Submission to the Australian Government Policy Transition Group

Submission on the Minerals Resource Rent Tax (MRRT)

October 2010

Prepared by the Chamber of Commerce and Industry Western Australia

CCI

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CHAMBER OF COMMERCE AND INDUSTRY WESTERN AUSTRALIA

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About CCI

The Chamber of Commerce and Industry of Western Australia (CCI) is the leading business association in Western Australia.

It is the second largest organisation of its kind in Australia, with a membership of 6,000 organisations in all sectors including resources, manufacturing, agriculture, transport, communications, retailing, hospitality, building and construction, community services and finance.

Most members are private businesses, but CCI also has representation in the not-for-profit sector and the government sector. About 80 per cent of members are small businesses, and members are located in all geographical regions of WA.

Introduction

This submission is in response to the Federal Government's Policy Transition Group (PTG) *Issues Paper* released on 1 October 2010 regarding the technical design of the Minerals Resource Rent Tax (MRRT), transitioning existing petroleum projects to the Petroleum Resource Rent Tax (PRRT), and policies to promote exploration expenditure.

This submission focuses mostly on the MRRT. Iron ore alone is particularly important to the Western Australian economy. It accounted for almost half of the state's total value of commodities production in 2009-10. Therefore, the MRRT is likely to have a disproportionate impact on the WA economy relative to the rest of the country. The proposed tax is a key concern for the state's business community as a whole, not just the resources sector.

CCI understands that it is not the role of the PTG to revisit the existing MRRT design principles announced on 2 July 2010, nor is it to consider the process adopted by Government in developing this new tax. However, the fact remains that our primary concerns with the MRRT relate to the lack of debate over the merits of the tax itself and the quality of the policy formulation process adopted by Government in developing this tax. These issues are the focus of our submission (see 'Issues of Concern – process and principles' from page 9).

To ensure proper consideration is given to the merits and impact of a rent tax on iron ore and coal extraction, CCI would prefer to see the final MRRT taken to the National Tax Summit in 2011. Although this may prolong uncertainty over the tax, the cost to industry and the economy in implementing a hastily assembled tax, without due consideration of its long run impacts or alternative options, would be much greater.

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The MRRT ought to be considered in the wider context of national tax reform given that the National Tax Summit is to examine the recommendations put forward in the report, *Australia's Future Tax System* (i.e. the Henry Review), one of which was to implement rent taxes on the extraction of non-renewable minerals.

It is therefore only reasonable that the final design of the MRRT put forward by the PTG be taken to the National Tax Summit where the wider community should have an opportunity to consider alternative options for the taxation of minerals in Australia, and the suitability of rent taxes for minerals altogether.

Our submission highlights the concerns we hold in relation to the impact and suitability of rent taxes relative to the universal tax principles of efficiency, equity, transparency, adequacy and competitiveness. The key to maintaining a competitive taxation environment is to apply these principles of taxation to minimise the overall effect of the tax system on the business sector and individuals.

Although our concerns chiefly relate to the principles underpinning the MRRT and the process undertaken to develop the tax, we also highlight our concerns about the design and implementation of the MRRT itself (see 'Issues of Concern – design and implementation' from page 23). These relate in particular to the design and application of the $50 million threshold, the allowance (or uplift) rate, the potential for base broadening, and mechanisms to increase exploration expenditure.

However, we also have broader concerns about the narrow Terms of Reference given to the PTG. The Committee will find it difficult to facilitate positive, fundamental changes to the design of the MRRT given that its recommendations must be revenue neutral. Considerations over the design and implementation of this tax should be guided by tax principles and a pragmatic application of those principles, not by the Government's fiscal strategy. We would like to see this requirement of the Terms of Reference amended or relaxed to ensure the PTG are able to deliver meaningful changes to the MRRT design.

We are also concerned about the uncertainty surrounding the crediting back of future increases in State and Territory royalties under the MRRT. Questions have been raised about the constitutional validity of the MRRT if future royalty increases are not offset, although accommodating future increases could also reduce MRRT revenues for the Federal Government, making the tax less viable. This difficult trade-off highlights the need to debate this tax more broadly against alternatives. A more principled and considered approach would avoid such pitfalls.

CCI thanks the PTG for the opportunity to comment on its Issues Paper and provide input on this important process. We welcome further debate and discussion with the PTG on the issues raised in this submission.

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Summary of key points

1. Industry is extremely disappointed that the first opportunity it will have to formally comment on the MRRT is over a period of just one month. The Government has also ignored industry concerns by directing the PTG to consult solely on MRRT design and implementation rather than on the merits of the tax itself. There has been little debate on the merits of rent taxes and their suitability to mining (see 'Issue 1: The policy formulation process', on page 9).

2. Industry consultation on the initial design of the MRRT was hasty, lacked transparency and was limited to just three companies. It remains unclear how the Government arrived at the current broad design of the MRRT. The assumptions underpinning the MRRT revenue forecasts also remain under wraps. CCI appreciates the confidential nature of some of these issues, but such considerations need to be balanced against the wider public interest. This is, after all, a major new tax on a key sector of the economy. At a minimum, it would be helpful to see a 'sanitised' report on how the current design was reached (see 'Issue 1: The policy formulation process', on page 9).

3. Imposing rent taxes on mining due to its use of non-renewable resources violates the principle of horizontal equity in taxation. Using a nation's natural resources to earn rents is not limited to the mining sector alone. Rents can be found in many sectors which exploit natural resources, and moreover, government policy itself can create rents. If mining rents are to be taxed, then why should the same not hold for all rents, and in particular those that public policy creates? (see 'Issue 3: Tax equity and the MRRT', on page 12).

4. The MRRT is unlikely to achieve administrative efficiency. There is uncertainty over the Government's forecasts of revenue intake from the tax, while compliance costs are likely to be significant. Some industry analysts reportedly estimate that the tax in its current form might only apply to 50 firms and revenue intake could be as low as $2.5 billion in the first two years compared to Government estimates of $10.5 billion (see 'Issue 4: Rent taxes and administrative efficiency', on page 14).

5. It is often assumed that governments can tax economic rents without significantly distorting economic behaviour. However, this assumption ignores the unique aspects of the mining sector where the incentive to earn rents are key to motivating firms to undertake the significant economic risks involved in large capital outlays on exploration, development and research into new technology. A rent tax could therefore distort activity in the sector in the long run, even though activity in the short run might remain firm (see 'Issue 5: Rent taxes and economic efficiency' on page 15).

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6. Additional taxes and charges on mining can be justified on the grounds of securing an adequate return to current and future generations for exhausting the country's non-renewable resources. However, what is of more importance to the community is how those returns are spent. To genuinely compensate the community for the use of its non-renewable resources, the Government should ensure that returns are devoted to accumulating alternative assets that will benefit society in the long run. Apart from the regional infrastructure fund, the spending initiatives proposed by the Government for the revenue raised by the MRRT achieve little in the way of building assets for the future (see 'Issue 8: Tax adequacy and Government spending initiatives' on page 21).

7. A particular concern for CCI is the Government's claim that it will fund the rise in the superannuation guarantee charge using revenue raised from the MRRT. With the exception of the public service, the superannuation guarantee charge is paid by private employers, not the government. Therefore, CCI would like further clarity on how much MRRT revenue is earmarked for increasing the super guarantee charge, and exactly how those funds are to be applied (see 'Issue 8: Tax adequacy and Government spending initiatives' on page 21).

8. While it is important to secure an adequate return for the community from the depletion of our non-renewable resources, this objective must be balanced against the wider, globally competitive environment that Australian resource companies and their customers operate within. The Terms of Reference given to the PTG does not gauge the impact of the MRRT on Australia's international competitiveness. Resource companies operate in a global environment, where capital and labour are highly mobile. Although Australia provides a stable environment to conduct mining business, overseas jurisdictions are increasing their efforts to attract new investment. The National Tax Summit provides an appropriate forum to consider these impacts and what trade-offs the community is willing to accept (see Issue 7: MRRT and Australia's international competitiveness, on page 17).

