Submission to the Senate Select Committee of the Scrutiny of New Taxes: Minerals Resources Rent Tax

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1. Overview

The focus of this submission is on the economic justification for the proposed Mineral Resources Rent Tax (MRRT) and the expanded coverage of the Petroleum Resources Rent Tax (PRRT), and the regional economic impacts that are likely to be generated. Many issues are common to the earlier version of the proposal, the Resource Super Profits Tax (RSPT). This submission is organised into comments on four key themes:

1. Underlying justifications for resource rent taxes
2. Impacts on the mining industry of specific MRRT design details
3. Impacts on regional areas and adjustments for the two speed economy
4. Identifying how resource rents should be allocated

These comments are particularly focused on the addressing the following items in the terms of reference:

> *(b) The short and long term impact of those new taxes on the economy, industry, trade, jobs, investment, the cost of living, electricity prices and the Federation;*
>
> *(c) estimated revenue from those new taxes and any related spending commitments,*
>
> *(d) the likely effectiveness of these taxes and related policies in achieving their stated policy objectives*

2. Specific Comments on underlying justifications

The following underpinning principles (summarised in the Henry Review) are accepted.

1. There is a well established set of economic principles that where resources are fixed in supply, then entities holding property rights can extract returns above the normal payments for factors of production (including opportunity costs of capital, entrepreneurship and skill). These additional returns are known as rents. They are particularly relevant to land and natural resources. ('Rent seeking' refers to the situations where entities petition government for particular treatment or regulations to create artificial limitations). The

theory holds that standard market mechanisms of competition do not operate to compete away those rents, because the resource supply is fixed.

2. The Henry Review makes a strong case for some form of a resource rent tax to be applied:

    a. Where non-renewable resources are involved (P218), as there is a loss of natural capital

    b. Where natural resources are involved, because the finite and fixed nature of the resource means that economic rents can be earned (P218)

    c. Where there are large increases in prices of natural resources over time, as royalty mechanisms do not maintain an adequate share to government.

3. The Henry Review also correctly establishes the case (P218 - 219) that it is more appropriate for private industry to exploit resources because private industry (a) is generally more efficient in production mechanisms, (b) responds faster to changing market conditions and (c) is more likely to optimise resource extraction (the Hotelling rule).

4. The Henry review makes the argument (P219) that the community owns the resources, and that the government has a responsibility to seek appropriate returns from its use.

5. The Henry Review identifies three main ways of charging for the exploitation of non-renewable resources: output-based royalties, rent-based taxes, and income based taxes.

6. The three broad mechanisms for capturing resource rents differ in administration and compliance (transaction) costs, with the royalties having the lowest costs and the rent-based taxes having the highest costs (P225).

7. Rent-based taxes are identified as being theoretically more efficient (P225), and have three main variants: (a) A negative and positive net cash flow (Brown) tax, (b) a positive only net cash flow (Garnaut and Clunies Ross) tax, and (c) a cash flow equivalent tax with allowance for corporate capital.

There are issues with the following underpinning arguments made in the Henry Review, which have flowed through to the design of the MRRT.

8. The major issue with the recommendations of the Henry review, and the subsequent design and justification of the RSPT and the MRRT is that issues of design, scale and purpose are confounded. The issues around design refer to the type of mechanism used to capture resource rents to the public. In some cases, there are strong arguments for moving from a royalty system to a tax system, particularly if the same amount of resource rent is to be collected. The issues around scale refer changes in the amount of rent, while the issues of purpose relate to the reasons why it is captured and how it should be used. The arguments in favour of changing the system do not automatically mean that increases in the amount of rent captured or the purposes for which it is spent are appropriate.

9. A key problem with the Henry Review, and the subsequent justification of the subsequent resource taxes, is that it identifies that resource taxes should be placed on extractive resources without clarifying the underlying arguments in relation to the stock of capital. Mining depletes the stock of natural resources, but allows for other forms of capital to be developed in its place. A sustainability framework would focus on the need to ensure that any losses in natural capital are at least compensated by increases in other capital, such as improved knowledge, technology and infrastructure. A key justification of a portion of resource rents going to society (through resource taxes) are that these can be invested in creating new capital, helping to maintain sustainability. Allowing all resource rents to be captured by private interests generates risks that the natural capital is squandered on consumption. This means that a key purpose of raising the rent should be to increase other forms of capital.

