Replacing Mining Royalties and Company Tax

A submission by **Prosper Australia**[*] to the

Inquiry into the National Mining Tax

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Abstract

A new federal tax on economic rent accruing to corporations should *not* be imposed on top of existing taxes, but should lead to the abolition of State mining royalties and corporate income tax. To that end, the new tax should have the broadest possible base. In recognition of the States' ownership of minerals, the revenue raised by the new tax from mines in each State should be refunded to that State, subject to abolition of royalties, and with consequential adjustments to horizontal fiscal equalization. The applicability and mechanism of the new tax on corporate economic rent should *not* depend on the source of the rent or the size of the company. For the mechanism, the existing petroleum resource rent tax (PRRT) offers a worthy model, except that the rate would need to increase in order to pay for the elimination of corporate income tax.

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1 Normal profit vs. economic rent

In **microeconomics**, which takes the viewpoint of the *individual or firm* (and therefore of the accounting profession), the "rent" paid for a business site is a cost of production, and "profit" is the surplus left over after all costs, including rent, have been paid.

In **macroeconomics**, which takes the viewpoint of *society* (and therefore, we hope, of public policy), the roles of rent and profit are reversed. **Normal profit** (not to be confused with accounting profit) is the necessary return on capital. It comprises the risk-free interest rate, which is the price of time-preference, plus insurance, which is the price of risk, plus *economic* profit, which is the price of uncertainty (the difference being that "risk" is quantifiable and therefore insurable, while "uncertainty" is not). Normal profit is a cost of production because if the capital employed in an industry does not yield its normal profit, it will not be maintained or replaced, and new investment will go elsewhere. In time, competition will reduce the return on capital to the normal level. Consequently, sustained super-normal returns (super-normal "profits" in accounting terms) indicate some sort of protection from competition. The return to that protection is **economic rent** and is the surplus left over after all costs of production, including normal profit, have been paid.

The so-called "rent" of a vehicle or a building (not to be confused with the underlying land) is not *economic* rent but rather a return on capital, and is more appropriately called "hire" for macroeconomic purposes. But the expression "rent-seeking" refers to *economic* rent.

2 The folly of taxing normal profit

As normal profit is a cost of production, any tax on normal profit is likewise a cost of production and must be recovered through prices. If the tax cannot be recovered through prices, it suppresses production or shifts production to some other jurisdiction in which costs are lower. If the tax *is* recovered through prices of products, it makes those products less competitive than they would otherwise be. Thus Australia's corporate income tax stands condemned.

In contrast, a tax on economic rent is *not* a cost of production, but merely cuts into the surplus, i.e. the margin by which prices exceed necessary costs, including normal profit. As long as the tax does not exceed the surplus due to protection from competition, prices are set by the demand and by the protection, so the tax neither needs to be nor can be recovered by raising prices—although those who pay the tax, having grown very fond of the surplus, can be relied upon to pretend otherwise.

3 Land rents vs. mineral resource rents

As economic rent is the return to protection from competition, the assets that yield economic rent are those that cannot be replicated by competitive effort. These include:

- **land** and other **natural resources**, which cannot be replicated at all;
- **natural monopolies**, i.e. markets in which the first successful entrant has an unassailable advantage over later competitors;
- **statutory monopolies**, i.e. markets in which competition is possible but forbidden;
- **tradable licences** to participate in a *statutory cartel*, i.e. a market in which competitors are required to have licences, the number of which is artificially limited by the government (as in, e.g., the taxi industry in most Australian jurisdictions).

If a rent-yielding asset is tradable, the price is the discounted present value of the expected rent stream.[1] In the case of tradable licences, the licences in each tranche are equivalent, so the price of one is the price of all the others. In the case of land, because the value per unit area tends to be a smooth function of location, the value of each site can be deduced by observing transactions involving nearby sites. Especially helpful to the land-valuer is the buyer who buys land with improvements (e.g. a building) and promptly demolishes the improvements: the price paid for the bare land is then the purchase price *plus* the demolition cost. So land and tradable licences lend themselves to **valuation-based** assessment of the economic rent. This method is indeed used for "land tax" and site-value-based municipal rating.

