTU estimates. The MRRT regime provides full credits for State royalties and carries unused royalties forward at the long-term Government bond rate plus 7 per cent; royalty payments are thus excluded from calculation of companies' effective tax rate under the MRRT regime.

cent) is reduced to a 22.5 per cent effective rate by the 25 per cent extraction allowance.

Moving from the proposed Resource Super Profits Tax (RSPT) system to the proposed MRRT system has resulted in a significant reduction in the effective tax rate to be faced by mining companies. The scale of this reduction can be seen in the chart below.

Chart 7: Effective tax rates under the RSPT and MRRT systems[9]



The MRRT also has a substantially narrower base than the RSPT, applying only to iron ore and coal rather than the broader range of commodities to which the RSPT was intended to apply. This substantial concession to the industry has resulted in a diminution in the number of companies to be liable to the tax, from 2500 to around 320. The ACTU believes that the Australia's Future Tax System review was right to recommend a broadly-based resource rent tax with a 40% headline rate, but we accept that the Government has negotiated in good faith with the industry to address its concerns, and continues to work through the Policy Transition Group to address technical issues that arise.

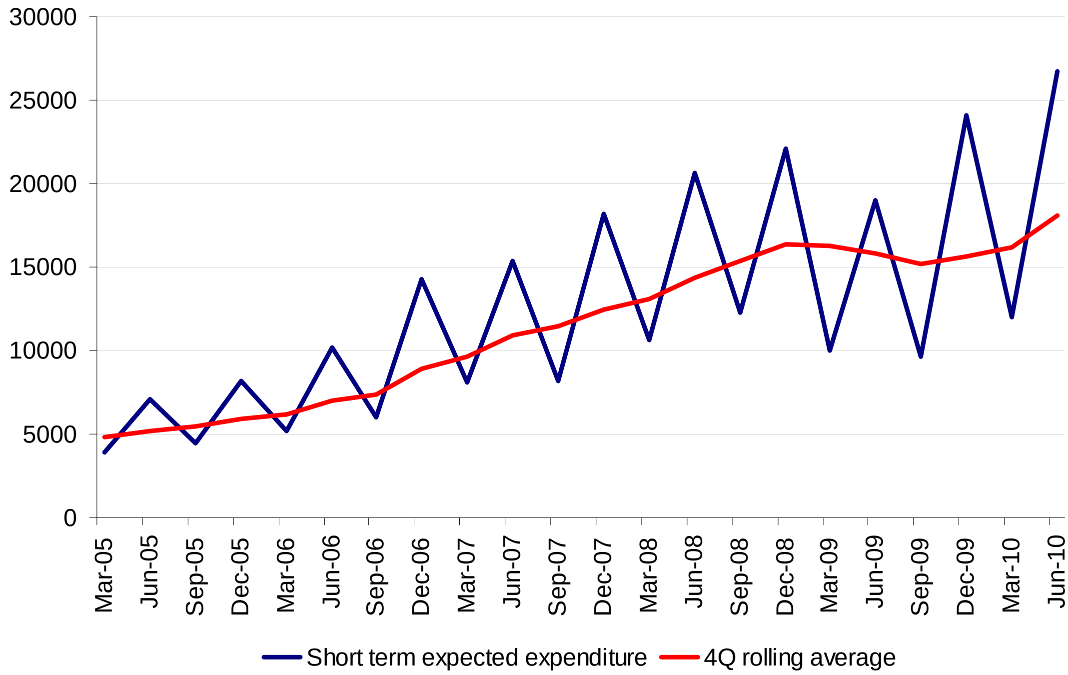
[9] Based on ACTU calculations which assumes a 10 year Commonwealth bond rate of 5%. The RSPT rates include a 28% company income tax rate, and the MRRT rates include a 29% company income tax rate.

Despite the generous concessions afforded to the mining industry, the MRRT package achieves many of the same fundamental goals as the RSPT package. The ACTU therefore strongly supports the MRRT package.

There is no evidence to suggest that the announcement of a resource rent tax has materially affected investment and activity in the Australian mining industry.

