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Submission to Senate Select Committee on Scrutiny of New Taxes
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The Minerals Resource Rent Tax was not well-explained by the Government and was certainly not understood by the electorate.

It was seen as an opportunistic tax that could be levied on a highly profitable sector of the economy in order to help restore the Commonwealth's fiscal balance. The Government did little, if anything, to dispel this notion. Indeed, the original description of it as a "super-profits" tax – a term which has specific meaning in economics – probably helped create an impression that it was simply a means of skimming profits from an industry fortunate enough to be enjoying a period of high profit. It is hardly surprising therefore its opponents were able to mount an emotive and misleading campaign opposing the tax.

The purposes of the tax were well-explained in the Henry Review, and in Ken Henry's Post-Budget Address to the Australian Business Economists.[1]

We do not need to repeat, in this short submission, those purposes – but we do believe the Government needs to communicate them in terms, which the public can understand. We agree strongly with the general policy principle of using taxation as a means of:

- Stabilizing the economy, particularly in relation to the strong boost in economic activity caused by a minerals boom

- Paying for depletion of non-renewable natural resources. In this regard a rent-tax is superior to royalties because royalties take no account of non-constant extraction costs and are not necessarily related to prices.

We believe that in terms of accounting any revenues from the MRRT should be allocated to the Government's capital account, to be spent only for capital purposes – including not only physical infrastructure, but also for investment in environmental restoration and human capital (education and training). Because it is pro-cyclical and because it is for depletion of capital it should not be used for recurrent purposes. (This means that to meet its 2013 Budget projections, the Government may need to seek other sources of enduring public revenue.)

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[1] Ken Henry, Post-Budget Address to the Australian Business Economists Secretary to the Treasury 18 May 2010
http://www.treasury.gov.au/documents/1813/HTML/docshell.asp?URL=Secretary_address_ABE.htm

Not only does the Government need to explain the function of the MRRT; it also needs to re-frame this tax, and any carbon tax, as instruments in structural adjustment policy. Just as the Hawke-Keating Government successfully steered the economy away from a structure dependent on tariff protection and restraints on competition this Government has an opportunity to steer the economy away from dependence on commodity exports and on CO2 intensity towards an economy more capable of competing in a world where we must live on our entrepreneurship and other skills, rather than on selling non-renewable resources. We are attaching a chapter from our publication *More than Luck: Ideas Australia needs now*[2] which stresses how rent taxes and carbon pricing should be seen in this context.

Undoubtedly, there will re-surface claims that a MRRT will cost jobs and will depress superannuation returns. On the former claim, there is no evidence, and, indeed in an economy close to full employment, the question should be whether we have the labour resources to fill the demands of the mineral sector. On the latter claim, we believe the argument is false. Superannuation funds hold a wide portfolio of investments, and even if there were slightly lower returns from mining shares, these would be offset by higher returns in other sectors as a result of benefits such as a lower exchange rate, better infrastructure, and, in the case of the Government's proposals, a lower corporate tax rate.

We are attaching an article from the current issue of D!ssent, written by one of our Research Fellows, Ian McAuley, expanding on these ideas.

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[2] *More Than Luck: Ideas Australia needs now* (2010) Edited by Mark Davis and Miriam Lyons, A Centre for Policy Development publication http://morethanluck.cpd.org.au

MORE THAN LUCK
Extract: Living off our resources

By Ian McAuley

Read the entire book at http://morethanluck.cpd.org.au

How we frame policy choices — the conflict model

Will an emissions trading scheme or a carbon tax harm our economy? What economic sacrifices must we make if we are to protect the Murray-Darling Basin?

Such presentations of policy choices, implying tradeoffs between social, environmental and economic objectives, are commonplace. Governments and corporations are urged to adopt "triple bottom line accounting", reporting separately on social, environmental and economic performance. Government departments are structured around such classifications, with public policy (or campaign manifestos) emerging through compromises between conflicting social, environmental and economic objectives. The 2010-11 Budget, for example, with its tight fiscal discipline and its cutbacks for environmental programs, could be seen as a win for the economy and a loss for the environment.

However convenient as such classifications may be, they contribute to a way of thinking which can lead to poor policy, because realistically there is no such separation.

If economic policies do not contribute to the people's welfare, what is their point? There will always be debate about whose welfare should have priority – children, working families, the aged – and about how we trade present costs and benefits for future costs and benefits. To suggest however that economic activity has some virtue in its own right is to seriously confuse means and ends. The notion of some trade-off between "social" and "economic" objectives makes no more sense than the (apocryphal) statement attributed to an officer in the Vietnam War: "we had to destroy the village in order to save it".

Similarly, the notion of a trade-off between economic and environmental policy overlooks the nature of economic choices. Economics is concerned with how we use scarce resources. The scarcest resources of all are what we call "environmental" resources — our atmosphere, oceans, water, soils, and ecological systems.[1]

Unfortunately, the political conflicts over the Rudd Government's proposed Emissions Trading Scheme (ETS) were about trade-offs: opposition to the ETS focused on its economic cost.
One can blame political opportunism or sloppy thinking in Opposition ranks, but the point is that the idea of a trade-off is so embedded in our thinking that the Rudd Government felt it was unable to turn the debate around.

We have become conditioned to thinking about economics in terms of a few simple indicators, the main ones being Gross Domestic Product (GDP), inflation, employment, interest rates and public debt, while ignoring other economic indicators such as poverty, ignoring what is not easily measured, such as human happiness or the state of environmental assets, and ignoring the great complexity of the way people interact with one another and with nature.

James Scott of Yale University calls this process "thin simplification". The policy advisor seizes on a few simple indicators, forgetting that these indicators are mere abstractions incapable of capturing the complex reality of the systems to which they refer, and, in time, comes to see nothing else.[2] The policy advisor, the politician, and the journalist believe that any policy which detracts from the performance of these indicators is poor policy. Simon Kuznets, who, 80 years ago, developed the conventions of national accounting that we still use today, warned that the welfare of a nation cannot be inferred from such measures. Today there are people like Joseph Stiglitz working on more inclusive indicators of economic progress, but in our policy development we are still locked into limited ways of thinking.

