Chapter 3

The impact of the MRRT on the budget

3.1 This chapter considers the impact the shortfall in MRRT revenue will have on the budget and the extent to which this shortfall was predictable (and indeed predicted by many outside of government). It also questions the government's decision to link the growing cost of new and ongoing budget measures to what even the Gillard government now recognises as a highly volatile and uncertain source of revenue.

3.2 Consideration is also given to whether MRRT revenues are likely to increase over time or whether in fact the design features of the MRRT mean it is unlikely to raise significant amounts of revenue in the foreseeable future – if ever.

Was the revenue shortfall predictable?

3.3 At various points during the inquiry, witnesses told the committee that the low level of revenue raised by the MRRT relative to Treasury's predictions was, in fact, entirely predictable, given the design features discussed in the previous chapter.

3.4 In fact, the Senate Select Committee on the Scrutiny of New Taxes, which conducted the most comprehensive inquiry into the government's MRRT had repeatedly warned that the government's mining tax package was a fiscal train wreck in the making. [1]

3.5 FMG told the committee that, on the one hand, it was not surprising that Treasury had not been able to determine the impact the starting base depreciation and netback arrangements on revenue. As Mr Pearce of FMG explained:

> I am not surprised they could not see it. It has been very hard for us to see, and we are in charge of our own detail. Both calculations and the principles embedded in both the netback and the starting base are incredibly complex. It has taken us, as I say, the better part of two years to work through our own circumstances with the assistance of outside experts and consultants to help us firm up the opinions, the facts and the database that will support our positions opposite the tax office. So I am not surprised at all that Treasury have not been able to work their way through the detail, because we did not know the outcome of that process in detail until we went live last July.[2]

3.6 However, when asked if he was surprised by the low revenue raised by the MRRT, Mr Pearce responded:

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1 Senate Select Committee on Scrutiny of New Taxes, *The Mining Tax: A bad tax out of a bad process*, 29 June 2011, http://www.aph.gov.au/Parliamentary_Business/Committees/Senate_Committees?url=scrutinynewtaxes_ctte/completed_inquiries/2010-13/national_mining_taxes/report/index.htm &, Labor's Mining Tax a fiscal train wreck in the making, Senator Mathias Cormann Press Release, 29 June 2011, http://mathiascormann.com.au/media/2011/2011.06.29%20-%20Mining%20Tax%20Inquiry%20Report.pdf

2 Mr Stephen Pearce, Chief Executive Officer, Fortescue Metals Group, *Proof Committee Hansard*, Perth, 8 April 2013, p. 3.

> Not at all. We had been saying for years—often, with AMEC, as a fairly lonely voice in the wilderness—that our belief was that the tax as designed would not raise any income for the government.[3]

3.7 A number of witnesses told the committee that it appeared unusual that the government had failed to properly allow for the fact that it had limited visibility of the impact on revenue of the starting base and netback arrangements.

3.8 For instance, in suggesting how the MRRT might be improved, Professor Neville R. Norman wrote in his submission:

> Deductions or subtractions such as the starting allowance should be designed with full knowledge of the likely sums being claimed. There should be boundary conditions, including a lower bound of zero of the tax, thus preventing tax credits or rebates arising This is an elementary point of tax design that seems to have been forgotten.[4]

3.9 Clearly a competent Treasurer would have ensured he had that information in front of him before pressing ahead with signing the MRRT Heads of Agreement.

3.10 Asked whether he was surprised that the government appeared to have signed up to what he suggested were overly-generous concessions to the mining companies in the MRRT Heads of Agreement, Dr Denniss responded concisely – he was.

3.11 He added further that he was surprised that:

> …if they were taking it at face value or were making estimates without any information from the firms—for example, as you said, those asset valuations—they did not have some sort of contingency built into the negotiation. By that I mean that, given the incredible incentive for the firms to increase the cost base, they should have either had some promises from the miners up front or left the door open to come back and revisit exactly this issue. I think it was poorly designed in that regard.[5]

3.12 Professor Fargher made a similar point when he was also asked if he was surprised that the government had agreed to the market value based depreciation arrangements without being fully aware of what the starting base value would be and its fiscal impact:

> Was I surprised? The honest answer is yes. You mentioned several factors in the design of the tax where the tax base was observable and estimates could be made based on prices and exchange rates. I believe that Treasury did make those estimates. You mentioned previously that the starting base and depreciation arrangements were viewed as somewhat unobservable by Treasury. My concern and surprise stems from the fact that negotiations led

3 Mr Stephen Pearce, Chief Executive Officer, Fortescue Metals Group, *Proof Committee Hansard*, Perth, 8 April 2013, p. 5.