10. The Henry Review downplays the important role that property rights, private investment and public investment have in developing natural resources. An assumption underpinning much of the analysis is that natural resources have already been discovered, and are held by private investors. This follows the standard textbook example to explain resource rents, but does not reflect reality.

    While discovery and quantification remains important, most extractable natural resources can not be developed without significant private and often public investment in supporting infrastructure such as rail and port facilities. In situ resources often have low potential rents. As resources are proven, and infrastructure is developed, then potential rents increase. Well developed property rights systems that reward private investment in exploration, development and extraction stages help to increase potential rents, and when resources are extracted, to generate economic surpluses. These surpluses are important for economic development, which is why there is often a case made for public investment in areas such as exploration and infrastructure development.

    The problem with assuming that all resource rents 'belong' to the public can be illustrated with the following example. Assume a proven mineral resource is held under private lease in a very remote part of Australia. The potential costs of constructing infrastructure mean that the resource has no excess rent available – it cannot be commercially developed. Now assume that another entity builds a transport corridor past the resource to service another purpose. This immediately makes the first resource viable, and allows potential rents to be generated. But if the transport corridor was fully built by private investment, is it appropriate to consider that the increase in potential rent is publicly owned?

    This means that an assumption that all resource rents are essentially public property, and up to 100% can be legally captured, is not correct. It is the potential for rents to be created that helps to stimulate private investment. The theoretical economic argument that excess rents can be appropriated without affecting the level of activity is only true in an abstract case where there is perfect knowledge and appropriate infrastructure provided for the resource. In reality resource rents are created by combinations of resource scarcity, public investment and private investment. Potential resource rents would be much lower if there was no public

investment (largely state government investment in exploration and infrastructure) or private investment (across a range of activities). If all resource rents were appropriated, it would reduce the incentives for these types of investments to occur.

These reasons are likely to justify the selection of lower levels of resource rent capture in the MRRT compared to the RSPT, as well as setting the RSPT well below 100% capture. A key problem with the Henry Review is that it argued for a 40% RSPT rate (and a combined statutory tax rate of 55%) without adequate justification of the rate. (The only apparent justification is that this rate was applied for the Petroleum Resource Rent Tax). If the review was consistent with arguments that all the rents derived from mining were owned by the public, then it would be logical to set the resource rent tax close to 100%.

In fact this is an optimisation problem, with at least three key elements. Resource rents are needed to justify:

a. The loss of natural capital in terms of the amount needed to substitute other forms of capital,

b. The returns to justify public investment (largely state government investment)

c. The returns to justify private investment.

While reasons (a) and (b) indicate that the tax rate should be substantially above 0%, reason (c) suggests it should be well below 100%. Currently, little rigorous analysis is available about an optimum level. It is likely that each of these groups are important, which indicates that an appropriate tax rate will be somewhere midrange.

3. Specific comments on the design of the MRRT

The MRRT makes a number of significant concessions to the mining industry compared to the original design of the RSPT. Issues of note are:

1. The exclusion of all extractive mining apart from coal and iron ore, and the exclusion of smaller firms is well justified in terms of avoiding transaction costs and optimising compliance efforts. In Queensland, the bulk of royalty income (approximately 85-90%) is derived from coal production.

2. The combination of a lower taxation rate (30%), a 25% extraction allowance, and an addition 7% on the uplift rate provide recognition of the role of private investment in generating resource development. These concessions reduce the rate of effective tax to between 42% and 45%, and will help to maintain attractiveness for investment.

3. Transition arrangements are generous, allowing companies to value capital assets at market value. This may favour larger and more established operations.

It is difficult to assess if the arrangements under the MRRT are optimal. As any level of the MRRT above existing royalty payments will effectively reduce industry profits, it may be difficult to secure full industry support for any level of a MRRT. Proposed investment in both mining and onshore gas (which is to be assessed under the PRRT) remains very strong, which provides some indication that the proposed MRRT arrangements favour industry.