We have come to see our prosperity as a by-product of economic good fortune, and have come to believe that attending to environmental concerns is a luxury we can afford only if we put the economy first. Capturing this spirit, in moment of unguarded candour, referring to the Government's proposed ETS, the Opposition Leader Tony Abbott said:

'Basically this is a tax on the way we live because the way we live depends on energy, electricity, petrol – this is the ultimate lifestyle tax.'[3]

The reality is that we are living off our (and the planet's) capital. We need a fundamentally different economic structure that will make best use of all our resources.

The lucky country — Greece with minerals

By the human development index, a UN indicator combining life expectancy, GDP per capita, education and living standards, Australia does well: out of 182 countries it is second only to Norway.[4] Australia can also boast of being one of the very few OECD countries to have escaped a recession during the Global Financial Crisis (GFC).[5]

But is such economic performance sustainable?

Australia is an unusual country, once described as a third world country temporarily enjoying a first world living standard. Throughout our post-1788 history, there have been bouts of good fortune—the opportunity to supply world markets with wool, gold, beef, wheat and, for the past 40 years, coal, iron ore and other minerals. As we have depleted one resource, we have turned to another just as it has been needed by other countries. Donald Horne dubbed Australia as "The Lucky Country" in 1964, even before most Australians had heard about the Pilbara and when Roxby Downs was only an isolated and dusty cattle station.[6] While most other prosperous countries have built their economies on efficient use of human capital, Australia's prosperity, from the time the Macarthurs started exporting wool, has owed much to the exploitation of non-renewable resources. We have exported our resources with minimal processing, and have imported our needs from countries with more developed industrial structures.

Table 1. Exports as a percentage of imports, high technology industries, 2008

Ireland	231
Switzerland	201
Korea	182
Sweden	126
Japan	125
Finland	123
Hungary	118
Germany	115
Denmark	110
France	109
Mexico	108
Netherlands	106
Belgium	102
Czech Republic	90
Austria	88
United Kingdom	84
United States	83
Slovak Republic	83
Iceland	77
Italy	72
Canada	62
Norway	49
Poland	49
Portugal	47
Luxembourg	45
Spain	44
New Zealand	27
Australia	25
Turkey	21
Greece	19

Source: OECD in Figures 2009, "High technology" defined as aerospace; office and computing equipment; drugs and medicines; radio, TV and communication equipment; medical, precision and optical instruments.

To illustrate, Table 1, drawn from OECD data, shows exports of the products of high technology industries as a percentage of imports of those same products. Australia is near the bottom of the table, just above Turkey and Greece.

One indicator cannot paint a full picture, and to suggest that Australia is devoid of a high technology sector does an injustice to those few firms which have succeeded in world markets. Furthermore, it is unreasonable to paint our mining sector as purely extractive; in fact most modern mining operations involve complex technologies, and some mining firms have an element of downstream processing. Other indicators, such as patent activity, however, tell a similar story: Australia's industrial structure is not that of a developed country. Greece is in trouble because it has been living beyond its means; we are yet to realise that we too are living beyond our means.

Of course, as became evident in the debate about a resource super profits tax, there is a view that because Australia has very large reserves of certain minerals, including coal, iron ore, copper and uranium, we can continue indefinitely with our current resource dependence.

Even if such resources are in abundant long-term supply, however, there are costs of such dependence. Those costs include economic volatility, a loss of control, and a lopsided economic structure. Economic volatility arises because of the nature of world commodity markets. As the world goes through inevitable business cycles, and as some countries have rapid growth spurts as has been happening in China, prices of finished goods – e.g., ships, cars, whitegoods and computers – fluctuate. The fluctuations in the prices of raw materials that go into these goods are much more marked, however. Figure 1 shows the wild ride taken by world metal prices over the past 25 years.

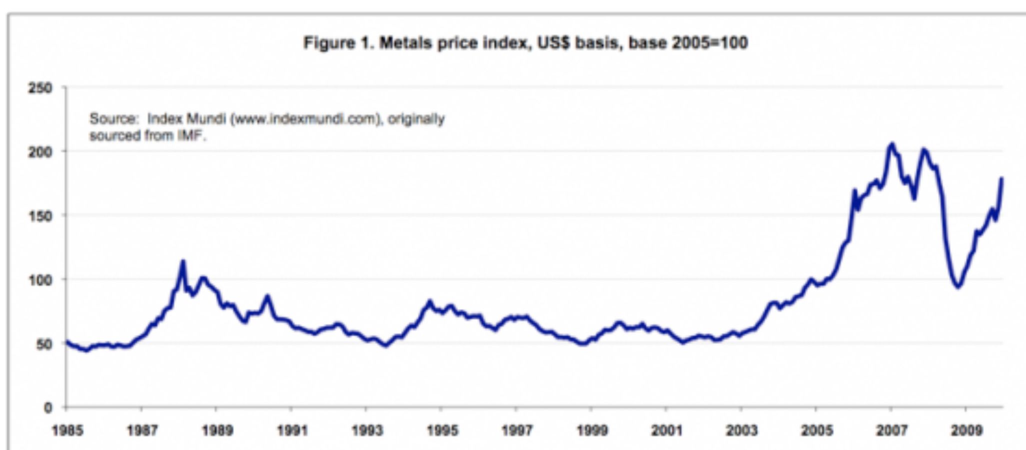

Figure 1. Metals price index, US$ basis, base 2005=100

As the Australian currency has been more volatile than most other currencies (another consequence of commodity dependence), the Australian dollar prices of commodities have fluctuated even more widely. Figure 2 shows long-term prices of iron ore, in Australian and US terms.