Mining investment rose by 2.8% in the March quarter and again by 2.6% in the June quarter.[10] Short term expected expenditure, investment expected to be undertaken in the first half of the 2010-11 financial year, also increased. The chart below shows short term expected investment expenditure in the mining industry over the past five years.

Chart 8: Short term expected mining investment 2005-2010[11]



There is a sharp disjuncture between the mining industry's public reaction to the announcement of the Resource Super Profits Tax on May 2 and its investment

[10] ABS 2010, *Private new Capital Expenditure and Expected Expenditure, Australia,* Cat no 5625.0, June 2010, Table 4, seasonally adjusted.
[11] Derived from ABS 2010, *Private new Capital Expenditure and Expected Expenditure, Australia,* Cat no 5625.0, June 2010, Table 1b, original.

behaviour. This disjuncture led Peter Martin of the Age and the Sydney Morning Herald to note[12]:

> *Mining executives appear to have been saying one thing and doing another during May and June, as they negotiated with the government over the resource super profits tax.*
>
> *Investment and investment-intention figures released yesterday show that while talking of putting projects on hold and moving offshore they were both boosting spending and dramatically lifting planned spending.* [The Age, August 27 2010]

The evidence, as opposed to the industry's rhetoric, demonstrates that the announcement of a resource rent tax has not discouraged investment in the mining industry. On the contrary, investment and planned investment both rose in the June quarter.

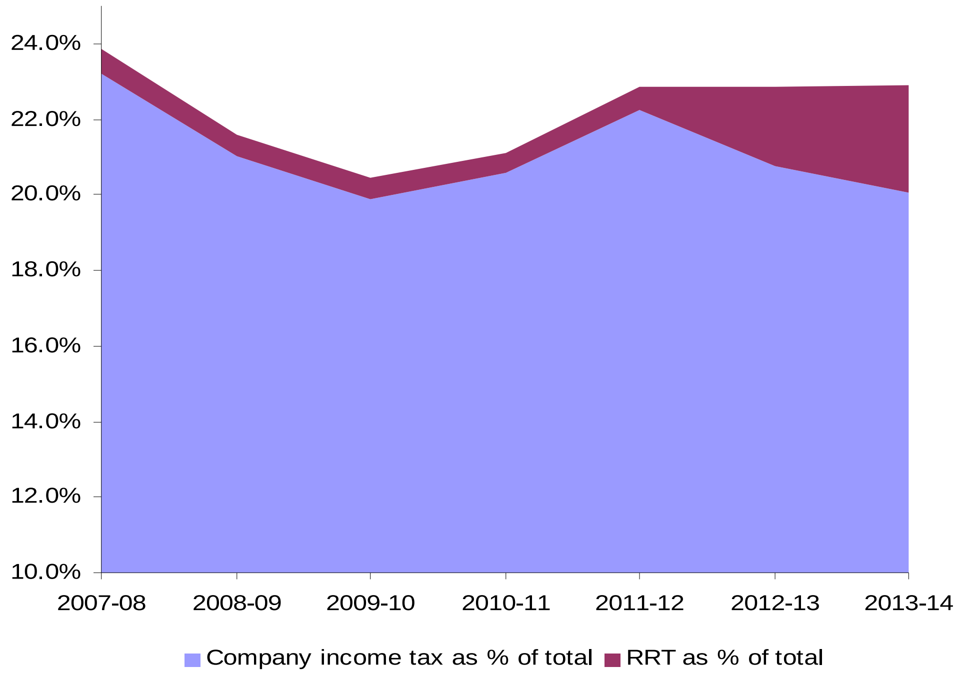
The Stronger, Fairer, Simpler Tax Package

The amended tax package, with the MRRT replacing the RSPT, still achieves the overall goals of the initial package. It finances a reduction in the company income tax rate to assist non-resource export industries and import-competing industries to deal with the more difficult environment they face as a result of the soaring Australian dollar.

The aggregate impact of the package on business taxation arrangements can be seen in the following chart of the share of total tax revenue paid by business (including the company income tax, the PRRT and MRRT).