4. Impacts on regional areas and adjustments for the two speed economy

4.1 Economic activity in regional areas

A core issue with the design of the MRRT will be potential impacts on regional areas. The resources sector makes a significant contribution to many regional and remote communities in Australia, so any slowdown in activity might have significant implications for economic activity and development. For example, the size of the direct economic stimulus from the resources sector in Queensland is shown in the following figures, where salaries and supplier expenditure from the major mining, gas, minerals processing and energy companies in Queensland were collected and mapped by postcode (Rolfe et al. 2010).

Results show that salary expenditures are broadly spread across the state, with business expenditures tending to be more concentrated around major centres and ports. When both salary and business expenditures are added together (Figure 3), the summed impacts show that almost every LGA in Queensland is receiving some level of direct expenditure from the resources industry.

Figure 1: Salary payments in Queensland Local Government Authorities with top ten expenditure areas labelled

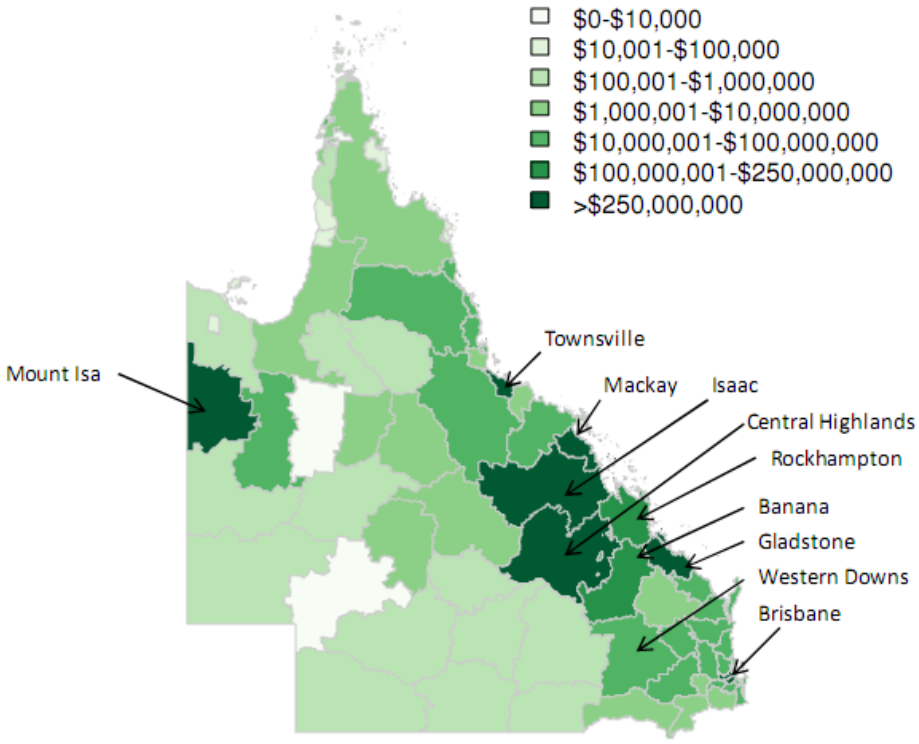


Figure 2: Supplier expenditures in Queensland Local Government Authorities with top ten expenditure areas labelled