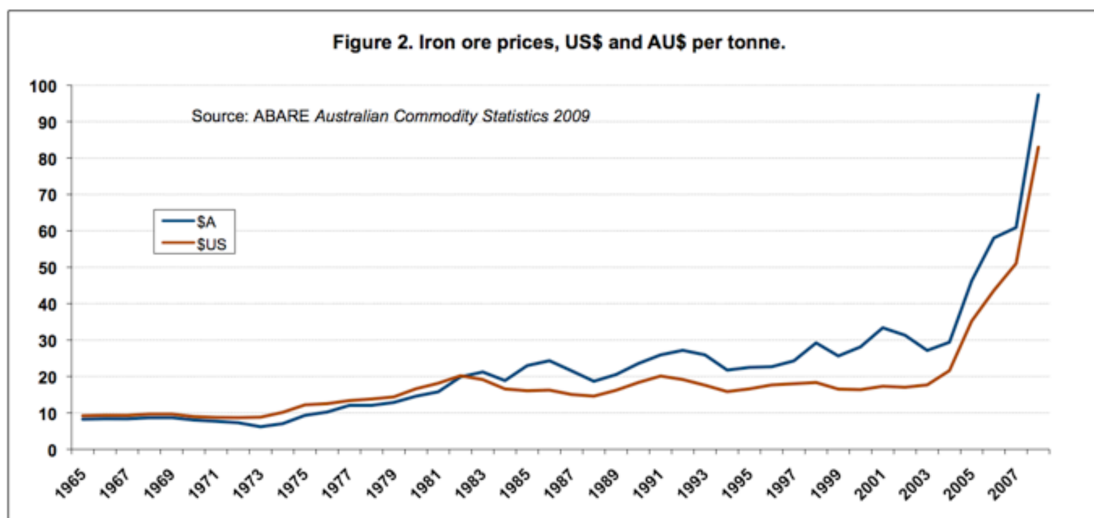

Figure 2. Iron ore prices, US$ and AU$ per tonne.

Due to this commodity dependence, Australia's economy is heavily reliant on the fortunes of the world economy. It used to be said that when America sneezes, Australia catches a severe cold. The same could now be said about our dependence on China's health. Australia's luck to date has been that as certain markets have matured, new ones have arisen, but there is no guarantee such luck will hold. Even if our luck holds, commodity dependence always results in exchange rate volatility. This means businesses in other trade-exposed industries, ranging from education to tourism, have fluctuating fortunes, making long-term planning and investment difficult. Individuals find their lives disrupted, having to move to find employment as regional economies rise and fall. Similarly demand for skills fluctuates, which means it becomes risky for people to become too specialised. The Reserve Bank finds that interest rates have to respond to international currency markets rather than to domestic conditions, with obvious consequences for house buyers and builders.

Another consequence, which became evident in 2010, is that commodity firms which have accumulated huge surpluses in the good times can use their financial reserves to exert political leverage. The whole economy can become hostage to a few firms.

Examples of extreme commodity dependence are provided by countries such as Saudi Arabia and Kuwait, where small numbers of people gain meaningful employment in the oil industry, while everyone else maintains material comfort through forms of welfare dependence. These countries struggle to develop the individual and investor incentives that apply in more developed countries. Their currencies rise to the level whereby non-resource industries have no hope of achieving international competitiveness; their economies become hollowed out. They cannot offer a range of employment to match the natural range of human skills. They do not have manufacturing sectors, where many people learn useful trades and skills. Australia has some similar problems, as identified in Treasury Secretary Ken Henry's description of a "three speed economy" — a resource sector in the fast lane, a naturally-protected domestic service sector in the slow lane, and a trade-exposed sector in the breakdown lane.[7]

Just as labour markets become distorted, so too do capital markets. Investors in resource-intense sectors become conditioned to expect high returns. In economic terms, what is known as the opportunity cost of capital rises for the whole economy. Other sectors of the economy find it hard to get funding, because investors expect high returns. The consequence is generally an under-capitalised economy. Both public sector investors seeking funds for infrastructure and private sector investors seeking funds for industrial plant, where returns are more modest, are starved for funds. A consequence of such under-capitalisation is low labour productivity in that large part of the economy which is not directly linked to the resource sector.[8]

The well-respected development economist Jeffrey Sachs, Director of the Earth Institute at Columbia University, points out that being resource rich probably uses up one to two per cent per year of economic growth potential compared with being resource poor.[9] The effects of resource dependence are pervasive; not only are there the exchange-rate effects (the "Dutch disease") but also there are distortions in rewards and incentives.

The "economically pure" or neoliberal belief, however, is that we should let global economic forces play their part. If that means Australia's economy becomes lopsided, with an overdeveloped resource sector while other sectors remain undeveloped, then just so long as income can be reasonably re-

distributed so as to avoid social tension, then we should accept it: any interference in this process is inevitably at the expense of economic growth.

Encapsulated in this belief is the notion that society is subservient to an anonymous, inanimate market, driven by its own rules. Just as we must accept the laws of planetary motion, so too we must abide by the rules of the market.

This notion of market dominance, now entrenched in our way of thinking, is a modern phenomenon. Fearing an emergence of dysfunctional economic dogmas in the post-war period, in 1945 Karl Polanyi pointed out that markets have traditionally been embedded *within* societies, subject to society's norms and rules. In other words, markets should serve social ends. Just as he feared the economic determinism of communism, so too did he anticipate and fear the rise of neoliberal philosophies which would place society as subservient to market forces.[10] (He would have been only partially comforted by triple bottom line thinking, because it still fails to place markets within society.)

Polanyi's thinking has no place in our brave new world, in which we are so conditioned to believe that any departure from pure market-based thinking is poor policy. Admittedly, mainstream economic thinking does acknowledge the limits of markets, with theories of externalities, natural monopolies, public goods and other market failures, but any extension of thinking to suggest that we should try to shape our national economies beyond that determined by the theory of Smith's "invisible hand" is heresy. The greatest insult that can be made of an economist is that he or she advocates "picking winners".