4 Professor Neville Norman, *submission 11*, p. 1.

5 Dr Richard Denniss, Executive Director, The Australia Institute, Australian National University, *Proof Committee Hansard*, Canberra, 3 April 2013, p. 3.

> to clauses being written without at least an estimate of their impact being made. I am not in a position to know whether estimates were in fact made.[6]

3.13 Professor Fargher was not, however, surprised by the low revenue raised by the MRRT. He reminded the committee that, together with Professor Peter Carey, he had written an article that was published in *The Age* on 16 February 2012 ('Mining's small change') which had argued that it was difficult to reconcile the Gillard government's projections with the 'very generous allowances' afforded to the largest miners through the starting base and depreciation arrangements in the MRRT legislation which was then still before the Parliament.[7]

3.14 In contrast to the government's projections, independent modelling suggested that design features of the MRRT, and in particular the starting base arrangements discussed in the previous chapter, would mean that little to no MRRT revenue was collected in the foreseeable future. An exchange between Professor Guj and Senator Bishop during the committee's public hearing in Perth on 8 April 2013 is particularly instructive in this regard:

> **Prof. Guj:** [...] One of the reasons why I am sitting in this room today is that the little bit of modelling which [I did] as a hobby, if you wish, was the only piece of quantitative work done that was in the public arena. I have not seen anything else done. I can only hope that Treasury did some modelling. I do not know; I have not seen anything.
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> **Senator MARK BISHOP:** They do not make their modelling public.
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> **Prof. Guj:** No. To their credit, though, I had an opportunity to talk to Treasury. They invited me to discuss my model, not theirs, and they were very much in line.
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> **Senator MARK BISHOP:** So they were aware of the detail of your model and they had discussions with you about it?
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> **Prof. Guj:** Yes. I had a discussion with Treasury and it was quite interesting that at the end of the discussion they said that in general terms, apart from some minor issue relating to how I made the assumption, they were in agreement with my conclusion.
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> **Senator MARK BISHOP:** State or federal Treasury?
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> **Prof. Guj:** Federal Treasury. I said, 'Well, what are you going to do about it?' They said that was a different story altogether. So it is not as if it comes as a great surprise that we are not getting much money.[8]

Treasury view

3.15 Treasury at various times over the past three months has directly contradicted the Treasurer's assertions that changes in commodity prices, production volumes,

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6 Professor Neil Fargher, *Proof Committee Hansard*, Canberra, 3 April 2013, p. 11.

7 Professor Neil Fargher, *Proof Committee Hansard*, Canberra, 3 April 2013, p. 10.

8 Professor Pietro Guj, *Proof Committee Hansard*, Perth, 8 April 2013, p. 20.

exchange rates and state royalties for iron ore or coal were to blame for the significant MRRT revenue shortfall compared to the government's budget estimates.

3.16 The Secretary of Treasury also effectively rejected the Gillard government's assertions that it was in fact Treasury who was to blame for getting the MRRT revenue forecasts wrong.

3.17 Indeed, it is worth pointing again to the evidence by Treasury Secretary Dr Parkinson both before Senate Estimates in February 2013 and before this inquiry.

3.18 First, when asked what went wrong with Treasury's MRRT revenue estimates (and whether he accepted responsibility given the Gillard government was pointing the finger at Treasury) Dr Parkinson told Senate Estimates:

> We have adjusted those estimates for the things that we can see that have changed in the interim. What we have not done is adjust the estimates for things that we cannot see. It is obviously very difficult for us to get a handle on some of these things, and now we have to go through a process of trying to work out what has actually been behind the moves. Just to be clear, there are five factors that determine the extent of revenue collections. The first is commodity prices and volumes; we can see the commodity prices—subject to the fact that we cannot see long-term contracts, but we can get a reasonable estimate—and the spot prices in real-time and we can get very quick estimates of movements in volume. The second thing that we can see in real-time is the exchange rate, and the third thing we can see in real-time is state royalty rates. What we cannot see is the starting cost base that the firms are able to pick, nor can we see the netback arrangements—that is how the price at the shipping gate compares to the valuation put on it at the mine.