9. The Terms of Reference given to the PTG is not conducive to achieving fundamental changes to the MRRT design. The Committee will find it difficult to facilitate meaningful amendments to the design if its recommendations must be revenue neutral. Considerations over design and implementation should be guided by tax principles and a pragmatic application of these principles - not by the Government's fiscal strategy. CCI would like to see this requirement of the Terms of Reference amended or relaxed to ensure that the PTG are able to deliver genuinely positive changes to the MRRT design (see 'Issue 9: Revenue neutrality in the Terms of Reference', on page 23).

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10. The requirement for the PTG to be revenue neutral in its recommendations also raises concerns that the MRRT rate and/or base may need to be increased and/or broadened to achieve the Government's existing revenue targets. CCI warns against any such move. This would increase perceptions of Australia's sovereign risk in the eyes of international investors and resource companies. Along with the Minerals Council of Australia, we encourage the PTG to recommend that the key design parameters of the tax be enshrined in core legislation, not carried in regulations (see 'Issue 11: Raising the tax rate or broadening the base' on page 27).

11. There is considerable uncertainty over whether the current design of the tax allows for the crediting back of future increases in State and Territory royalties. Potential constitutional issues and tax complexities arise if future increases are not offset, although accommodating future increases could also significantly reduce MRRT revenues for the Federal Government, making the tax less viable. This difficult trade-off highlights the need for a broader debate of this tax against alternatives. The Henry Tax Review urged negotiation between Federal and State Governments on constitutional aspects of the tax, and we are concerned that the Federal Government views it instead as a matter for miners to resolve with their respective State and Territory Governments (see 'Issue 10: Constitutional issues and the crediting of royalties' on page 24).

12. It is unclear how the $50 million threshold has been calibrated by the Government. CCI believes that the threshold should be determined by the principles of tax equity and efficiency – not government revenue intake. In particular, CCI believes the threshold should apply as an indexed, tax-free threshold to limit distortions. The PTG should be free to recommend changes to this threshold without needing to be revenue neutral (see 'Issue 12: Design and application of the $50 million threshold' on page 28).

13. The MRRT design prescribes a uniform cost of capital (i.e. the allowance rate) across the iron ore and coal sectors as a whole. However, a project's cost of capital will reflect a number of issues, particularly its form of financing and the risk related to that venture which can be underpinned by a number of factors – especially the size and experience of the firm itself. On this point, over two-thirds (or $39 billion) of the value of iron ore and coal projects currently in the pipeline in Western Australia are attributable to small and midcap miners, who generally have a higher cost of capital than established, globally active miners. A tax that does not recognise this could impinge on the viability of some of these projects (see 'Issue 13: Determining the MRRT allowance rate page', on page 29).

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14. By prescribing an allowance rate, the Government is effectively determining that any profit earned by a project above its capital outlay and its cost of capital is an economic rent. This does not recognise that firms seek to earn a commercial rate of return and ignores what rate of return investors demand from a project. These rates of return are rarely equivalent to a firm's cost of capital, which is the minimum required rate of return. CCI is also concerned about including the Long Term Bond Rate in the calculation of the MRRT allowance rate. This opens the value of MRRT liabilities and revenues to activity in global bond markets, which can be volatile and may bear no relation to the profitability of individual mining operations (see 'Issue 13: Determining the MRRT allowance rate page', on page 29).

15. The PTG asks for feedback on policies to promote exploration expenditure across all minerals and energy commodities - not just iron ore, coal, oil and gas. CCI has long advocated for a flow through share (FTS) scheme to be established in Australia to encourage exploration expenditure. A FTS scheme encourages investment in exploration by enabling the transfer of tax deductions of exploration companies to individual investors, and it can be particularly beneficial to junior explorers, who often struggle to raise sufficient capital. Moreover, it is disappointing that the PTG is required to be revenue neutral even in this recommendation, especially since these considerations appear unrelated to the MRRT and extended PRRT. The PTG should be free to investigate the best possible means of increasing resource exploration without needing to be revenue neutral in its advice (see page 'Issue 14: Policies to promote exploration expenditure' on page 32).

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Issues of Concern – process and principles

Issue 1: The policy formulation process

The development of a rent tax on Australia's minerals sector has followed a disjointed process.

CCI understands that it is not the role of the PTG to revisit the existing MRRT design principles announced on 2 July 2010, nor is it to consider the process adopted by Government in developing this new tax.

However, the fact remains that our primary concern with the MRRT is not over its design and the means of its implementation. Rather our key concerns relate to the lack of debate over the merits of the tax itself, and the quality of the policy formulation process adopted by Government. After all, the MRRT represents a major new tax on one of Australia's most important industry sectors.

The original Resources Super Profits Tax (RSPT) was introduced with no community or industry consultation over its merits, design or impact. Its design was poor and its impact on the resources sector would have been significant. This is reflected by the fact that the tax was eventually dumped. The revised MRRT represents an improvement on the RSPT. However, its development involved only limited industry input, which was in any case hastily sought by Government.

Moreover, this brief consultation with industry was disappointingly opaque. It still remains unclear how the Government arrived at the current broad design of the MRRT as the details of the discussions with the three miners have not been publicly released. The assumptions underpinning the Government's MRRT revenue forecasts also remain under wraps. While CCI appreciates the confidential nature of some of these issues, such considerations need to be balanced against the wider public interest. This is, after all, a major new tax on a key sector of the economy.

At a minimum, it would be helpful to see a 'sanitised' report on how the current design was achieved – one which respects the confidential nature of any particular aspects of the discussions while maintaining transparency.

The PTG is now seeking to consult with industry more widely and transparently, although this consultation is being conducted to a very tight timetable over a period of just one month. This has limited the PTG to seek advice mostly from firms directly impacted by the tax. It appears that little consideration could be given to the potential longer term impact of the tax on the broader business community and the economy.

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It is extremely disappointing that the first opportunity that the wider industry and community have to formally comment on this tax is over a period of just one month. Additionally, the Government has effectively ignored industry concerns over the original RSPT and MRRT by directing the PTG to solely consult industry about tax design and implementation rather than on the merits of the tax itself.

There has been little debate on the merits of rent taxes and their suitability to mining. Although Australia has operated a Petroleum Resources Rent Tax (PRRT) since 1987, it is far from a model tax. In fact, its application still remains a source of uncertainty and has been the subject of legal challenges, clarifications and tax rulings over the years.

Some of the issues that have arisen under the existing PRRT regime pertain to fundamental issues such as liability of take or pay payments to tax; deductibility of pre-development expenditure; point at which petroleum becomes subject to tax (i.e. the taxing point itself); the deductibility and assessment of operational hedge losses and gains; and deductibility of certain head office costs[1]. In fact, this year the ATO has issued three draft rulings pertaining to the *Petroleum Resource Rent Tax Assessment Act 1987*.

Despite the obvious lessons from the PRRT, it is disappointing that the most significant parts of the MRRT will be the last to be finalised and subject to such a hurried process. Transparency in taxation demands that a tax system clearly identify what is to be taxed and how the liability is calculated. In contrast, the RSPT and MRRT proposals have only introduced complexity and uncertainty, with taxpayers unable to identify how much tax they could be paying.

Overall, this process represents a piecemeal approach to policy formulation by Government. It does not instil confidence within industry or among international investors. There is considerable uncertainty about the impact of the new tax, and in Western Australia many businesses – not only within the mining sector - have felt the impact of this uncertainty.

The PTG is to report to Government on the final design of the MRRT by the end of this year in order that legislation can be drafted to implement the tax. However, to ensure proper consideration is given to the final design of the MRRT, CCI would prefer to see the final MRRT taken to the National Tax Summit in 2011.

Although this may prolong uncertainty over the tax, the cost to industry and the economy in implementing a hastily assembled tax, without due consideration of its long run impacts or alternative options, would be much greater.