We do shape markets, however. We privilege the financial sector immensely, with measures such as compulsory superannuation and subsidies for private health insurance. We have privileged the resource sector with infrastructure and with low charges for extracting resources. We leave sectors of the economy, ranging from newspaper shops and taxis through to health professions, exempt from competition policy. We privilege housing with grants to owners and through maintaining a high level of immigration. By contrast we load labour-intensive industries with the burden of payroll tax. We do shape our economic structure, but not in a purposeful way.

There is a legitimate point that many of our past interventions to shape our economy have been ineffective, have led to unforeseen inefficiencies, and have created privilege for the few at the expense of many. For example, protective tariffs and quotas may have been appropriate instruments a hundred years ago, but by the time the Hawke Government was in office they had become serious impediments to our prosperity. Authorisation of retail price maintenance as a means of assisting retailing, imposed huge costs on consumers.

The fault with these interventions was not their intent, but their design. If we are to intervene in markets, we should do so in ways that do not impede innovation and which do not encourage monopoly profits. That means, where possible, harnessing the power of markets through using market-based instruments: for example, a tax on undesirable activities may be superior to a ban, because a tax sends a price signal, while a ban can spurn a black market. A measure which applies widely is superior to one which favours particular industries or firms; for example supporting general transport infrastructure or basic research is generally preferable to privileging railroads for a particular industry or supporting private research.

We can use our taxes and other public policy interventions to shape our economic destiny to ensure that we have a more resilient structure, so that we are not so buffeted by the commodity cycle.
The foregoing, of course, is based on a model in which we have plentiful resources. In reality, Australia is bumping up against resource constraints.

When luck runs out — policies for resource limits

Even if we have resource abundance, there is a strong case for shaping our economic structure towards a more balanced set of activities. If, as is now obvious, we have binding resource limits, the case is even stronger.

Through a combination of excess demand (aggravated by irresponsible pricing) and the early effects of global warming, we are facing severe water shortages. As stated by the International Panel on Climate Change 'By 2030, water security problems are projected to intensify in southern and eastern Australia.'[11] When we wrecked our soils through grazing sheep we were able to move on to other crops, but when we run out of water we won't have anywhere else to turn.

More seriously, in terms of greenhouse gas emissions per capita, Australia is up there with the worst contributors, as shown in Table 2.[12] The main culprit is coal, particularly brown coal.

Table 2. CO_2 emissions, tonnes per capita

Country	Tonnes per capita
Luxembourg	22.35
United States	19.10
Australia	18.75
Canada	17.67
Finland	12.19
Czech Republic	11.83
Netherlands	11.13
Ireland	10.13
Korea	10.09
Belgium	9.97
Germany	9.71
Japan	9.68
Denmark	9.24
Greece	8.74
United Kingdom	8.60
New Zealand	8.48
Austria	8.38
Poland	7.99
Norway	7.85
Spain	7.68
Iceland	7.53
Italy	7.38
Slovak Republic	6.82
France	5.81
Switzerland	5.62
Hungary	5.36
Portugal	5.20
Sweden	5.05
Mexico	4.14
Turkey	3.59

Source: OECD in Figures 2009.

Greenhouse gas intensity is not an inevitable by-product of industrialisation, or of private transport. For example, Germany, which is much more industrialised than Australia and with similar high car ownership, has half our CO_2 intensity per head and per unit of GDP.

If (or more rightly when) our energy resources are priced at a level which reflects their true cost – a cost which accounts for their environmental damage – we will realise their scarcity and be forced to adapt. That price may arise from a carbon tax or from a cap and trade scheme. Economists will say that it is sound economics, environmentalists will say that it is sound environmentalism; both are concerned with better allocation of scarce resources, and both agree that dirty energy producers should not be subsidised by exempting them from paying for their environmental externalities.

The notion that investments required to make the adaptation will hurt our economic growth does not stand up. If there has to be heavy investment in modernising our energy-intensive industries, then there may be a short-term diversion from consumption to investment, but it is better to make that small sacrifice early. For example, the longer we live with the illusion of cheap transport and domestic fuels, the more large houses we will build on our urban fringes. It is a cruel hoax on house owners to shield them from the unsustainability of our settlement patterns.

Modelling commissioned by the Australian Conservation Foundation and the Australian Council of Trade Unions, undertaken by the National Institute of Economic and Industry Research, shows that

strong action to cut greenhouse gas pollution by 25 per cent will make households better off by 2030 than if we were to continue with "business as usual", and, in the meantime, will have positive employment consequences.[13] Farsighted industry leaders, such as Origin Energy Managing Director Grant King, have called for carbon pricing to remove the present relative price penalty applying to clean power.[14]

If Australia acts now we have an opportunity for an early start in new energy technologies, for which there will be world-wide demand. Australia's expertise in mineral exploration and drilling, for example, should provide a head start in geothermal power development, but that opportunity will not be realised while clean energy has to subsidise dirty energy. We once had a world lead in solar technology, but we lost that when we failed to see its value.

One point, though, is that investment in new technologies and in new plants requires patient capital. The assets involved are long-lived but do not show spectacular early returns. Geothermal and wind power will require new transmission lines. Metropolitan subway systems require extensive tunnelling. Stormwater catchment requires re-design of our urban infrastructure. In contrast, incremental expansion of an existing coal fired power station, already privileged by having access to long-established transmission lines, shows earlier returns.

In that respect, we need to keep the cost of capital down, and to reform our investment taxes which, at present, reward short term speculation at the expense of long term investments.[15] It is important, too that we come to accept more modest expectations about long term profits. As pointed out by Elroy Dimson and his colleagues at Princeton University, compared with other countries Australia enjoyed abnormally high investment returns over the 20th Century, thanks largely to commodity dependence.[16] The hysterical reaction to the resource super profits tax confirms that Australian businesspeople, conditioned by a run of high profits, are living in a fantasy world of high and enduring investment returns.