And that:

> There is an initial starting cost base, and then there is a netback arrangement which basically says that we can envisage a price at the docks, ready to go on the ship, but we do not know how much of that price is actually attributed to the various points in the production chain. The point that is relevant for the MRRT is close to the mine—that is, when it comes out of the ground. It is very difficult for us to actually get a handle on those. What we will do—and we did this at MYEFO—is use the best available information. We use the best available information on commodity prices, we use our exchange rate forecasts and we update that for actuals—we use the things that we can see. The things that we cannot see, we have actually got to try and get to the bottom of, and the Treasurer has been very explicit in saying that the Treasury and the tax office, in the normal course of events, will unpick this and try to understand what is going on.[9]

3.19 Dr Parkinson further reinforced those statements before this inquiry:

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9 Dr Martin Parkinson, Secretary, Treasury, *Proof Committee Hansard*, Canberra, 3 April 2013, pp.51-52

3.20 I said at our estimates hearing that there are a range of factors that influence the revenue estimates, some of which we could see and some of which we could not see in broadly real time. We could see prices to a reasonable approximation in real time, we could see volumes to a reasonable approximation in real time, we could see state royalty rates and we could see the exchange rate. But the other factors that determine the extent to which revenue is collected are things that we do not have any particular insight into at the moment. The obvious one of those is the starting base and the other costs associated with production.[10] Treasury did not concede any flaws in its modelling, noting nevertheless that it had recently reviewed its forecasting methodology (as was a matter of public record). Dr Parkinson told the committee that, following on from this work, Treasury was thinking about the forecasting accuracy of its 'top-down' approach to its MRRT modelling – that is, an approach where Treasury had taken a broad industry-wide aggregate of estimated MRRT revenue (including how mining companies had used allowances), rather than attempting to determine revenue on a project-by-project basis. However, Dr Parkinson again conceded that at this stage it was not possible for Treasury to determine whether a project-by-project approach would be any better or worse than the top-down approach or what impact allowances available to miners was in fact having on revenue.[11]

3.21 When Dr Parkinson was asked by the committee why the firms negotiating the MRRT with the Gillard Government in late June/early July 2010 had not been required to set out the likely fiscal implications of the market value based depreciation arrangements, he responded that ‘firms may have known exactly what the starting base was at that time, but there was no legal obligation on them to report that to us.’ Asked, in turn, why the government had then signed up to depreciation arrangements without knowing the revenue implications, Dr Parkinson simply responded that this was ‘a policy question’, indicating that Treasury could not answer the question.[12]

3.22 Yet Treasury also told the committee that the miners negotiating the MRRT Heads of Agreement had in fact given advice to the government that the market value of relevant iron ore and coal assets for the purposes of the market value based depreciation arrangements was about $360 billion at the time. [13]

Design features or unexpected 'loopholes'?

3.23 While some of the commentary from those arguing in favour of an increased mining tax has argued that the miners have exploited unintended 'loopholes' in the MRRT to avoid significant payments under the tax, the generally accepted view expressed during this inquiry – including from Treasury, the mining industry and

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10 Dr Martin Parkinson, Secretary, Treasury, *Proof Committee Hansard*, Canberra, 3 April 2013, pp.28.

11 Dr Martin Parkinson, Secretary, Treasury, *Proof Committee Hansard*, Canberra, 3 April 2013, Canberra, p. 33.

12 Dr Martin Parkinson, Secretary, Treasury, *Proof Committee Hansard*, Canberra, 3 April 2013, Canberra, pp. 29-30.

13 Mr Robert Heferen, *Proof Committee Hansard*, Canberra, 3 April 2013, p. 30.

critics of rent-based resource taxation – was that so-called 'loopholes' were, in fact not loopholes, but quite deliberate design features of the MRRT.

3.24 As the MCA told the committee, while some commentators would have it:

> …that the key design fundamentals, the market value assessment of existing project capital assets, the starting base, deferred tax assets, capital expenditure deductions and the creating of royalties are loopholes or concessions. Again, this does not bear rational scrutiny with respect to established precedents in tax law and accounting practice. The market value determination of capital assets is established in Australia's capital gains tax law. Deferred tax assets is a standard accounting practice. The immediate deductibility of capital expenditure on MRRT-applicable projects is proper treatment for a resource rent tax, just as it is for the petroleum resource rent tax.
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> Given that there was no reform of state and territory royalties as indicated and intended by the Henry review, royalties remain a cost of doing business and therefore, like any business cost, are deductible from tax-subject revenues.[14]

3.25 Similarly, when asked if aspects of the MRRT that had apparently affected revenue, such as the market value depreciation arrangements and royalty crediting, represented 'loopholes', Professor Ergas responded:

> They are certainly not loopholes in the conventional sense. As you say, a loophole is an unintended consequence that people, in a sense, exploit typically by circuitous means. These were fairly obvious features of the MRRT that many commentators picked up on at the time when the MRRT was announced. Indeed, we discussed that at some length in our published paper, which came out shortly after the MRRT was settled. So I do not think they could be described as unexpected, relative to the design of the MRRT.[15]

3.26 Under questioning, Treasury officials agreed that it would be wrong to characterise design features of the MRRT such as market value based depreciation arrangements, netback arrangements and the crediting of state royalties, as 'loopholes.'[16]

3.27 It is clear to the committee that market value based depreciation, netback and royalty crediting arrangements were in fact deliberate design features of the MRRT explicitly agreed to by the Gillard government.

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14 Mr Mitchell Hooke, Chief Executive Officer, Minerals Council of Australia, *Proof Committee Hansard*, Melbourne, 29 April 2013, pp. 36-37.

15 Professor Henry Ergas, *Proof Committee Hansard*, Canberra, 3 April 2013, p. 19.

16 Mr Rob Heferen, Executive Director, Treasury, and Dr Martin Parkinson, Secretary, Treasury, *Proof Committee Hansard*, Canberra, 3 April 2013, p. 34.

3.28 In the committee's view, the Gillard government has no one but itself to blame for the non-costed, yet costly, fiscal consequences of those deliberate MRRT design features.

3.29 After a bruising battle with the mining industry and in the shadow of a difficult election, the new Gillard Labor government had neither the insight, the strength or the appetite to follow proper process to ensure the implications of the MRRT Heads of Agreement were properly assessed before being formally locked in.

3.30 This is yet again further evidence of both the fiscal recklessness and incompetence that has characterised the Gillard government in general and Mr Swan's tenure as federal Treasurer in particular.

The linking of costly budget measures to hypothetical MRRT revenue

3.31 As a Parliamentary Library analysis of MRRT revenue and expenditure estimates released following the 2012-13 Budget points out, there is:

> ...no practical hypothecation of MRRT revenue to linked measures. While legislation that has been passed by the Parliament to implement some measures has been dependent on the successful passage of the MRRT legislation, future revenues and expenses are simply put through the Consolidated Fund.[17]

3.32 Nonetheless, in order to sell the MRRT to a sceptical public, the Gillard government when announcing the RSPT and then the MRRT explicitly linked a number of costly budget measures, such as the increase in compulsory superannuation, company tax cuts and a long list of other promises to revenue from the MRRT. Many of those promises have since been deferred or scrapped altogether by the Gillard government. The reason is that the money just wasn't there to pay for them as a result of the failure of the MRRT.

3.33 If the current government were to remain in office beyond this year it is expected that further measures attached to the MRRT, such as the Low Income Super Tax Offset will also be scrapped.

3.34 The abovementioned Parliamentary Library’s analysis, which was based on the MRRT revenue and expenditure on linked measures as forecast in the 2012-13 Budget, calculated that the net impact of the MRRT package (that is, MRRT revenue minus expenditure on linked measures) would be +$2.068 billion in 2012-13 and -$619 million in 2013-14. Of course, the +$2.068 billion was based on revenue of $3 billion in 2012-13. The Parliamentary Library concluded that:

> ...unless MRRT revenue increases significantly in future years it will be difficult to cover expected future higher costs of some measures, such as

17 Kai Swoboda, 'Minerals Resource Rent Tax: changes to revenue and expenditure estimates,' in Parliamentary Library, *Research Paper No. 9, 2011-12*, 'Budget Review 2012-13,' 11 May 2012, p. 160, available at http://www.aph.gov.au/About_Parliament/Parliamentary_Departments/Parliamentary_Library/pubs/rp/BudgetReview201213.

> the $3.6 billion costs in 2019-20 associated with the superannuation guarantee reaching 12 per cent.[18]

3.35 The Parliamentary Library analysis also concluded that while the flow of MRRT revenue would be quite volatile, the cost of linked expenditure items would be ‘relatively stable and expected to grow over time, [and] will have to be paid even if the mining revenue falls.’

3.36 The government has previously indicated that it believes it is reasonable to fund commitments through MRRT revenue, despite the variability of this revenue. The Treasurer explained this position in February 2012:

> There are swings and roundabouts when you have a variable revenue stream [but] I don't accept that in an environment where revenue is adjusted depending upon variable factors beyond the forward estimates it is unsustainable to make the commitments we have made. They are entirely sustainable within the budget framework.[19]

3.37 However, others suggested that there is a clear and growing structural risk to the budget when tying growing costs in the budget to a volatile revenue source like the MRRT.