The MRRT ought to be considered in the wider context of national tax reform, particularly given that the Summit is to consider the recommendations put forward in the *Australia's Future Tax System* report (i.e. the Henry Review) – one of which

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was the proposal to implement rent taxes on the extraction of non-renewable resources. It is therefore only reasonable that the community is given an opportunity to consider alternative options for taxes on mining and the suitability of rent taxes for minerals altogether, alongside consideration of a final MRRT.

Issue 2: The merits of a rent tax

There has been little debate and analysis over the relative merits of rent taxes versus royalty schemes or other forms of taxation.

The Government released the final report and its initial response to the Henry Tax Review on 2 May 2010. This included the Henry Review Panel's research and arguments in favour of introducing rent taxes on non-renewable resources. In particular, the Henry Review highlighted the inefficiencies related to royalty regimes[2]:

"Analysis commissioned by the Australia's Future Tax System review found the most inefficient taxes levied in Australia include mining royalties and crude oil excise...For example, every additional dollar of revenue raised from royalties is estimated to cost the community around 70 cents because miners reduce their investment and output."

However, the public never had an opportunity to properly debate and consider these arguments prior to the RSPT proposal, which was set out in the 2010-11 Commonwealth Budget just nine days later on 11 May 2010. With such little debate conducted on the merits of rent taxes versus royalty regimes, the National Tax Summit provides an obvious forum to finally conduct this analysis.

Economic rents represent payments to the factors of production over and above the amount necessary to keep that factor in its current employment. There, it is often assumed that governments can tax rents without significantly distorting economic behaviour. However, there is useful academic and industry research into optimal taxes for mining which should help to inform policy decisions regarding taxation of the mining sector. For example, a 2006 independent World Bank report into the impact of mining royalties[3] found that:

"Some types of royalties are better suited to the collection of economic rent than others. Royalties based on mineral volume or weight are least appropriate, because they are wholly insensitive to measurements of rent. Value-based royalties are only slightly better - they will move up and down with price but are not tied to the cost side of the project's economics. Profit-based royalties are better yet because they take into account receipts and costs, although they too do not account for a return on capital. Pure economic rent-based taxes have been proposed for the mining sector but have not found favour with either governments or industry.

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The closest approaches have been efforts in countries such as the Philippines and Papua New Guinea (now repealed) to levy an additional profits tax based on a calculation that seeks to determine: (1) whether a profit threshold has been reached and (2) all amounts that exceed a defined internal rate of return to which a tax rate is then applied. The sliding-scale royalty based on a ratio of costs and profits in Ghana... also appropriates some economic rent but neglects return on capital. Taxes based on economic rent principles can be applied to any business but almost never are. The one exception is petroleum, for which, from time to time, particularly in times of very high prices, governments may devise and apply some form of additional tax based on the firm's rate of return.

Countries' geological, economic, social, and political circumstances make each nation unique, and an approach to royalty taxes that is optimal for one nation may be impractical for another. It is also not advisable to universally say that royalties are good or bad, because those judgments depend on the circumstances of the parties involved, a project's economics, and the observer's point of view."

In addition, Lund (2008) highlighted in his literature review of rent taxation for non-renewable resources that[4]:

"In order to minimize the need for distortionary taxes, economists have recommended rent taxes, which are supposed to be neutral. A combination of factors makes the design of these taxes or alternative arrangements for government revenue very challenging. There can be large rents in periods when resource prices are high, and thus a strong public demand for government revenue. There is high uncertainty in prices and geology, and technology is often owned by big multinationals. This raises issues about attitudes to risk and asymmetries of information, which are exacerbated by high tax rates."

The debate over the optimal and most efficient means of taxing the mining sector is not limited to rent taxes. The final form of the MRRT should be taken to the National Tax Summit for consideration alongside alternatives and a wider debate on the need for additional taxation of the resources sector. Below, we highlight some of the concerns held over the merits of rent taxes relative to the universal principles of taxation, and their applicability to the mining sector.

Issue 3: Tax equity and the MRRT

Rent taxes on mineral extraction contradict the principles of tax equity.

Horizontal equity in taxation requires that taxpayers in similar circumstances should face a similar tax burden. Vertical equity requires that taxpayers with different abilities to pay remit taxes in proportion to their exposure to the tax base.

As the PTG Issues Paper states, a rent tax is one mechanism for pricing the natural resource from which mining companies earn their profits, by transforming the

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resource in the ground to a saleable commodity. Royalty charges are another mechanism for pricing these resources.

These resources appropriately attract a charge beyond company taxes because a nation's endowment of non-renewable natural resources belongs to the present and future generation/s.

Achieving vertical equity is often put forward as an argument in favour of rent taxes. Vertical equity essentially aims to ensure that taxes paid increase with the amount of income, or profits earned. Royalties do not operate in this way as they are levied on the volume or value of the resource at a set rate, ignoring the profitability of the project. This lack of 'progressiveness' in royalty charges for non-renewable resources in Australia was highlighted by the Commonwealth Treasury in its justification of the RSPT in the 2010-11 Budget[5]:

"In Australia, governments have generally allowed private firms to extract non-renewable resources in return for a charge that has not kept pace with the increased value of Australia's resource deposits. This has resulted in Australia forgoing some of its potential national income gain from the stronger terms of trade."

This statement broadly reflects the Government's motivation for additional taxation on mining companies, that is, the need for the broader community to benefit from the economic rents earned from the resources which it owns.

However, in attempting to achieve vertical equity for the community by taxing the rents associated with resources, the principle of horizontal equity is violated. This is because the exploitation of a nation's natural resources to earn rents is not limited to the mining sector alone. Horizontal equity demands that taxpayers in similar circumstances should face a similar tax burden. However, as Tilton (2004)[6] points out, rents can be found in many sectors which exploit natural resources. For example, forestry, fishing, viticulture and other sectors can also generate rents from time to time.

Moreover, government policy itself can create rents. For example, when new transport infrastructure is built, the homes and businesses nearby often earn significant rents through higher property values or increased consumer traffic. Government licensing of some industry sectors (e.g. taxies) can often result in high prices for those licenses. This can also be viewed as an economic rent resulting from growing demand for a fixed-supply resource.

This raises the fundamental question that if mining rents are to be taxed, then why should the same not hold for all rents, and in particular those that public policy creates? For the government to target one form of economic rent while ignoring others does not achieve horizontal equity. In this context, the MRRT – which only

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targets rents generated by iron ore and coal producers while ignoring other mineral resources – is even more questionable.

In order to achieve horizontal equity, CCI does not advocate that the base of the MRRT be broadened to include all forms of mineral extraction. Nor do we suggest that rent taxes be extended to other industry sectors. Rather, this issue highlights a significant shortcoming of rent taxes for mining relative to the principle of tax equity. This reinforces our belief that the merits of a rent tax and their suitability to mineral extraction should be debated more widely at the National Tax Summit.

Issue 4: Rent taxes and administrative efficiency

Rent taxes on minerals are unlikely to be administratively efficient.

Efficiency in taxation requires that the system be administratively efficient so that the cost of managing and complying with a tax are not excessive relative to the revenue raised. The tax should also be economically efficient so that any distortions caused by individuals changing behaviour because of taxation are minimised.

It is difficult to calculate the administrative efficiency of most taxes. Often, the cost of managing and complying with the tax is difficult to measure. However, the range of items raised by the PTG in its Issues Paper attests to the fact that the MRRT is likely to be very costly for the Government to administer and manage, as well as costly for industry to comply with.

In this regard, it is welcome that one of the aims of the PTG in consulting with industry is to identify opportunities to minimise associated compliance and administration costs related to the MRRT.

However, a more significant issue in determining administrative efficiency is for the Government to address the uncertainty over its forecasts of revenue intake from the MRRT. As highlighted above, administrative efficiency is measured by compliance costs relative to the revenue raised by the tax itself.

Although the MRRT has a significantly smaller tax base than the RSPT (it is likely to apply to 320 companies rather than 2,500 previously), the Government estimates that the tax will raise $10.5bn in the first two years - only marginally below the initial $12bn estimate under the RSPT. The methodology and assumptions underlying this estimate have not been made public.