Public policies towards sustainability

We need policies to re-structure our economy. Specific policies should be developed carefully, backed up by research and proper benefit-cost studies. In a document of this nature it would be premature to suggest, say, that we should have carbon quota of X tonnes (a carbon tax may be far better), or a specific depreciation allowance for renewable energy (it may be better to have different types of capital incentives).

It is possible, however, to articulate some general policy principles.

First, we should recognise the interaction of all policies. Compartmentalisation of policies leads to poor thinking and poor decisions, generally resulting in the elevation of a rarefied and abstract notion of "the economy". We need to restore a "public service", so that government employees do not confine their concerns to particular portfolios, and agencies do not see themselves in combative relationships.

Second, we should recognise that the purpose of economic policy is to serve society. This idea is hardly radical; it is to be found in mainstream economics texts. It does not emerge in public policy debates, however.

That may mean we sacrifice some headline growth (e.g. measured GDP) to ensure we live in a more harmonious society. It does not mean some utopian levelling, but it does mean that we restore equality of opportunity, for example through access to education and health care, and ensure that our economic incentives align with people's contributions. As Wilkinson and Pickett point out, unfairness, and perceptions of unfairness, sap societies of their strength and resilience.[17]

Third, we need stop thinking of tradeoffs between "environmental" and "economic" policies. Environmental assessment should not sit alongside economic assessment: all consideration of allocation of scarce resources should be integrated. The externalities associated with consumption of environmental assets should be brought fully to account.

Fourth, we need policies which re-shape our economy to restore balance between resource extractive industries and other industries. That will generally be through harnessing the power of markets through prices, rather than through direct interventions (not the regulatory approach favoured by the present Coalition Opposition). Practical policy outcomes will include:

- the full pricing of carbon and other greenhouse sources, full pricing of water and of other scarce resources;
- the reform of taxation to remove penalties applying to long term patient investment, to remove the incentives for speculative investment in housing, and to encourage investment in human capital. The Henry Review has drawn attention to many distortions in our present arrangements, but much work is needed on means to achieve reform
- the reform of the financial sector to shift investment funds from financial speculation to wealth creation. Reforms should aim to ensure the financial sector is the servant, not the master, of the real economy
- adjustment assistance, where necessary, to firms and individuals, bearing in mind that if the government can hold a steady course on economic reform, there should be few surprises needing compensation. A carbon tax or auctioned permits will raise revenue to provide adjustment assistance, but there is no reason why all such revenue should be directed to adjustment assistance or compensation to households. For the most part firms and individuals should have time to adjust without needing assistance; and,
- the provision of necessary public goods to allow re-shaping of the economy. Depletion of natural capital should be balanced by investment in public capital, including physical infrastructure in transport, water, and energy transmission, investment in research and human capital, and investment in public education. Such investment should be guided by rigorous and transparent benefit-cost analysis. Investment in education is necessary not only to provide the skills for an internationally competitive economy, but also to forestall opposition to change.

To clear the way for such policies, however, we need to dispel the myth that we are a developed country; living off natural assets has led us into complacency. We need to become a real developed country, earning our keep through our (renewable) human capital and entrepreneurship.
Such re-shaping involves a fundamental transformation of our economy, no less dramatic than the transformation that took place during the Hawke-Keating years. We have demonstrated that we can undertake economic transformation, and, although it will involve difficulty, the alternative path of stagnation, with a small extractive sector and a large low productivity sector, subject to the swings of world commodity prices, is not attractive to contemplate.

Endnotes

1. There will be some who hold the view that human values should not be applied to environmental resources – that there are legitimate interests beyond human interests. An anthropocentric view which has regard to option values and which applies a very low discount rate to long-term costs and benefits is unlikely to assign significantly different values to environmental resources than a more encompassing view.

2. Scott, J.C (1998) *Seeing Like a State: How Certain Schemes to Improve the Human Condition Have Failed*, Yale University Press
3. Lewis, S. (2009) “Emissions Trading Scheme killed by elevation of new Liberal leader Tony Abbott” *Herald Sun* December 2nd 2009. Available online: http://www.heraldsun.com.au/news/emissions-trading-scheme-killed-by-elevation-of-new-liberal-leader-tony-abbott/story-e6frf7jo-1225805923852 ↩
4. UNDP (1999) *Human Development Report Available* online: http://hdr.undp.org

5. Australia’s escape from recession was a stroke of definitional luck. By convention a “recession” is defined as two successive quarters of falling GDP. Australia had only one quarter of falling GDP; had that fall been averaged over two quarters, Australia would have been in recession. Also, because Australia has high population growth, there can be falling GDP per capita while there is rising GDP.

6. Horne, D. (1964) *The Lucky Country* Penguin Books
7. Henry, K. (2010) “Fiscal Policy and the Current Environment” Post-Budget Address to the Australian Business Economists, 18 May 2010.

8. Formally this phenomenon is described by the Stolper-Samuelson Theorem, originally applied to the economics of industry protection, and more recently by proponents of a resource rent tax. See Stolper, W. and P. Samuelson (1941) “Protection and Real Wages,” *Review of Economic Studies*, 1.

9. Sachs, J. (1996) Globalization and Employment Public Lecture to the ILO, Geneva
10. Polanyi, K. (1957) *The Great Transformation: The Political and Economic Origins of Our Time* 1945, Beacon Press edition.
11. IPCC (2007) *Climate Change 2007 Synthesis Report*.

12. The figures for Luxembourg are an artefact of energy reporting. Luxembourg has much lower gasoline taxes than its populous neighbours. Most of its emissions should be recorded against Germany, France and Belgium.