In other cases it is easier to assess economic rent by deducting an allowance for normal profit from the accounting profit. This **profit-based** method is used for the petroleum resource rent tax (**PRRT**).

4 Whether economic rent can be "taxed" at 100%

Under a *profit-based* resource-rent tax (**RRT**), the assessed rent depends on the activity of the taxpayer, who must therefore be allowed to keep some of the assessed rent as an incentive to get on with it. So the tax rate must be somewhat *less* than 100%. Furthermore, a credit must be given for sub-normal profit, lest the risk of failure, combined with the tax on success, reduce the statistically expected return below the normal profit and thereby deter investment.

Neither of these issues arises under a *valuation-based* resource-rent charge, because the assessed rent does *not* depend on the behaviour of the payer. In such cases, efficiency does not require the resource owner to keep any part of the rent or to receive a credit for failing to realize normal profits.

5 Why credits for sub-normal profits should *not* be refundable

The existing PRRT estimates the economic rent of an oil field as the margin by which accounting profit exceeds an allowance for normal profit, namely the 10-year federal bond rate plus 5% p.a. (or 15% p.a. in the exploration phase). The tax rate is 40%. Credits for sub-normal profit can be carried forward at an uplift rate equal to the allowance for normal profit, but are not refundable in cash.

Under the abandoned **resource super profits tax** (**RSPT**), credits for sub-normal profits *were* to be refundable, with interest at the 10-year federal bond rate, which was assumed to cover the risk that the Commonwealth would repeal legislation requiring it to refund unused credits. On that heroic assumption, the same bond rate would cover the risk and uncertainty of the whole project—that is, it would be sufficient allowance for normal profit.

Critics of the RSPT rightly noted that the risk of losing credit refunds was absurdly underpriced, and that an appropriate pricing of the risk would raise the allowance for normal profit to such a degree that the credits might as well not be refundable.

While agreeing with that conclusion, we cannot help noticing that the RSPT was superior to the existing company tax, which provides no allowance for normal profit, let alone credits for sub-normal profit. Moreover, to the extent that the RSPT departed from the ideal of taxing economic rent, the solution was to modify the base—not to reduce the rate, let alone fudge it by means of an "extraction allowance" (what?!) which reduced the headline rate of 30% to an effective rate of 22.5%. We must conclude that the mining companies deposed a Prime Minister and almost a government,[2] not because of the vices of the RSPT, but because of its virtues.

[1] This does not imply that the discounting rate is appropriate or that the expectations are accurate.

[2] Cf. G. R. Putland, "Why Gillard could lose: It's an 'economic rent' election", *Left Focus*, Aug. 19, 2010.

6 Why royalties should *not* coexist with the RRT

Some critics allege that a federal RRT on mainland resources would violate "States' rights" because the resources belong to the people through the States, not through the Commonwealth. The proposed retention of State mining royalties as offsets against the federal RRT (first the RSPT, and now the MRRT) is apparently a response to that argument.

We submit that the argument and the response are ridiculous for the following reasons:

- Under the conditional grants power (s.96 of the Constitution), State ownership of the resources can be recognized by refunding the RRT collected from each mine to the State in which the mine is located, on the condition that the State abolishes royalties. Horizontal fiscal equalization (HFE) can be adjusted accordingly.

- State royalties, being based on ownership, are vulnerable to legal and historical arguments over whether the State really owns the minerals—as when the High Court struck down the Cadia copper royalties in NSW—whereas a federal RRT, being based on the federal taxing power, would have no such weakness.[3]

- The taxing power of a State cannot be used to imitate a specific or ad-valorem royalty, because the resulting tax would be an excise in contravention of s.90 of the Constitution; the existing royalties are constitutional precisely because they are *not* taxes.

- Imposing a federal RRT in addition to royalties would further complicate the tax system—which is already so diabolically complex that any more complication would be not merely incompetent or negligent or reckless, but *malicious*.