Unsurprisingly, industry analysts have cast doubt over this estimate. Some suggest the tax is likely to apply to only 50 firms and that the revenue intake could be as low as $2.5 billion[7] in the first two years. Such a shortfall could immediately make the MRRT administratively inefficient compared to the cost of managing and complying with the tax.

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Taking the final MRRT proposal to the National Tax Summit gives the Government an opportunity to become more informed about the administrative efficiency of the new tax. It could more closely consider the likely revenue intake from a finalised MRRT, while industry could also give estimates of the likely cost of compliance.

This would provide a more accurate picture of the administrative efficiency of the new tax relative to alternative tax measures to increase the return to the community from the extraction of mineral resources.

Issue 5: Rent taxes and economic efficiency

Rent taxes on minerals are unlikely to meet the principle of economic efficiency.

Economic efficiency in taxation aims to minimise any distortions caused by individuals changing behaviour because of taxation.

Because rents represent payments to the factors of production over and above the amount necessary to keep that factor in its current employment, it is often assumed that governments can tax rents without significantly distorting economic behaviour. However, this assumption ignores some unique aspects of the mining sector.

As Tilton (2004) points out, in the resources industry it is precisely the incentive of earning economic rents that drive companies to outlay such vast amounts of capital on exploration, development and research. After all, it is the hope of discovering a deposit so vast and rich (i.e. a bonanza, not a marginal mine) that it can generate a significant amount of rent that justifies such large outlays.

These activities give value to a nation's endowment of mineral and energy resources. Prior to the discovery of a deposit, or the development of the necessary production technology to allow extraction, those resources carry no value.

Therefore, removing or reducing the incentive of earning rents will affect investment and technological advancement in the mining sector in the long run. Extracting mining rents today can distort economic behaviour to the detriment of the economy. As Tilton (2004) describes it:

"...governments that tax the pure rent (even though they carefully leave the quasi-rent and other rent[8]) are doomed to watch their mineral sector slowly decline over time as their known deposits are depleted. This means that the argument for higher taxes to capture the pure rent in mining is misguided if a country wants to maintain a viable mining sector over the long run. It is worth noting as well that the presence of large Ricardian rents in the short run (the sum of the quasi-rent, other rent, and pure rent) coupled with the absence of such rents in the very long

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run creates a danger of short-sighted public policy. Higher taxes on mining will almost always appear successful for a time... Their adverse effects on mine production and government revenues may take years to become apparent - and then, unfortunately, take many more years, even decades, to reverse."

In addition, a key concluding principle of the 2006 independent World Bank report into the impact of mining royalties[9] is that:

"Care should be taken to weigh the immediate fiscal rewards to be gained from high levels of tax, including royalty, against the long term benefits to be gained from a sustainable mining industry that will contribute to long-term development, infrastructure, and economic diversification."

Therefore, it is clear that the potential long run impacts of rent taxes on incentives and their associated economic costs need to be considered alongside the immediate benefits of a rent tax. The mining sector is too important to the Australian economy for additional taxation to be hastily implemented without broader debate and analysis of its long term impact. The National Tax Summit gives an opportunity for exactly this.

Issue 6: Addressing the opportunity costs of mineral extraction

Increasing taxes to address the opportunity costs related to mining may not be appropriate.

The desire to receive an appropriate return for the community in depleting the nation's non-renewable natural resources underpins the Government's action in formulating the MRRT[10]:

"The breakthrough agreement [on the MRRT] *keeps faith with our central goal from day one: to deliver a better return for the Australian people for the resources they own and which can only be dug up once."*

This concept of incurring an 'opportunity cost' (i.e. the notion of being 'dug up' once) in extracting resources was introduced by Hotelling (1931). There is likely to be an opportunity cost related to exploiting a nation's non-renewable natural resources given that an additional unit of mineral or energy production today becomes unavailable for the future. However, pricing this opportunity cost as a means of compensating the community for exhausting the non-renewable resource ignores the global dynamics of mining.

Although individual resource deposits in a particular jurisdiction will eventually be depleted over time (implying an opportunity cost for the jurisdiction), this is not the case for the world as a whole. As Tilton (2004) highlights, there are significant mineral and energy deposits currently being extracted worldwide and new deposits are regularly discovered. Many metals are also no longer just used once but are

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increasingly being recycled and reused. Additionally, known or suspected deposits that are currently uneconomic to explore or extract might in future become economic to exploit with the right market conditions and technological advancements.

For these reasons, empirical studies attempting to measure the opportunity cost of exhausting non-renewable resources today have found, for the most part, that these costs are often negligible or zero - not only for metals but also for oil and other energy sources (Tilton 2004; Adelman 1990). As a result, markets and investors tend not to see non-renewable resources as 'scarce'. This implies that it is the economic rent - not the opportunity cost - that apparently gives value to mineral resources in the ground.

As Tilton (2004) points out, history has shown that conserving reserves for the future that can be profitably exploited today does not necessarily serve the interests of the community. For example, according to Tilton (2004) nitrate deposits in Chile became worthless in the early 20th century as new technology created a more attractive substitute. Over the past several decades, the rise of low-cost ocean transportation for bulk commodities coupled with the discovery of rich iron ore deposits in Australia and Brazil have similarly undermined the economic viability of many iron ore deposits in North America and Europe.

Therefore, while it may be the case that some intrinsic opportunity cost exists in relation to the depletion of a nation's non-renewable resources, it is important to recognise that taxation to address that opportunity cost and compensate the community is not always appropriate when considering the wider global dynamics of the resources sector.

CCI does not refute the idea that exploiting a non-renewable resource carries an opportunity cost. Neither do we advocate an aggressive and significant depletion of Australia's natural resources in the short term to 'cash-in' on current market conditions. However, in the public interest it is important to consider these opportunity costs relative to the wider globally competitive environment that the Australian resources sector operates within. This global aspect has been lacking in national debate about mining taxes to date, and we would envisage that the National Tax Summit would provide an ideal opportunity to host such debate.

Issue 7: MRRT and Australia's international competitiveness

The MRRT could harm the international competitiveness of Australia's mining sector.

Following on from the above considerations, it is important to gauge international tax competitiveness as part of implementing a new tax on the mining sector. Tax competitiveness goes beyond simple effective rates of tax, and refers to the total

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size and structure of the tax burden. The structure and burden of the system should not discourage people and businesses to locate to and conduct business in Australia compared to alternative locations.

Although mobile factors of production (e.g. labour and equipment) can escape high tax rates by moving to other countries, immobile factors – such as resource deposits - cannot. This often provides an incentive to governments to impose higher taxes on resource extraction.

However, Lund (2008) points out that there can be tax competition on immobile factors in relation to mining. Whatever the case, if tax rates are high, companies will prefer to move to another country even though the resource cannot be moved. This is because according to work carried out by Osmundsen (2005)[11], mining companies have unique factors of production, such as skills and technology, which they only use where it is most rewarding. According to Lund (2008), this implies that a country is limited in its ability to tax resource extraction by the tax level in other countries competing for attention of the same companies.

This is an important consideration, and on this level, Australia does not necessarily rank well as a mining destination. For example, much has been made about the mid-year update of the Fraser Institute's *Survey of Mining Companies* which gauged the views of 3,000 exploration, development, and other mining-related companies around the world. This update to the regular annual survey was conducted during the height of debate over the RSPT when the tax was first introduced and then withdrawn. Unsurprisingly, respondents reacted very negatively. The scores given to Australian states on the Institute's headline 'policy potential index'[i] fell so sharply that the average rank of the Australian states fell to 31st out of 51 jurisdictions in the mid-term survey from an average ranking of 18th in the annual 2009-10 survey.

However, what is more striking is that the annual 2009-10 *Survey of Mining Companies* conducted by the Institute before the announcement of the RSPT still illustrated Australia's relative uncompetitiveness. For example, on taxation regimes, the survey asked respondents for ratings on personal, corporate, payroll, capital, and other taxes, and the complexity of tax compliance.