13. ACF and ACTU (2010) *Creating jobs – cutting pollution*. Available online: www.acfonline.org.au
14. Fraser. A (2010) “ETS collapse to boost coal-fired plants” The Australian 19 May 2010. Available online: http://www.theaustralian.com.au/news/nation/ets-collapse-to-boost-coal-fired-plants/story-e6frg6nf-1225868403280
15. ibid.
16. Dimson, E, P. Marsh and M. Staunton (2002) *Triumph of the Optimists: 101 years of Global Investment Returns* Princeton University Press.
17. Wilkinson, R. and K. Pickett (2009) The spirit level: why greater equality makes societies stronger Bloomsbury Press

Taxing the miners' uncommonly large profit

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> *... those magnificent Dutch seamen who came here from 1606 on. They were looking for a land or a country which would be the source, as they put it so marvellously, of 'uncommonly large profit'*
>
> Manning Clark

Introduction

Almost the first action of the Gillard Government was to water down the Resource Super Profits Tax (RSPT), and to re-name it as a Minerals Resource Rent Tax (MRRT). While many design features of the RPST were retained, thresholds and rates were reduced, the tax is to be applied only to the iron ore and coal industries, and is to apply only to companies with profits above $50 million. The re-naming may not appear to be material, but it is a more formal term, "rent" being the word economists use to describe a profit arising from economic privilege.

In writing about this issue, I should declare a conflict of interest, because almost 20 percent of the value of shares in my self-managed superannuation fund is in mining companies. I was therefore looking forward to Government's original tax changes, because a higher tax on successful mining companies was to fund lower taxes on other companies. In terms of cash flow, my superannuation fund stood to benefit because the dividend yield on mining shares is very low (1.5 percent for my modest holding), while it is much higher (4.1 percent) for my industrial shares. Mining companies, being more expansionary than most other companies, retain a high proportion of their profits; in fact many pay no dividends.

Because my fund, like most others, is reasonably balanced, over the long term, when capital gains are included, the accumulation return with the RSPT may have been close to neutral, but those capital gains are a long time off. I could see no way, however, that I would be worse off.

The notion that superannuants would suffer – stated specifically on professionally made placards in choreographed demonstrations and implied in Minerals Council advertisements – was just one of the falsehoods of the hysterical campaign against the RSPT. The only people who might have a large proportion of their personal wealth in mining shares are mining company executives: perhaps these are the people whose interests those demonstrators really had in mind.

I should also declare a wider personal interest, which goes well beyond the paltry dividends and uncertain capital gains of my mining shares. Like 22 million other Australians I stand to benefit from the taxes paid by the corporate sector: that too is part of my dividend, and I am disappointed to find that part of my dividend has been scaled back.

Even more basically, I want to live in a country with a well-developed, broad economy. Many years ago, on an Australian Government posting, I lived in the Middle East, in the heart of the oil-rich sheikdoms – countries with huge financial wealth flowing into economies which, by most criteria, would be considered undeveloped. Because of these countries' high exchange rates, there was no way they could develop import-competing or export industries other than oil. There was extreme welfare dependence, with many able people in highly-paid make-work jobs – something like the old Soviet Union but with high incomes. Worse, from an economic perspective, the whole financial incentive structure was distorted: the returns to both capital and labour in the oil sector were so high as to kill enterprise in those parts of the economy which could show only more modest returns.

The foregoing lays out my personal interests. Some may call them prejudices, but whatever the case it behoves one to make such a declaration. I, like many other Australians, would have benefited, financially and in other ways, from the RSPT. I will still benefit from the amended version but I regret the missed opportunity for a more public dividend from mining.

To turn to a more detached analysis, I want to outline three aspects of the RSPT and of the MRRT, only the first of which has had a great deal of publicity. The other two have been largely pushed aside in the din of slanging matches and emotive television advertisements. These are:

- the impact of the taxes;
- the consequences if higher taxes retard the mining sector's expansion;
- the nature of the original RSPT proposal with its *de facto* public share in mining companies' fortunes.

Finally, I want to comment on the government's handling of the issue, which has been very poor by any criterion of good policy development.

1. Is it fair?

The industry's mathematical presentation of the RSPT was simple. The present company tax rate is 30 percent. Under the RSPT the base company tax was to fall to 28 percent, but on top of that there would be a 40 percent tax on the remaining 72 percent of earnings. In arithmetic:

$0.28 + 0.4 \times 0.72 = 0.568$ – or 57 percent rounded.

The main assumption in that simple equation was that *all* companies would be paying super profits on *all* their income. A profit becomes a "super profit", however, only after a threshold return on funds employed – 6 percent in the RSPT proposal. A mining company enjoying a high return would indeed have a *marginal* tax rate of 57 percent, but to reach an *average* tax rate of 57 percent it would have to have an infinite profit.

The new version raises the threshold from 6 percent return to 11 percent (linked to the long term bond rate), and reduces the rate from 40 percent to 22.5 percent, while reducing the cut in the general company tax rate. By the same formula the marginal rate would be:

$0.29 + 0.225 \times 0.71 = 0.44975$ – or 45 percent rounded.

There was a great deal of argument about the fairness of the RSPT. It needs to be considered in the light of tax concessions presently applying to the mining industry, however. The industry has generous depreciation allowances, such as an immediate write-off of environmental protection and certain exploration activities, even if they are capital in nature. Mining operations benefit from the Fuel Tax Credits Program, which rebates the 38.1 cents per litre fuel excise; it is reasonable that mining companies should not have to pay a road user charge for stationery applications, but, to the extent that fuel excise is, *de-facto*, also an environmental tax, full exemption confers some level of privilege.

Another difficulty in making comparisons with other industries is that mining, being capital intensive, is far less burdened by state payroll taxes than more labour-intensive industries.

Because of these and other complexities neither the government nor the mining lobbies should have made categorical statements about comparative tax rates under the RSPT, but that didn't stop the industry from making outrageous claims. The miners criticised the Henry Review for using research showing that mining had a 7 percent lower tax rate than the "all industries" average, but any single figure comparison would be open to attack. And that's before there is any consideration of the value of minerals in the ground.

It is possible, however, to make some historical comparisons, and, as the Henry Review has pointed out, the combined Commonwealth and state (royalty) tax rate on resource profits has fallen from around 55 percent at the beginning of this decade to less than 20 percent in 2008-09. Even if one quibbles with the details, it is clear that the community dividend from the sector has not kept pace with the sector's profits.