- The chief economic and political advantage of an RRT over royalties, namely that an RRT targets economic rent and therefore does not suppress production, is neutered if royalties are retained rather than replaced.

7 Why interest should *not* be deductible

If an enterprise finances its capital expenditure mostly or entirely through debt, the interest rate reflects the risks and uncertainties of the business and therefore claims most of the normal profit. If the interest is tax-deductible, the remaining tax base more closely reflects economic rent. This arrangement, known as **thin capitalization**, effectively turns the corporate income tax into a tax on economic rent, which is what it should have been all along. But so determined are the legislators to tax the necessary costs of production that they have introduced "thin capitalization rules", which treat thin capitalization as if it were a rort.

Notice, however, that the defence of thin capitalization depends on interest being part of normal profit, which in turn is a deduction from economic rent. Because an RRT already allows that deduction for normal profit, including interest, any further deduction for interest would be double dipping.

The defence of thin capitalization also assumes that interest is incurred in order to acquire true capital, not rent-yielding assets. Because true capital can be *produced* by private effort, borrowing may facilitate its production and thereby add to the wealth of nations. But because rent-yielding assets are not produced but merely *acquired*, borrowing to facilitate their acquisition does not of itself create wealth, and there is no public interest in allowing a deduction for interest on such borrowings.

[3] Cf. G. R. Putland, "High Court clears Henry rent tax", *Australian Financial Review* (Letters), Aug. 27, 2010, p. 56.

8 Why iron ore and coal should *not* be discriminated against

There is no justification for applying the MRRT only to iron ore and coal while exempting other minerals. While different types of mines have different distributions of costs and revenue across their working lives, the differences in their tax bills should be determined by applying the same set of rules to different circumstances—not by having one set of rules for iron ore and coal and another set of rules for the rest, as if the cost and revenue profiles depended only on the target mineral. Arbitrary line-drawing invites endless lobbying and rent-seeking on both sides of the line.

Similarly, there is no justification for treating solid minerals differently from petroleum, whether the petroleum is onshore or offshore. There should be one set of rules for both.

Similarly, there is no justification for treating the rents of mineral resources differently from the rents of natural or statutory monopolies. But any valuation-based rent charges must be deductible against the base of any profit-based economic-rent tax, to ensure that the combination does not take more than 100% of the rent.

There is no justification for exempting smaller companies from any RRT, especially when the same companies are not exempt from the more damaging corporate income tax.

But when a large fraction of economic rent has been captured for public purposes, there is ample justification for abolishing corporate income tax. Having thus eliminated the taxation of normal profit in the hand of the company, one would no longer need mechanisms for preventing "double taxation" of normal profit. These mechanisms include dividend imputation.[4]

As the PRRT has been in place for many years, the obvious reform path is to make the new uniform economic-rent tax resemble the old PRRT as closely as possible, albeit with a higher rate in order to generate enough revenue to replace the corporate income tax.

The motivation for limiting the MRRT to larger miners of iron ore and coal is of course political. But the political calculations are myopic: the politics of abolishing the all-pervasive corporate income tax should be more attractive than the politics of limiting the MRRT.

9 Conclusion

By proposing a lightweight and selective RRT which is not capable of displacing any existing tax, the Government has set itself too modest and, ironically, too *difficult* a task. Had the Government proposed to refund the RRT collected in the several States to the respective States, subject to abolition of existing royalties, it could have turned the "States' rights" argument in its own favour while boasting of the superior efficiency of the RRT. Had it proposed a broad-based economic-rent tax as a replacement for royalties and corporate income tax, it could have deflected all criticisms of the new impost by pointing out that they were more applicable to the old ones. But by failing to offer the elimination of even the existing royalties, let alone corporate income tax, the Government has accepted all the odium for introducing a new tax and none of the kudos for abolishing old ones.

[4] An alternative path to elimination of dividend imputation is the abolition of personal income tax, preferably in combination with corporate income tax; cf. G. R. Putland, "Swallowing a camel: carbon tax v income tax", *On Line Opinion*, Aug. 11, 2010.