[i] The policy potential index measures the effects on exploration of government policies including uncertainty concerning the administration, interpretation, and enforcement of existing regulations; environmental regulations; regulatory duplication and inconsistencies; taxation; uncertainty concerning native land claims and protected areas; infrastructure; socioeconomic agreements; political stability; labour issues; geological database; and security.

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Almost 30 per cent of respondents ranked Australia's tax regime as either a mild, strong or major (i.e. implying they would not invest here) deterrent to pursuing investment here. On this measure Australia's major mining jurisdictions of the Northern Territory, Queensland and Western Australia were ranked 31st, 32nd and 36th respectively in the world. On the broader policy potential index, the Northern Territory, Queensland and Western Australia ranked just 14th, 24th and 19th respectively in the world.

Measures of international competitiveness in a globally active sector such as mining ought to go beyond taxation alone. This is perhaps the most disappointing aspect of the Terms of Reference given to the PTG - it does not gauge the overall impact of the tax on the international competitiveness of Australian miners.

Resource companies operate in a global environment, where capital and labour are highly mobile. Although Australia's terms of trade have risen significantly in recent years and Australia provides a broadly stable political, economic and civil environment to conduct business, other aspiring regions and established mining nations are also stepping up their efforts to attract new investment.

For example, anecdotal evidence suggests that world mining exploration activity is increasingly focussing on South America, Africa and other emerging regions. There is some evidence of this in relation to non-ferrous metals (i.e. excluding iron ore, coal, and oil and gas). The Mineral Economics Group's *Worldwide Exploration Trends Survey* confirms that despite the effects of the GFC, in 2009 Latin America increased its share of world non-ferrous exploration expenditure to 26 per cent. Africa's share held firm at 15 per cent while other regions such as Russia, China, Mongolia, Europe, mainland Asia and the Middle East collectively increased their share to 17 per cent. In contrast, Australia's share fell to 13 per cent.

Data from the Australian Bureau of Statistics[12] also shows that on aggregate, mineral exploration expenditure in Australia has not recovered from the effects of the GFC with spending rising by only 0.4 per cent to $2.23 billion in 2009-10 following a decline of almost 10 per cent in the previous year.

More recently in September 2010, ResourceStocks Magazine's *World Risk Survey* saw Australia's ranking as a place to conduct mining business fall from third in 2009 to 26th in 2010. The survey asked mining executives to rate countries across 11 categories comprising issues such as infrastructure, land access and civil unrest. The categories that most affected Australia's ranking this year were sovereign risk, financial risk and red tape[13], which are linked to the introduction of the mining tax.

Chinese and Japanese investors have also expressed direct concern over the impact of the mining tax. Chinese steel makers have made the point that they and their downstream customers in the automotive and housing appliances sector are

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unwilling to accept higher input costs for steel should higher taxation costs be reflected in the contract prices of iron ore[14].

There are also several practical examples of how global dynamics - whether technological advancement, strategic positioning or market conditions – and not just taxation are important to the competitiveness of the mining sector. For example:

- In the US, the development of hydraulic fracturing technology and horizontal drilling has led to the extraction of shale gas which has helped to offset the decline in US production from conventional gas reservoirs. This has significantly reduced America's dependence on imports of natural gas.

- Buoyant market conditions for iron ore have attracted new investment into exploration and production capacity worldwide. This is evident in the more than doubling of China's iron ore imports from South Africa, Ukraine and Canada in 2009[15].

- China and Russia are seeking a closer strategic trade relationship on coal. For example, in September 2010 China agreed to increase its coal imports from Russia by 70 per cent over 20 years in return for a US$6 billion loan. In turn, Russian coal producers will use these funds to finance equipment, develop resources in its Far East region and build coal-transportation links to China. The countries will also set up joint ventures to develop coal resources in Russia and conduct research into coal-to-liquids technology (Russian coal exports to China rose 15-fold in 2009 to about 10 per cent of China's total coal imports[16]).

- Russia and China are also seeking greater co-operation on natural gas. The two nations agreed on conditions for a natural gas supply contract (except price) in late September 2010. Russian authorities believe it will commence delivery of natural gas to China by 2015 if the nations can agree on all aspects of their cooperation, including infrastructure and sources of delivery[17].

It is true that all of these dynamics could occur regardless of changes to the policy mix in Australia, but this misses the point. Australia ought to strive to improve its competitiveness and positioning internationally to keep on top of these dynamics. In this context, the setting of a major new tax on Australian miners absent of detailed consideration and with little industry input certainly does not help.

Therefore, while it is important to secure an adequate return for the community from the depletion of the nation's non-renewable resources, it is imperative that this objective be considered in the context of the wider, globally competitive

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environment that Australian resources companies and their customers operate within. This issue has been lacking in debate over the MRRT to date. The National Tax Summit provides an appropriate forum to consider these impacts and what trade-offs the community is willing to accept.

Issue 8: Tax adequacy and Government spending initiatives

The MRRT is unlikely to meet the principle of tax adequacy. Plus, the nature of the planned expenditure to be funded by MRRT revenue may not adequately compensate the community for use of its non-renewable resources.

The principle of adequacy in taxation refers to taxes being adequate to finance appropriate levels of government expenditure. As highlighted in Issue 4 above, CCI has concerns about the assumptions that underpin the Government's forecast of revenue from the MRRT. Moreover, we are also concerned about how the Government intends to spend the revenues from the MRRT.

While the Government's aim of securing an adequate return for the community for the exhaustion of its non-renewable resources is appropriate, what is of more importance to the community is how those returns are spent. In order to genuinely compensate current and future generations for use of our non-renewable resources, those returns ought to be devoted to accumulating alternative assets that will benefit the community in the future. However, the Government intends to channel revenues from the MRRT into:

- A $6 billion regional infrastructure fund;
- A cut in the company tax rate to 29 per cent in 2013-14 (with some possibility of a further cut to 28 per cent depending on the government's fiscal position);
- A cut in small business's tax rate to 29 per cent rate from 2012-13;
- Enabling small businesses to immediately write off assets valued at under $5,000 and to write off other assets (except buildings) in a single depreciation pool at a rate of 30 per cent; and
- Increasing the superannuation guarantee rate from 9 per cent to 12 per cent by 2019-20.

Apart from the regional infrastructure fund, these spending initiatives achieve little in the way of building alternative assets as a means of compensating future generations. Rather, they appear to be aimed at re-distributing wealth from the mining sector to the wider economy as a means of addressing the 'two-speed economy'. This is evidenced by the Government's pledge to return just $2 billion

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over 10 years to fund infrastructure in Western Australia from the proposed $6 billion regional infrastructure fund. This is a very small return to a state that has very big infrastructure needs, and from which a big portion of MRRT revenues will be generated. As the WA Treasury states[18]:

"...preliminary estimates suggest that Western Australia's contribution to the MRRT/expanded PRRT revenues would be in the order of 60-65%."

Moreover, CCI is not convinced that direct policy action is needed to address the asymmetric growth profile of the Australian economy. As Deloitte point out in their paper to the Minerals Council of Australia on the two-speed economy[19]:

"Unease about the two speed economy and industries or regions being "left behind" ignores the fact that growth across sectors and regions has rarely (if ever) been uniform in Australia or indeed, in any market economy. In a modern, dynamic, growing economy, there are always sectors that are expanding and contracting as demand and supply conditions change and prices adjust. Australia does not have a "two-speed economy"; it has thousands of industries operating at different speeds, with price and resource adjustments taking place constantly... there is nothing unusual about regional growth disparities in Australia. Economic growth in Australia has rarely, if ever, been uniform between States and Territories over the last twenty years. Indeed, current disparities are low by historical standards. In addition, there is nothing particularly unusual about different sectors growing at different rates in Australia. Indeed, this seems to be the rule rather than the exception."

