Submission on resource rent taxes by George Fane, ANU

1. Overview: A distinction should be made between existing projects for which exploration and/or development licences have already been allocated to private companies and new projects for which licences have not been allocated. It is argued here that:

(1) Applied to an *existing* project without advance warning, the market value of the present and future revenue from a rent tax is equal to the market value of the wealth effectively expropriated from private share holders.

(2) Under plausible assumptions, a rent tax announced in advance and applied to a *new* project that is to be allocated by work program bidding is less efficient than a royalty and would raise less revenue than that produced by the royalty.

2. Neutrality and efficiency: Since both the above propositions follow from the neutrality of a rent tax, it is useful to begin by clarifying what is meant by neutrality and efficiency. In the context of business decisions, a tax is said to be ‘neutral’ if it leads businesses to make the same decisions on production, investment, employment and everything else as they would have made in the complete absence of the tax. *Provided* that there is no market failure in the absence of all taxes, that situation will be efficient and if the tax is neutral then imposing it will not cause any deviation from the original efficient situation. However, in the context of the Australian mining sector, the situation in the absence of all taxes would not be efficient because licences are allocated by work program bidding and not by cash auctions. Work program bidding gives firms an incentive to overinvest in order to gain access to mining sites. Royalties help overcome the inefficiencies created by work program bidding, but a neutral rent tax would not.

3. Existing projects: It was claimed by the Treasurer that the original version of the proposed mining tax, the RSPT, would have been neutral. Let’s assume that this claim is right, or nearly right, and focus initially just on the rent tax and not on the refunding of royalties, even though this is an important part of overall package. Proposition 1 above follows immediately from this assumption: if mining companies make the same decisions on production, investment, employment etc. with the rent tax in place as they would have made in its absence, then their pre-rent tax net cash flow — that is, all revenue minus all expenditure — will be the same with the tax in place as it would have been in the absence of the tax. Therefore if the government takes 30% of the pre-rent tax net cash flow, private shareholders are left with only 70% of the net cash flow that they would have had in the absence of the tax.

The rent tax will not meet a legalistic definition of expropriation that focuses only on the ownership of shares themselves, and not on the ownership of the cash flows that give the shares their value. But from a practical perspective it comes to exactly the same thing as expropriation of 30% of the shares, since it makes no difference whether the government takes 30% of a person’s mining shares or 30% of the cash flows that give them their value. All taxes contain an element of expropriation, but in the case of a rent tax on an existing project it is the essence of the tax. It is the sole source of the revenue that it raises and also the reason for its neutrality.

In denying that a rent tax would be applied to the banks, the Treasurer stated that: "There is a world of difference between the banking system and mining. Mining uses the resources owned by the Australian people for which a fair fee or royalty or rent should be paid. That is why we have put in place our resource rent tax. We are not moving in that direction in the banking system.” (*The Age*, 21 February 2011). In fact, the two preceding paragraphs show that, from an economic perspective, there is no difference between the unexpected introduction of a rent tax on mining companies and the unexpected introduction of a rent tax on banks. In both cases, each dollar of tax revenue is obtained by reducing the value of the shares held by private shareholders by one dollar. The Treasurer's attempted justification for a rent tax on mining as a way in which the community can obtain fair return on the resources that it owns would be valid if the tax were applied only to new projects, or if existing projects could *immediately* deduct the full market value of their investments at the time of the announcement of the tax. But once a site has been allocated, either by work program bidding or by cash bidding, the community no longer owns the mineral rights.

There is of course an important political difference between imposing a rent tax on mining companies and imposing one on banks: in the latter case, the expropriation of share holders would be blatantly obvious to all, but in the former case it is apparent only to those who distinguish between unallocated resources that the community still owns and already-allocated resources over which mining companies have obtained rights as a result of competitive, open tendering.

4. Royalties and new projects allocated by work program bidding: the economists who support the mining tax appear to assume that equilibrium in mining projects is reached when the marginal cost of minerals from each mine is equal to the net-of-royalty price of minerals received by the mining companies. This would probably be a good approximation to reality if mining licences were allocated by auctions, but it is a very misleading assumption in the actual situation in which licences are allocated by work program bidding.

If a rent tax on new projects is going to raise revenue it must be the case that the mining companies undertaking new projects are expecting to earn supernormal profits ('rents')—that is, expected profits in excess of a normal rate of return on the funds invested, after allowing for risk. But if the company that wins the work program bid is expecting to make a supernormal profit, why does another company not make more lavish work program bids, thereby reducing expected profits, but nevertheless gaining the right to the site? The most important reason is probably that only a few companies have access to the infrastructure necessary to exploit most sites.[1] In this case, the supernormal profit that is taxed by a rent tax is not the value of the minerals owned by the community, but only the *difference* between (a) the value of contribution to the project of the infrastructure owned by the winning bidder and (b) the corresponding value of the infrastructure owned by the second highest bidder. Under plausible assumptions this difference is likely to be much less than the revenue that could be raised by a royalty. Replacing royalties by a rent tax will therefore reduce government revenue from new projects. It will also reduce efficiency because royalties help correct some of the inefficiencies created by work program bidding and, to the extent that it is indeed neutral, a rent tax does nothing to correct these inefficiencies.

5. Conclusion: The introduction of a rent tax on existing projects raises revenue only to the extent that it effectively expropriates shareholders of mining companies. The Henry Committee was right to recommend the auctioning of exploration and development licences for new projects. And *if* auctions were introduced, there would be a case for combining them with a rent tax on new projects. However, in the absence of auctions, the replacement of royalties by a rent tax on new projects is likely to reduce both revenue and efficiency.

[1] The appropriate way to deal with a monopoly arising from the ownership of infrastructure is to require the owner of the infrastructure to allow access to others at a regulated price. Because of its neutrality, a rent tax would do nothing to reduce the inefficiency caused by monopoly, even though it might collect some of the monopoly profits.