[12] Martin, P. 2010, 'Miners' money doesn't back their tax talk', *The Age,* 27 August 2010. Available online: http://www.smh.com.au/business/miners-money-doesnt-back-their-tax-talk-20100826-13u7g.html. [Accessed 15/10/2010].

Chart 9: Business tax revenue as a proportion of all tax revenue[13]:



The Stronger, Fairer, Simpler tax package is forecast to result in a constant share of total tax revenue paid by business. However, the share of revenue derived from company income tax is forecast to fall and be replaced by resource rent taxation (including the MRRT and the PRRT). The package can therefore be seen as a form of industry assistance to all industries other than the sections of the mining industry that will be liable to pay resource rent taxes. This will assist manufacturing and services sectors including tourism.

This assistance is urgently needed. It is clear that non-mining export industries are struggling with the strong Australian dollar. Manufacturing, tourism and higher education are particularly affected. For example, the Chief Executive of the Australian Tourism Export Council, Matt Hingerty, said "three billion dollars more is leaving the country from travel as is coming in and we haven't seen that for 30 years."[14] It has been reported that Monash University has predicted a fall of 10 per cent or more in its foreign student enrolments for 2011, while Curtin University academics predicted that foreign enrolments across the Australian higher education

[13] Graph compiled using data derived from: Commonwealth Budget Paper No 1 2008-09, p.9-17; Commonwealth Budget Paper No 1 2009-10, p.9-18; Commonwealth Budget Paper No 1 2010-11, p.9-17; Economic Statement of 14/7/2010, p.19.
[14] Quotes in ABC Online, "Strong dollar double edged sword for tourism", 14/10/2010, Available from: http://www.abc.net.au/news/stories/2010/10/14/3038254.htm?section=business. [Accessed 14/10/2010].

sector could collapse by over 25% by 2015.[15] The manufacturing industry is contracting in employment terms.

While there are always factors other than the exchange rate at play in the fortunes of particular industries, it is no mere coincidence that all Australia's non-commodity based export industries are suffering at the same time. Economic modelling suggests that 10 per cent appreciation of the AUD leads to a decrease in investment in the manufacturing industry of around 4.2%.[16] Other industries are also likely to see a decrease in investment and a decrease in demand for their products as the currency appreciates.

The MRRT package is a vital and necessary part of the policy response to the effects of the mining boom on other Australian industries. The package is designed to ameliorate the effects of 'Dutch disease in several ways:

- By saving the benefits of improved resource revenues for the future in the form of superannuation;
- By investing in infrastructure to enhance supply capacity; and
- By reducing the rate of company income tax.

Increasing the Superannuation Guarantee rate to deliver financial security for workers in retirement is estimated to cost the Australian Government $3 billion in foregone revenue due to the preferential tax treatment of superannuation relative to wages. The Government's improvements to superannuation, including the increase in the SG rate, are projected to result in over $500 billion in additional funds in Australians' superannuation accounts by 2035. This is a sound public investment for the future and it is made possible while adhering to the Government's strict fiscal rules by the revenue derived from the MRRT.

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[15] Collins, S-J., 'Foreign students in retreat', *The Age,* 14/10/2010. Available from: http://www.theage.com.au/national/education/foreign-students-in-retreat-20101013-16k03.html. [Accessed 14/10/2010].

[16] Swift, R. 'Measuring the effects of exchange rate changes on investment in Australian manufacturing industry' [Paper from the Australian Conference of Economists (34th: Melbourne: 26-28 Sept 2005). Freebairn, John and Griffiths, Bill (eds).], *Economic Record*, v.82, Special issue, Sept 2006.

The MRRT revenue also enables the Government to expand investment in vital infrastructure, particularly in resource-rich states. Mining regions have struggled with the additional pressures that rapid economic expansion can bring. The ACTU strongly supports the use of revenue from the MRRT to improve social and economic infrastructure in mining regions. Allocation of funds for infrastructure investment should be done in consultation with local stakeholders including community groups, unions, local governments and others.