Redistribution is a very different proposition to compensation in the context of charges for using non-renewable resources. Compensation demands that the returns be used for the long-term benefit of the community. Re-distribution is a short-term approach that might benefit the economy in the short run as long as the terms of trade remain favourable. After this time however, the community will neither have alternative assets in place, nor will other parts of the economy continue to enjoy the redistribution of wealth from the mining sector.

A particular point of concern for CCI is the Government's claim to fund the rise in the superannuation guarantee charge directly from MRRT revenue. With the exception of the public service, the superannuation guarantee charge is paid by private employers, not the government. Therefore it is unclear, if in stating this, it is actually the Government's intention to use MRRT revenue to fund its obligations to pay the higher superannuation guarantee to Commonwealth public service employees and statutory office holders, rather than the wider workforce. If this is the case, the Government should spell it out.

The Government will incur some costs from its reforms to superannuation for low paid and older workers, but as far as CCI is aware, these changes will not be

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funded by the MRRT and are in any case entirely unrelated to the proposed increase in the super guarantee charge[ii]. The rise in the charge is also not expected to affect the cost of the Government's co-contribution scheme, in fact the Government effectively made cuts to this scheme in the 2010-11 Budget[iii].

Therefore, CCI would like further clarity on how much MRRT revenue intake is earmarked for increasing the super guarantee charge, and exactly how those funds are to be applied.

It may be the case that the Government intends to indirectly fund the increase in the super guarantee charge by cutting company tax. However, if this is the case, it is unlikely that the financial benefit to businesses from these cuts will offset the higher costs from raising the superannuation guarantee charge. The proposed increase in employer superannuation payments from nine per cent to 12 per cent in seven increments over a decade is likely to cost business in excess of $20 billion annually (in current dollar terms) once fully implemented[20].

Issues of Concern – design and implementation

Issue 9: Revenue neutrality in the Terms of Reference

The Terms of Reference given to the PTG are not conducive to achieving fundamental changes to the tax design.

The Terms of Reference (TOR) given to the PTG requires that the Committee's recommendations be consistent with the Government's fiscal strategy as stated in the 2010-11 Budget. It states further that any policy deviation from the Government's announcement of the broad design of the MRRT on 2 July 2010 must be *fully offset* within the PTG recommendations in terms of impacts on revenue or costs.

[ii] From 1 July 2012 the Government will provide a super contribution of up to $500 for workers with incomes up to $37,000. This ensures that no tax will be paid on superannuation guarantee contributions for those with incomes up to that amount in 2012-13. This is intended to reward low income workers for saving. Also from 1 July 2012, the Government will allow workers aged 50 and over with super balances below $500,000 to make up to $50,000 in concessional contributions - this is up from the current cap of $25,000.

[iii] The Budget contained provisions to permanently maintain the super co-contribution matching rate at 100% (from 150% previously). It also froze the indexation of the super co-contribution income thresholds for 2010-11 and 2011-12 at $31,920 (the lower income threshold) and $61,920 (the higher income threshold).

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This requirement for the PTG to be revenue neutral in its recommendations binds the Committee's deliberations. The Committee must ensure that all aspects of its considerations on MRRT design (however important they may be) be guided by their impact on the Government's bottom line in order that the Government continue to collect revenue from the final tax as already budgeted.

It is difficult to envisage how the PTG can deliver any major concessions to industry without adversely impacting Government finances.

As highlighted in Issue 4, we already hold concerns over the integrity of the Government's revenue forecast from the MRRT. On current design, the tax could already earn significantly less than what is expected.

Considerations over the design and implementation of the tax should be guided by the principles of taxation and a pragmatic application of those principles – not by pre-determined Government revenue estimates.

In this context, we welcome the Government's apparent willingness to consider the level at which the MRRT threshold applies, despite potential impacts on the Budget. We note that the Minister intends to discuss the revenue impacts of any such change to the threshold with the Treasury[21].

Indeed, this should be par for course for all the design changes to the MRRT in order to give the PTG freedom to achieve, as far as possible, an optimal tax design. The Committee should not be bound by considerations on revenue impact. This should be a challenge for the Government and Treasury to manage once the PTG optimise the tax design.

Issue 10: Constitutional issues and the crediting of royalties

The non-crediting of future increases in State and Territory royalties under the MRRT may create potential constitutional conflicts. This highlights the need to debate the present MRRT design more widely and consider alternatives.

Under the Australian Constitution mineral resources are owned by the Crown and State and Territory Governments are entitled to charge mining companies a royalty in return for accessing those minerals. Mining companies operate under state agreements ratified by Acts of Parliament that detail the royalty regime.

The Constitution does not explicitly state that minerals are an area over which the Federal Parliament has jurisdiction. Indeed, each of the States and Territories has its own legislation regulating the exploration for and production of onshore minerals.

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The Henry Tax Review identified this as a key issue to be resolved in implementing any national tax on mining. Although the Review[22] identified that "the current charging arrangements for minerals fail to collect a sufficient return for the community…", and that "The current arrangements should be replaced with a uniform resource rent-based tax…administered by the Australian government", it also made the very important observation that, "The Australian and State governments should negotiate an appropriate inter-governmental allocation of the revenues and risks from the resource rent tax."

However, we are not aware that any such negotiations have taken place. The Henry Review presented two options for dealing with this: (1) that State royalties be abolished and the Federal Government assign its rent tax revenue to the States; or (2) that State royalty payments be credited against the Federal rent tax but fixed at a particular point in time to ensure that Australian Governments do not automatically fund future increases in royalties.

The latter option was pursued for the RSPT, but crucially, these options have very different impacts – they are not one and the same. For the two to have a similar outcome, the crediting of royalties should not be fixed at a particular point in time. Rather, future royalty increases would need to be credited back to mining companies for it to be akin to the option of abolishing royalties altogether.

If not, it would mean that any future increase in royalties would effectively result in the double taxation of miners, that is, a higher royalty charge (which is not credited back by the Federal Government) and a rent tax. This situation also creates an uneven playing field across the states. While the royalty offset enables a company to claim a federal tax credit for royalties' paid, subsequent increases to royalty rates would effectively see the credit offset apply differently in the states and territories.

Documents released under Freedom of Information and reported in the media[23] suggest that the Federal Government received legal advice on this issue, suggesting that it could be unconstitutional for a Federal tax to discriminate between the states and territories in its application.

The Heads of Agreement which outlines the broad design of the MRRT appears to correct this in stating that "All State and Territory royalties will be creditable against the resources tax liability but not transferrable or refundable". The statement is broad enough to be interpreted as including future royalty increases. However, we are surprised that the Government continues to suggest that it will not refund any future royalty increases (other than increases already agreed to at the time of announcement of the rent tax).

CCI understands that by agreeing to credit future royalty increases, the Federal Government's own revenue stream from the MRRT could suffer to the extent that

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State and Territory Governments increased their royalty rates (i.e. State and Territory Governments have a 'carte blanche' opportunity to raise royalties at the expense of the Federal Government). So the trade-off is essentially between the stability of the Federal Government's MRRT revenue stream, versus the potential constitutional and equity implications associated with not crediting back future royalty increases.

CCI believes the latter are more important issues to address. If these are not addressed, then the final tax will be inequitable in charging miners twice for the privilege of accessing resources, and moreover, it could be undermined by potential legal challenges over its constitutional validity.

Some suggest that mechanisms should instead be implemented to disincentivise State and Territory Governments from increasing royalty rates in future. For example, it has been suggested that the Commonwealth Grants Commission could adjust GST payments to the States and Territories to offset any future hikes in royalty rates[24].

But such actions only serve to add a further level of complexity to an already complicated tax. A solution to this issue should deal directly with the distortion that the current design creates in incentivising State and Territory Government to raise royalties. It should not preserve the distortion and seek to offset its effect elsewhere.

In our view this difficult trade-off the Federal Government faces on the MRRT between potential constitutional conflicts versus a sufficient revenue stream, highlights the need for a broader debate of this tax against alternatives. A more principled and considered approach would avoid these kinds of pitfalls.