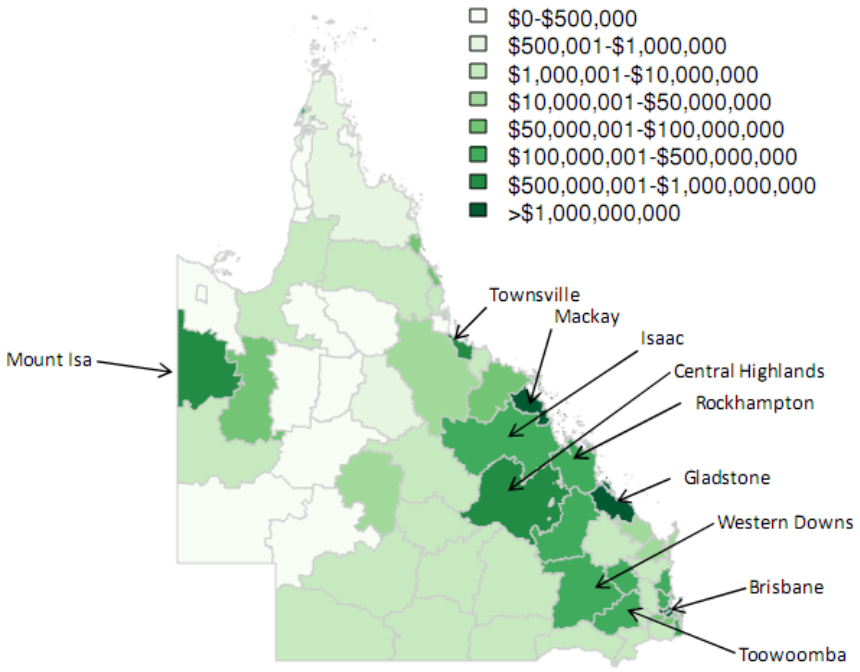
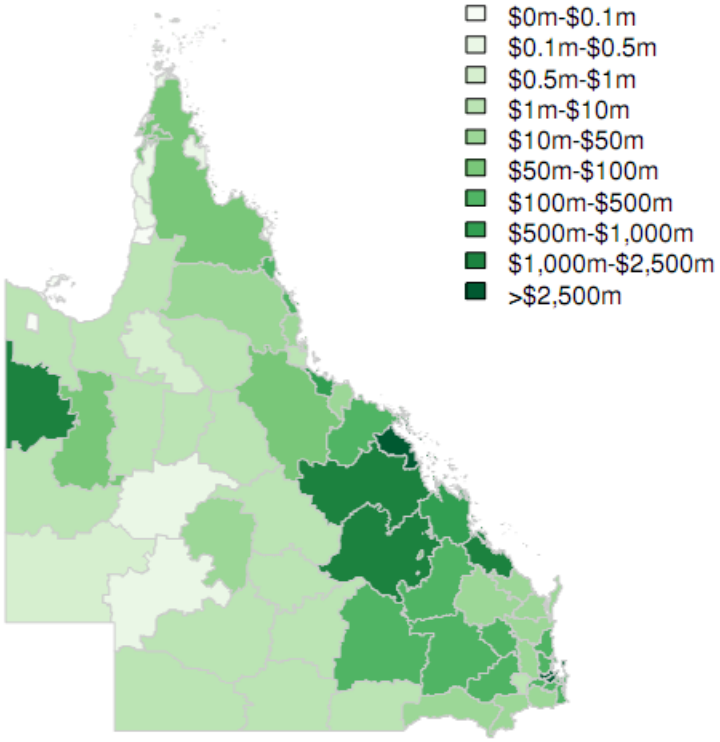


Figure 3: Total Economic Stimulus from Resources Sector by Local Government Authority



These results show that levels of activity in resources are extremely important in driving regional economies in Australia, and that it is very important that the design of the MRRT (and PRRT) do not lead to a major slowdown in economic activity in regional areas.

4.2 Dealing with infrastructure, service and Dutch Disease issues in regional areas

The mining sector generates substantial economic wealth and flow-on effects on employment, business activity and populations. For example, Rolfe et al. (2009) identify that the resources sector underpins about 20% of the Queensland economy when both ongoing operations and new capital developments are considered. The impacts in some regions such as the Bowen Basin in Central Queensland and the minerals triangle in north-western Queensland (around Mt Isa) are much larger.

The mining sector generates many additional pressures in regional areas through growth pressures and demands for infrastructure and resources (Rolfe et al. 2007, Lockie et al. 2009, Petkova-Timmer 2009). Extra activity, transport of construction inputs, and increased workforce movements puts substantial pressure on infrastructure such as roads. Rapid increases in populations in resource regions place new pressures on social services and social infrastructure. Shortages in housing mean new developments push housing prices and rents to extremely high levels, with subsequent social impacts on residents with lower incomes. Businesses in other industry suffer local forms of Dutch Disease as labour and resource prices rise. In some resource towns, labour and housing shortages make it impossible for a diversified economy to emerge, so that the economic stimulus from new activity is transferred to other centres. Rolfe et al. (2010) show that more than 50% of total economic impacts of the mining sector in Queensland flow through to Brisbane.

A key deficiency with the Henry Review is that it does not address the spillover effects of the mining sector on communities and other parts of the economy. It appears that an underlying assumption in the analysis is that problems of negative externalities have already been addressed through regulatory and other approval mechanisms. The issue of potential spillover effects is important, because there are opportunities for resource taxes to be used to address these impacts.

