Submission into the Senate Economics References Committee Inquiry into the development and operation of the Minerals Resource Rent Tax

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This submission is related to the key questions identified for the inquiry.

a) the design of the MRRT and the extent to which the design of the tax as opposed to other factors such as commodity prices are responsible for the mismatch between actual revenue and revenue projections;

The underlying premise of the inquiry is that the primary role of the Minerals Rent Resource Tax is to raise funds for the Australian Government. This is wrong on both theoretical and practical grounds.

There are four key economic principles that might be used to support some public capture of resources rent. First, mining an exhaustible resource destroys natural capital, so investments need to be made into other forms of capital to maintain sustainability. Second, governments need a return on the public investments that have been made across a range of infrastructure and services to allow the resource rents to be created. Third, governments need to address the demands for services and infrastructure that mining booms directly generate, particularly in regional areas where mining occurs. Fourth, governments need to address the Dutch Disease problems on the remaining economy, particularly the agricultural, tourism, international education and manufacturing sectors that are sensitive to higher exchange rates.

It is the state governments that have the responsibility for managing natural resources, as well as the infrastructure and services that are required to service the resource development and associated communities. Development of the resources sector should be treated no differently to other sectors in the Australian economy, except the need to address any rundown in natural capital. The issues that justify some form of a tax are largely state based, and so the primary responsibility for managing any returns from the mining sector should remain with the state governments.

Apart from the impacts in natural capital, the resources sector is no different to other parts of the economy. There is no economic justification to tax one sector of the economy more heavily than others simply because higher profits are being made. Australia already has progressive taxation systems and the Grants Commission to redistribute government funds between states. The arguments mounted to justify an additional taxation mechanism to be applied at the Commonwealth level and to redistribute funds across the country are political; they are not justified on economic grounds.

There are two key questions about the design of the MRRT. The first is whether a resource tax is more efficient than a royalty system, and the second is whether additional revenue should be raised.

The efficiency of resource taxes over royalties

In relation to the choice between a rent tax and a royalty system, economists typically point out that royalties tend to be a drag on marginal operations and allow higher rents to be captured over the life of a project. Addressing the first point, the key argument is that by relating rent payments to profits (rather than outputs), resource operations will be profitable for longer, with lower levels of resource rent paid at the beginning and closing stages of a mine, balanced by higher payments in the more profitable mid-life operating stages. However, moving to a resource rent instead of a royalty also involves substantial risks to government:

- there is much less certainty about the amount of revenue that government will receive
- the revenues to government are delayed further, so there is a bigger temporal mismatch between when infrastructure and services need to be provided at the beginning of a project and when revenues begin to flow
- it is more difficult to apportion resource rents between locations when a company has several operations
- it may encourage development of low-profit operations that never deliver adequate resource rents to government.

Addressing the second point, the largest differences between resource rents and royalties occur when royalties are based on quantums and paid on a flat rate per unit of production. Ad valorum royalties where the royalties are set as a percentage of value allow royalties to automatically adjust with changes in revenues when prices vary. There is even less difference between a resource rent tax and specialised types of royalty arrangements. Under a progressive ad valorem system the rate charged increases with the value of the minerals, effectively capturing a higher proportion of the revenue (and profits). In Queensland there is already a multi-tier system of royalties for coal, and a variable rate system (between 1.5% and 4.5% on other minerals). Under a profit-based royalty system (as applies in the Northern Territory) the royalty rate to be applied is based on an estimate of the net value of a mine’s production.

In summary then, the theoretical efficiencies that are often used to justify a resource rent tax are largely overstated. Royalty systems can be designed that provide some flexibility in relation to resource prices on the one hand, effectively changing marginal royalty rates in line with changed prices and profits, at the same time as providing greater certainty about payments from industry to government and avoiding marginal low profit operations. While resource rents are theoretically more efficient than royalties in economic terms, a range of practical issues limit those benefits.

Increasing the take

The political interest in the MRRT has largely focused on the potential for the new tax to generate increased revenue to the government. In part, this has been supported by technical economic arguments that where super normal profits are involved, the profits in excess of ‘normal’ profits can be taxed without removing the incentives to operate. Under certain assumptions about having a closed economy and very good knowledge about available resources and future costs and prices, these arguments are valid. However, in an open economy with imperfect knowledge and large fluctuations in costs and prices, it becomes very difficult to identify ‘super’ profits from ‘normal’ profits. In reality, some mining ventures are very risky, and can only be justified if very large profits may be possible. In Australia there is a positive relationship between expected profits in the mining industry and opportunities for new development. Some proponents of the MRRT imply that there is a threshold between profits and new development where profits can be taxed at zero cost to future development. In the Australian situation where the extent of the resource base and opportunities for new development are not well known, a resource rent tax such as the MRRT will act as a drag on resource developments. It will not be costless in terms of lowering opportunities for new development, as it will reduce expected returns and the viability of new projects.

A resource rent tax will have a similar effect as a royalty in that it reduces the net private returns from mining. Increasing the take from a resource rent tax will reduce incentives to explore and invest in new mining projects (although the effects on existing projects with much greater certainty about resources and future outputs will be much smaller).

The implementation of the MRRT in Australia has been flawed in a number of ways.

- It has tried to transfer a state level responsibility to the Commonwealth
- It has not justified the move to a resource rent tax over a variable ad valorem royalty system
- It has not set out the expected negative relationship between taxation revenue under the MRRT and the level of future investment in the Australian resources sector.

Given the importance of the resources sector to the Australian economy, particularly in regional area, and particularly given the economic impacts flowing from construction stages, it has been very fortunate that the MRRT has raised little revenue. If the government take from the MRRT had been higher, then the negative consequences on existing operations and future mining developments would be much higher.

(b) the process by which the MRRT was designed, including the extent of the involvement of the Department of the Treasury and mining corporations who would be paying the tax;

The design process was flawed because it did not allow any considered debate over the design, or for different options to be put forward and discussed. As a result, flaws in the design were not identified. The key problem with the tax is that because it does not replace the royalty system of States, there are no economic efficiency gains generated.

c) the extent to which, if at all, the Government took into account the views of communities affected or potentially affected by iron ore and coal mining when designing the tax;

There is little evidence that the Government took the concerns of directly affected communities into account. The effects of the MRRT are ultimately negative for those communities because (a) the impost of the tax on the resources industry will slow down future investment and (b) much of the tax proceeds are distributed more widely.