In the first instance, the Henry Tax Review urged negotiation between State, Territory and Federal Governments on the constitutional aspects of this tax. In this context, CCI is concerned with the Federal Government's current stance that future increases in royalty rates are instead an issue to be resolved between miners and their respective State and Territory Governments. According to Minister Ferguson[25]:

"That's a fight, an argument [about future royalty increases] *that has to occur between the mining industry and those state governments of all political persuasions".*

This is not in the spirit of the initial recommendation of the Henry Tax Review and CCI would like to see more leadership from the Federal Government on this important issue. It should not be left to the PTG, miners, and State and Territory Governments to resolve.

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Issue 11: Raising the tax rate or broadening the base

Uncertainty over the revenue intake and the requirement for the PTG to be revenue neutral in its recommendations could lead to base broadening or rate hikes.

The lack of scope given to the PTG to consider fundamental reform of the MRRT design without adversely impacting Government revenues (see Issue 9) raises concern that the tax rate and/or base may need to be increased and/or broadened to achieve the Government's revenue targets.

It is not clear from the Terms of Reference (TOR) given to the PTG that such considerations are 'off limits' to the PTG. No such obligations are placed on the PTG through the TOR other than for the Committee's recommendations to be "consistent with the Government's fiscal strategy".

CCI warns against any recommendation to increase the MRRT rate or broaden the base in order that the Government's revenue targets are achieved. Such actions would increase perceptions of Australia's sovereign risk in the eyes of international investors and resource companies.

Similarly, because the TOR does not specifically rule out any investigation about extending the MRRT to other commodities or alter the rate of taxation, it does open the possibility for these changes to be pushed through on political grounds, particularly if the Government anticipates lower revenue intake from the tax due to changes in its own commodity price or production volume assumptions.

We note that part of the reason for narrowing the base of the MRRT compared to the RSPT was the fact that minerals other than iron ore and coal were unlikely to return significant revenue to the Government. However, faced with a potential shortfall in its budget and the associated political pressure that would bring, it is not inconceivable that the Government might seek to broaden the base to other commodities, or raise the rate of taxation.

We would hope that the Government's current promise not to broaden the MRRT base or increase the MRRT rate is an 'iron-clad' commitment. The consequences of breaking this promise could have a significant impact on the national economy, with particularly adverse implications for perceptions of Australia's sovereign risk.

Of course, as prices and production volumes in other parts of the resources sector may increase over time, there might also be a temptation on the part of future Governments to broaden the base or raise the rate of the MRRT in order to capture new rents. It is impossible to get a commitment from both sides of politics to eschew any such move in the long term.

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In this regard, CCI shares the views of the Minerals Council of Australia (MCA)[26] that the PTG recommend that the key design parameters of the tax be enshrined in core legislation, not carried in regulations. This will alleviate any uncertainty within the industry about the possibility of future Governments looking to change the tax unilaterally without the need to pass amending legislation through Parliament.

Issue 12: Design and application of the $50 million threshold

The calibration of the threshold should be determined by considerations about tax equity and efficiency, not government revenue intake. The threshold should apply as an indexed, tax-free threshold to limit distortions.

The PTG Issues Paper invites comment on the design and application of the $50 million threshold. There is considerable debate over this aspect of the MRRT because it is unclear how this threshold was calibrated by Government in the first place.

CCI believes that the application and design of the threshold ought to be driven by the principles of tax efficiency and equity. In this context, the threshold ought to serve three purposes:

- Achieve vertical equity by protecting smaller mining companies who are less able to pay MRRT liabilities;
- Achieve administrative efficiency by ensuring the costs incurred by Government in administering the tax and the costs incurred by smaller firms in complying with the tax do not exceed the revenue raised by levying these firms; and
- Achieve economic efficiency so that distortions caused by firms changing behaviour because of the threshold are minimised.

The threshold should be designed and calibrated to a level that achieves these outcomes. On a practical level, setting this threshold should be informed by the modelling and data provided by companies concerning cost of compliance and tax impact. The threshold should not be set at a level which achieves a particular revenue outcome for the Government.

The PTG notes in the Issues Paper that while it is open to suggestions about ways in which the threshold might be re-designed, "any change involving a cost to revenue would need to be offset within the PTG's recommendations". The threshold ought to be designed to achieve tax equity and efficiency regardless of the impact on revenue. To this extent, we welcome the Government's apparent willingness to consider the level at which the MRRT threshold applies despite potential impacts on the Budget (see Issue 9 above).

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Regardless of the threshold level, we do not believe that the threshold should apply as per the PTG interpretation – that is - taxpayers with profits exceeding the threshold pay tax on their entire profits, both above and below the threshold.

It is unclear how the PTG arrived at this interpretation given that the broad design announced by the Government on 2 July 2010 gave no such hint: it only stated that there will be no MRRT liability for taxpayers with low levels of resource profits (i.e. $50m per annum). Indeed, this aspect of the tax was a key source of uncertainty for industry for this reason.

Requiring taxpayers with profits exceeding the threshold to pay tax on their entire profits would not achieve economic efficiency. As the PTG recognises in the Issues Paper, it creates a perverse incentive for firms approaching the threshold to alter behaviour in order to remain below the threshold.

To reduce this distortion, CCI believes that the threshold ought to operate as a tax-free threshold whereby only profits in excess of $50 million (or whatever level may finally be agreed upon) are taxable. This would clearly have a revenue impact for the Government, but would go some way towards reducing distortionary behaviour.

Additionally we, along with the MCA[26], believe that the threshold should be subject to indexation on an annual basis. This will ensure vertical equity continues to be achieved in subsequent years as small miners remain exempt from the tax. It would also further reduce any perverse incentives in subsequent years for firms to alter behaviour and remain below a static threshold.

While the threshold will reduce costs for smaller firms by exempting some from having to pay the tax, it will not necessarily reduce compliance costs. As the PTG recognises in the Issues Paper, the inter-temporal nature of the MRRT calculation means smaller entities would still be required to maintain MRRT records.

Addressing this issue is difficult without introducing new complexities either for industry or the Tax Office (e.g. paragraph 274 of the Issues Paper). This underlines our belief that the MRRT should be considered in the wider context of tax reform together with a consideration of alternative means of taxation.

Issue 13: Determining the MRRT allowance rate

The allowance rate is unlikely to reflect the cost of capital and should not be uniform across the sector. Using the LTBR also opens MRRT liabilities and revenues to volatilities in global bond markets.

The MRRT is designed in such a way that the initial capital expenditure involved in a project is systemically offset against the project's revenues before the MRRT applies. This is achieved through the 'unutilised MRRT losses' which, in year 1,

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exactly equals the capital expenditure of the project assuming no revenues are earned or operating expenses incurred other than the initial capital outlay. The unutilised losses are then carried from year-to-year and offset against revenues as the project gets off the ground. This ensures that a project at least covers its initial capital outlay before having to pay MRRT.

However, the unutilised losses or capital outlay are also 'grossed up' or 'uplifted' in subsequent years at an allowance rate. The allowance rate itself is equal to the Long Term Government Bond rate (LTBR) plus 7 percentage points (or 700 basis points). This 'allowance' is added to existing unutilised losses and the sum of these are added to operating expenses. This aggregate amount is then subtracted from revenue each year to determine the MRRT profit or loss. In summary:

- *MRRT Allowance = (Unutilised losses)* x *(LTBR + 700 basis points); and*
- *MRRT Profit/Loss = (Revenue) – (Operating expenses + MRRT Allowance + Unutilised losses)*

Any profits resulting from this calculation are then subject to the 30 per cent MRRT tax rate, and after allowing for a fixed extraction value-add, the final MRRT liability is calculated.

In this way, the MRRT allowance adds an additional margin on top of the capital outlay (or unutilised loss) each year that must be offset against revenue before the MRRT applies. The allowance correctly recognises that there is a cost attached to a firm's capital outlay on a project and allows for this cost to be offset against revenues before the MRRT becomes payable.