3.38 For example, FMG argued that it was 'a dangerous thing to do to spend money based on a highly variable income stream.'[20] Professors Pincus and Ergas described it 'as a form of fiscal illusion.'[21]

3.39 Going further, Professor Pincus argued that the volatility of MRRT revenues made the government's linked expenditure measures problematic:

> Volatile tax bases can cause inefficiency if governments overstate their value and treat the expected revenue as if it were a sure thing and make fixed spending commitments against that revenue in situations where governments cannot simply smooth out revenue variations.[22]

3.40 The committee is of the view that targeting an important industry for Australia with a complex, inefficient and distorting new tax, which at best was going to generate highly volatile and downward trending revenue while linking any such revenue to the growing fixed cost of related promises is another demonstration of the extreme fiscal recklessness and incompetence that has characterised Mr Swan's tenure as Treasurer for Australia since 2007.

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18 Kai Swoboda, 'Minerals Resource Rent Tax: changes to revenue and expenditure estimates,' in Parliamentary Library, *Research Paper No. 9, 2011-12*, 'Budget Review 2012-13,' 11 May 2012, p. 160.

19 Adrian Rollins and David Crowe, 'Swan unruffled by "variable" mining tax', *Australian Financial Review*, 13 February 2012.

20 Mr Stephen Pearce, Chief Executive Officer, Fortescue Metals Group, *Proof Committee Hansard*, Perth, 8 April 2013, p. 13.

21 Professor Jonathan Pincus and Professor Henry Ergas, *Submission 2*, p. 4.

22 Professor Jonathan Pincus, *Proof Committee Hansard*, Canberra, 3 April 2013, p. 17.

Future prospects for MRRT revenue

3.41 While several mining companies and Treasury indicated to the committee that it remained to be seen whether revenues would improve, most experts appearing before the committee suggested that the design features of the tax made it highly unlikely that that MRRT revenues would end up anywhere near the government's budget revenue estimates.

3.42 For instance, after explaining the impact the starting base depreciation arrangements were having (and would continue to have) on MRRT revenues, Professor Fargher was asked if the MRRT was likely to raise any meaningful revenue in the foreseeable future. He responded, 'not in the next five years, if that is your definition of "foreseeable future".' [23]

3.43 Professor Garnaut told the committee that the MRRT may not ever raise significant revenue, essentially because of two features: the shielding of past expenditure through the market valuation of starting base assets; and the interaction between the MRRT and state royalties.[24]

3.44 FMG, now Australia's fourth largest miner, told the committee that while it expected to pay more than $1 billion in company tax and state royalties, it did not expect to pay any MRRT for at least five years. [25]

Committee view

3.45 The committee notes that the expenditure measures that the government tied to the Minerals Resource Rent Tax are fixed and increasing, whereas revenue from the Minerals Resource Rent Tax was always going to be highly volatile, unlikely to raise any significant revenue in the foreseeable future and, according to Treasury's own projections, even in a best case scenario downward trending over time.

3.46 The committee believes that the linking of expenditure measures to hypothetical Minerals Resource Rent Tax revenue was fiscally reckless and irresponsible and has exposed the budget to even greater structural risk.

3.47 Not only would scrapping this failed Minerals Resource Rent Tax be good for investment and the economy, it would also immediately put the Budget in a stronger structural position. Firstly, because the increased economic growth which would follow from the removal of this unnecessary lead from the mining industry's saddle bags which would lead to increased company tax and state royalty revenue. Secondly, because by scrapping all but one of the measures attached to the MRRT along with the MRRT itself, the structural position of the budget improves. The budget would no longer be exposed by the linking of a highly volatile downward trending revenue source to the growing fixed cost expenditure of the many promises the current government has attached to it.

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23 Professor Neil Fargher, *Proof Committee Hansard*, Canberra, 3 April 2013, p. 12.

24 Professor Ross Garnaut AO, *Proof Committee Hansard*, Melbourne, 29 April 2013, p. 7.

25 Mr Stephen Pearce, FMG, *Proof Committee Hansard*, p. 2, Perth, 8 April 2013

3.48 It takes a particular kind of lack of talent to come up with a significant complex new tax, which, when all is said and done, actually leaves the budget worse off.

3.49 It might seem counterintuitive to some, but abolishing the MRRT will be good for the Budget.