The complexity of the RSPT and the MRRT made it hard for people to follow the debate, for these taxes operate in a different way to ordinary company tax. The threshold before the tax applies is treated as a "capital allowance". That is, a reasonable return on funds employed was assumed to be 6 percent under the RSPT and was raised to 11 percent under the MRRT. In accounting terms the capital allowance applies to all funds employed – debt plus equity. Established mining firms have reasonably high debt and pay very little interest on their debt, because much of it is interest-free trade finance. That means, to calculate their tax liability, they can make a larger tax-offsetting claim for a notional 11 percent capital cost than their actual interest outlay. The real profit threshold before the RSPT or the MRRT kicks in, therefore, is higher than 6 or 11percent.

Mining spokespeople did not point this out, nor did they point out that the new tax régime is designed to replace state royalties and that the base corporate tax on normal earnings was to fall.

In any event, the focus of the debate, which was about tax rates, was a distraction. From an investor perspective, what counts more than the rate of tax is the return on equity, and, using a model based on the capital structure typical of well-established mining companies, I have looked at the pre-tax return on equity and the post-tax return on equity under the existing régime, under the RSPT, and under the MRRT. The assumptions are that the company is 50-50 debt and equity financed, that its cost of debt capital is 2.0 percent, and that it has been paying 1.0 percent of its turnover in royalties (a conservative assumption). The results are shown in Table 1.

Table 1. Comparison of returns, pre and post-tax

	Return on funds employed		
Pre-tax	Present régime	RSPT	MRRT
2.0%	0.5%	1.4%	1.4%
4.0%	3.3%	4.3%	4.3%
6.0%	6.1%	7.2%	7.1%
8.0%	8.9%	8.9%	9.9%
10.0%	11.7%	10.7%	12.8%
12.0%	14.5%	12.4%	15.3%
14.0%	17.3%	14.1%	17.5%
16.0%	20.1%	15.8%	19.7%
18.0%	22.9%	17.6%	21.9%
20.0%	25.7%	19.3%	24.1%

(The model is on the Web at

http://www.home.netspeed.com.au/mcau/academic/rsptmodel.xls

Readers can download it and enter their own assumptions.)

Under the RSPT proposals, up to a pre-tax return of about 8 percent, the return to investors would have been *higher* than at present, and for returns up to about 10 percent the additional tax burden would have been modest. Under the MRRT, the crossover point at which the tax burden becomes higher is around 15 percent.

To see those figures in context, over the 20 years to 2010, the average nominal return on Australian shares in all sectors has been just under 10 percent. By any reasonable criterion, above 10 percent we are entering the zone of "uncommonly high profit".

Mining companies, however, claimed that the returns they would receive under the RSPT were absurdly low, well below their cost of capital (the weighted average of their cost of interest and equity finance).

That may be so, but the question it begs is whether mining firms and their investors have become conditioned, over 40 years of Australian mining booms, to expect high returns. Over time, what lesser mortals may consider to be an "uncommonly large profit" may have become the norm for mining companies. Are they unaware of the tough reality of competitive markets in which most other businesses operate?

It has been common to hear mining companies referring to "hurdle rates" – the rate a new project must achieve – of 12, 15 or even 18 percent. While such figures include some buffer for risk, they are extraordinarily high. In the more mundane world of competitive small business, an inflation-indexed return of 6 percent would surely be considered a reasonable return and a return of 11 percent would be considered sheer luxury.

Were those pearl-draped demonstrators holding their designer placards out of touch with the real economy? Has mining distorted our notion of what constitutes a reasonable return to capital? Has the mining sector distorted our capital and labour markets? These questions are addressed in the next section.

2. What are the economic consequences of higher mining taxes?

Even if the Government believes increasing the tax on mining firms will dampen mining activity, it hasn't said so. The Treasury Secretary, however, in speaking about the RSPT, referred to problems such as the "Dutch disease", the "Stolper-Samuelson effect" (a distortion of capital/labour ratios in the economy), and a "three speed" economy. If the RSPT were simply a public revenue mechanism which had no effect on mining activity there would be little point in mentioning these effects, because they all refer to the way a small but highly profitable export sector distorts resource allocation in the rest of the economy.

In their public statements various spokespeople for the mining industry predicted dire consequences if the RSPT went ahead, but it's hard to ascertain how much is bluff, and even if predicted projects do not go ahead, there are many possible reasons for cancellation.

In a politically charged atmosphere it would be very hard for the Government to suggest that higher taxes will affect the decisions of mining companies. Similarly it would be in keeping with reactions to every other economic reform if the affected industry were to overstate its consequences. The debate, if we can use a such a term with its inference of rational discussion, was little different from the heated debates which accompanied tariff reductions, the GST and other reforms.

Even if the Government doesn't want to state it explicitly, there is a strong case for slowing down the expansion of the mining sector. It has been a magnet drawing capital and labour from other sectors, and in doing so is contributing to a distorted economic structure.

When one sector of an economy offers much higher returns than others, it attracts investment funds which may have gone into those other sectors. When an investor can obtain a return of 12 or 15 percent from mining, other businesses find it hard to get funds for ventures with lower returns. Economists may suggest that in time markets will respond adequately: once all demand from the mining sector is satisfied other ventures will get their share, at a lower return, but capital markets do not behave according to such textbook models. A high cost of capital means firms under-invest in technologies which would improve labour productivity: in other words, our labour productivity suffers because of the capital demands of the mining sector. Another effect is that a high commercial cost of finance flows directly and indirectly (through developers' capital costs) into the cost of housing finance.

Similarly a profitable mining sector attracts labour from other sectors. Unless we liberalise immigration even further, or allow many more foreign workers to come on temporary visas (assuming there is world supply of suitable labour), the mining sector will continue to bid up labour costs in many trades. Only geographic bottlenecks, such as housing in remote areas, protect us from an even greater flight of skilled and semi-skilled people to the mining sector.