Responsibilities for the spillover effects largely accrue to state and local governments, so the existing royalty systems are essentially the payment mechanisms available to address these issues. It is likely that as there is very rapid mining development and as infrastructure demands become more complex over time, the proportion of mining rents flowing to state governments needs to increase over time. However there is no analysis of the principles that will be used to allocate the proceeds of the MRRT between the Australian and state governments. The arrangement to credit state governments for existing royalty mechanisms is limited to the short term, because state governments would normally need to increase royalty rates over time to recoup their additional costs of infrastructure and service provision.

4.3 Dealing with Resource Curse and Dutch Disease issues at the national level

The prolonged boom in mining has other impacts on the economy at the national level. The major impacts of an extended increase in exports is upward pressure on the exchange rate, leading to adverse terms of trade for sectors such as manufacturing, tourism and agriculture. Essentially the mining boom is generating other spillover effects on the economy through competition for labour

and resources, impacts on capital markets, and impacts on the exchange rate. The growth and stimulus from the mining industry can generate adverse economic pressures on other sectors of the economy (Dutch Disease) or remove pressures on government and industry to make other structural changes (Resource Curse).

While wider spillover effects are generally not discussed in the Henry Review, the issue of the two speed economy was initially identified as a reason for introducing the RSPT. However, the mechanisms to do this are not clear in the design of the MRRT. There are two main options available. The first is to reduce expenditure through saving some of the windfall gains in a future fund, as is done by Norway. This would reduce upward pressure on exchange rates and help non-mining sectors to remain more competitive. The second is to invest in measures that would increase productivity.

Where there has been public debate around the two speed economy, it has been poorly framed as resource rich states versus other states. It is more useful to consider the two speed economy in terms of industry sectors, because a stimulus from the resources sector flows very quickly through into other sectors and across states. Growth in mining will also generate substantial activity in secondary sectors such as construction and transport, and services sectors such as insurance and banking. Within a state, even in resource rich states such as Western Australia and Queensland, the effects of higher exchange rates will disadvantage key sectors of manufacturing, tourism and agriculture. In fact industries in these states could be doubly disadvantaged by the combinations of high exchange rates and reduced availability of labour.

5. Identifying how resource rents should be allocated

A resource tax such as the MRRT generates opportunity costs in two important ways. First, there is substantial administration, compliance and other transaction costs involved. Second, there is the reduction in private sector incentives and stimulus that would have been achieved if the funding had been allowed to be allocated to the private sector. A key test in designing the MRRT is to show that the returns from transferring rents into government will generate returns larger than those opportunity costs.

There is potential for funds raised by the MRRT to generate important benefits, such as improvements in productivity measures and net capital amounts, and addressing potential spillover effects of mining. Currently the government has not provided a case to demonstrate that the benefits of the MRRT justify the opportunity costs that will be involved.

The analysis that is provided above suggests that resource rents that are generated from mining projects can be allocated for several different purposes:

(a) Higher rents in the form of excess profits stimulate the private sector to develop better knowledge, technology and infrastructure to access resources. Some level of rent capture by industry is important to provide appropriate incentives for development.

(b) Resource rents are also generated by public investment in infrastructure, knowledge and services. It is appropriate that rents generated by these investments are returned to the appropriate level of government making the investment (particularly state governments).

(c) Resource rents are also important to maintain the total stock of capital, so that losses in natural capital as mining occurs are substituted by other increases in human, technical, physical and other capital. Transferring losses in natural capital for consumption (or delayed consumption) is not appropriate.

(d) Resource taxes may also be important to address key spillover effects at local, regional and national levels. The main options for achieving this are to reserve funds from expenditure to minimise pressures on the economy and the exchange rate, or to invest in actions that will boost productivity in disadvantaged sectors.

There are several deficiencies with the proposed MRRT in the proposed allocation of funds.

- There is no strong justification for allocating funds for superannuation or general community infrastructure projects, as these are really allocations to consumption (current and delayed).
- There is no framework to show that funds will deliver net capital increases, or that funds will be invested to deliver wider productivity increases.
- There is no justification to show that MRRT should be raised by the Australian Government rather than the states
- There are no principles or mechanisms in place to justify how proceeds of the MRRT should be allocated between the Australian Government and the States.

References

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