However, the design is imperfect in prescribing a uniform cost of capital across the iron ore and coal sectors as a whole. The allowance rate is equal to the LTBR plus 7 percentage points, presumably as measure of the risk free rate of return (LTBR) plus a margin (700 basis points) to proxy a typical corporate bond yield.

However, a project's cost of capital will predominantly reflect the form of financing (i.e. debt or equity) and the risk related to that venture, which can be underpinned by a number of factors beyond a simple 700 basis points margin (or corporate bond proxy). Moreover, it is unreasonable to assume that every iron ore and coal project has a uniform risk profile.

For example, a greenfields project will entail significantly higher risks and costs than a brownfields development. Similarly, a project that is geographically isolated from existing infrastructure or one with difficult geological characteristics will also involve higher risks and costs.

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Also, the size of a firm, its experience in that sector, and the resources, skills and expertise available to it will also affect its cost of capital (the cost of borrowing for new firms and start-ups are always higher than for established firms). On this point, data from Access Economics' *Investment Monitor* shows that over two-thirds (or $39 billion) of the value of iron ore and coal projects in the pipeline in Western Australia (i.e. at all stages of production from 'possible' to 'under construction'), are attributable to small and midcap miners. These firms are likely to have a higher cost of capital than established, globally active miners. A tax that does not recognise this could impinge on the viability of some of these projects.

Perhaps the most flawed aspect of the allowance rate (and arguably, the design of the MRRT) is that the Government is effectively determining that any profit earned by a project above its capital outlay and its cost of capital is an economic rent.

This does not recognise that firms' seek to earn a commercial rate of return, and ignores what rate of return investors demand from a project. These rates of return are rarely equivalent to a firm's cost of capital, which is the minimum return that investors expect for providing capital. In reality, a commercial rate of return will need to be higher than the cost of capital itself, and even after this rate of return is met, it is still unclear as to whether rents are being earned.

We also have concerns about the way in which the allowance rate pins the risk free rate of return to Australia's LTBR. Although the LTBR is currently incorporated in the determination of the PRRT, it is not necessarily the optimal option. Including the LTBR opens MRRT taxpayers and the Government to risks and volatilities in global bond markets, which may bear no relation to the profitability of a mining project (assuming that the LTBR is to be captured at a specific point in time each year and applied for the purposes of calculating the MRRT for that year).

The LTBR is ultimately determined by global market forces, which do not always represent economic fundamentals and it can be subject to volatility. Therefore, changes in the LTBR could have a large impact on MRRT liabilities irrespective of the risks or profitability of a project itself.

For example, all things equal, strong demand for long term Australian government bonds would drive down the LTBR, lowering the MRRT allowance and increasing MRRT liabilities. Conversely, a rising LTBR would reduce revenue intake for the Government. In the example given in the PTG Issues Paper (page 22), a fall in the LTBR from its rate of 6 per cent across the example period to 3.5 per cent in year 3, and then to 3 per cent in year four would reduce the project's unutilised losses by $19 million in year 4 resulting in $6 million more of MRRT liabilities for the sample project in that year.

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Conversely, a shift in the LTBR upwards to 8 per cent by year 3 and to 8.5 per cent by year 4 would reduce the Government's revenue intake from the project by $5 million in year 4.

Therefore, the Government's assumption that the cost of capital of a project is a function of the risk free rate of return plus a fixed margin is too simplistic, and is a significant shortcoming of the current MRRT design.

The PTG could recommend that different MRRT allowance rates be applied on a case-by-case basis according to the relative risks of each project, or a uniform rate weighted according to key risks facing typical projects of a particular nature could be applied. But this introduces more uncertainty and ambiguity to the framework. There is no straightforward solution to this challenge and it highlights the practical constraints involved in the application of rent taxes.

Issue 14: Policies to promote exploration expenditure

A flow through share scheme could encourage investment in exploration expenditure in Australia. But the PTG should not have to be revenue neutral in examining this and other potential mechanisms to increase exploration.

The PTG Issues Paper asks for feedback on policies to promote exploration expenditure. This is unrelated to the MRRT or extended PRRT. As the Issues Paper points out: "This consideration is not limited to iron ore, coal, oil and gas, but is intended to cover all resource exploration activities in Australia."

CCI has long advocated for a flow through share (FTS) scheme to be established in Australia to encourage exploration expenditure. A FTS scheme essentially enables the transfer of tax deductions of individual exploration companies to individual investors. By doing this, the tax deduction of the exploration expenditure is leveraged in the capital markets in the subject year, attracting external investors rather than being accumulated tax losses, which will only be realisable if the company earns taxable income.

This mechanism has been used with considerable success in Canada, where it was first introduced to allow transfer (or 'flow through') of tax credits between corporations in order to boost investment into resource exploration. However, this was eventually extended to allow Canadian resource companies to transfer certain exploration expenses to investors, who were able to apply these expenses against their income.

At present, Canada's FTS scheme is available to mining, petroleum and certain types of renewable energy companies to facilitate financing exploration and project development activities. Since Canada introduced its FTS scheme there has been strong growth in its equity financing and it has become the world's leading market for raising equity capital for mining[27].

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A FTS regime can be particularly beneficial to junior exploration companies who lack the taxable income to raise sufficient exploration capital for fields on which they hold licences. Having junior firms active in exploration is particularly important to the future of the resources sector. Of course, a key challenge they face is access to capital. As a result, juniors are often required to focus on marginally prospective acreage with consequentially lower success rates.

One of the reasons for this occurrence is the impact of the income tax system. For companies that have a tax liability, the ability to deduct such costs immediately against other income provides an important form of cost relief. Entities that do not have (or have insufficient) income are therefore required to carry forward potential tax benefits for exploration expenditure which may never be used. As a consequence, this inability to obtain a tax deduction significantly reduces the after tax value of exploration activity undertaken by these companies.

The PTG Issues Paper asks if exploration expenditure is subject to a market failure that warrants intervention by the Australian Government. The above could certainly be considered a (tax-related) market failure that could be remedied in the public interest.

However, we note that even though the PTG's considerations over ways to increase exploration expenditure are separate from the MRRT and PRRT, the Committee is still required to be revenue neutral in its recommendations on this subject. The Issues Paper states that funding for any new incentive mechanisms for encouraging exploration need to be "fully offset" from within the Committee's recommendations.

Given that these considerations are not limited to iron ore, coal, oil and gas, but is intended to cover all resource exploration activities in Australia, it is not clear why the costs of any such mechanisms need to be offset within the Committee's recommendations on the PRRT and MRRT. The Committee is again likely to be hamstrung in delivering genuinely positive reforms on what is a very important issue for the sector and the wider economy. After all, the Issues Paper itself recognises the vital need to "ensure a pipeline of resource projects for future generations".

The costs and benefits of establishing a FTS scheme in Australia have been investigated in the past[28], and it has long been advocated by industry in Australia. The establishment of a FTS scheme was in fact a pre-election promise of the Rudd Government in 2007. The PTG now have an opportunity to investigate this (and other options) in depth, and in doing this it should not be held captive to considerations over potential revenue impacts. That is a job for Government and the Treasury. CCI would like to see the requirement for the PTG to be revenue neutral on this issue removed.

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Endnotes

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[8] Tilton (2004) suggests that economic or 'Ricardian' rents can be divided into three parts. The first (quasirent) reflects the mine's cost of capital and other fixed inputs. It exists only in the short run. If the mine does not recover its cost of capital, including a competitive rate of return, it will not replace its capital and in the long run will cease to operate. The second ('other' rent) comes from several sources, which similarly create rents only in the short run. For example, metal prices tend to fluctuate with the business cycle. During booms, they increase creating additional rents. Over the business cycle, however, these rents are needed to offset low prices during recessions. The third (pure rent) arises because the mine is exploiting a richer or higher quality deposit than the marginal mine. The pure rent for a mine depends upon many considerations, including its ore grade, its location near the surface or near a port), its mineralisation and ease of processing, and its associated by-products. Pure rent is normally what those advocating higher taxes have in mind when they stress the need to capture the wealth created by a country's geological legacy for its citizens.

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