A pervasive effect of a mining boom is its influence on exchange rates. When our exchange rate is raised, trade-exposed industries suffer. Costs of a high exchange rate are borne by import-competing industries, particularly manufacturing, and by export industries, such as tourism, education services and agriculture. A high exchange rate is attractive to people buying foreign cars or travelling overseas, but the costs are diffuse throughout the economy.

Another distortion is created by Australia's geography, for our mineral resources are concentrated in two states: Western Australia and Queensland can be booming while New

South Wales is in recession, making it politically hard for the Government and the Reserve Bank to manage monetary and fiscal policy.

Some economists argue that so long as income is flowing into the country, there are net benefits. If truck drivers and welders can earn $120 000 working in the Pilbara, or if shareholders in mining companies make high capital gains, income can be re-distributed through the tax and welfare systems. Indeed, over the last thirty years, Australia has seen a widening of private incomes (income before taxes and welfare payments) which have been brought back to some degree of equity with welfare payments, such as family allowances.

The point has some validity, but even a generous welfare system cannot compensate for the benefits people gain from being able to earn income from their own skills and enterprise. As Voltaire reminded us "work saves us from three great evils: boredom, vice and need"; of those three evils redistributive welfare can cover only one.

In any event, all countries find that the capacity of the tax and transfer system to reduce income disparities is limited. Taxes are needed for other purposes, particularly the provision of public goods such as health, education, defence, environmental protection and transport infrastructure.

Progressive taxes on labour as a means of redistributing income have probably gone about as far as they can go. In the early 1950s we had top marginal personal tax rates as high as 75 percent, but that was before people with high incomes were internationally mobile. A tax on resource rent brings progressivity into profits. Sixty years ago we taxed labour heavily because labour was immobile; resource rent taxes apply the same logic to mining. The Henry Review is about changing the tax base to less mobile resources, including minerals in the ground.

If higher taxes on mining do slow down the expansion of mining activity the resulting adjustment will be much more easily borne than the major industry re-structuring of the 1970s and 1980s associated with tariff reductions, which we came through successfully. In that re-structuring manufacturing lost 80 000 jobs, and its share of GDP fell from 25 percent to 18 percent. By contrast, the entire mining sector employs only 170 000 people, or 1.6 percent of total employment. And there is no serious talk about job losses in mining; the most extravagant claims about the RSPT were about mooted projects not going ahead. Even the Minerals Council was careful in its advertising, saying simply "it will affect jobs". (Few people picked up this nuance: the impression created was that the RSPT would cause job losses.)

As a general point, in an economy approaching the zone economists call "full employment", it is hard for any industry to claim that its projects have any virtue in terms of net job creation. All that can happen is for employment to shift between one industry and another. One could have re-framed the Mineral Council's advertisements to say "if the RSPT goes ahead, we will stop taking workers out of other sectors of the economy".

Similarly we are supposed to believe that there is some intrinsic benefit to investors in keeping mining activity in Australia. Undoubtedly industry lobbyists have overstated the attraction of other countries. In general, those countries which apply lower taxes to mining do so to compensate for other factors, including natural hazards, political instability, inadequate

infrastructure and personal risks such as terrorism. Even if some expansion is in other countries, Australian equity holders in large companies such as BHP-Billiton and Rio Tinto will still benefit. Investors generally benefit from geographical diversification.

More basically, a decision not to go ahead with a mining project is not a permanent loss. The minerals remain in the ground for future use. (By contrast, loss of a project such as a corporate R&D facility or an aerospace operation is permanent; those chances are usually once off.) We are supposed to believe it is good if foreign investors can come and dig up our minerals, but it is undesirable if Australian investors get income from digging up other people's minerals. It's a difficult logic to follow.

There were other claims about "retrospectivity" and "sovereign risk". By the way some parties used the term "retrospectivity" all tax changes are retrospective. Their point was that a mining project is planned with a certain tax régime in mind, but so too are all investments in all sectors. The only way a country could avoid sovereign risk by these extreme interpretations would be to have tax rates hard wired in an immutable constitution.

Circumstances change, and undoubtedly those who planned the present projects did not factor in the recent high mineral prices, and, unless they were negligent in their project assessment, did factor in scenarios which allowed for some variations in taxes. In any event, a tax that is triggered only once a reasonable threshold is reached can hardly be called risky.

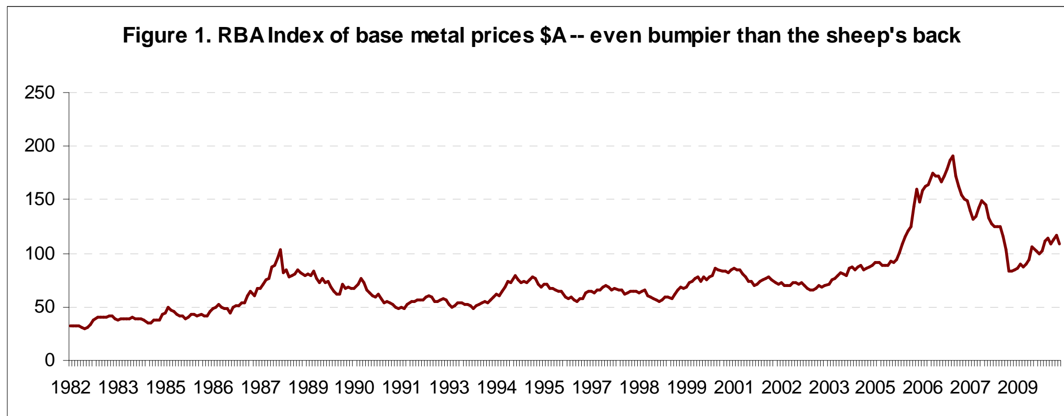
The most specious suggestion was that now is not the time to introduce a resource rent tax, because the future of the world economy is looking less bright than it did in early 2010. That conveniently overlooks the very nature of rent taxes; if prices or export volumes fall, profits will come back, and the rent tax will ease or will not apply at all. In fact, the companies would have the benefit of a lower corporate tax rate.

The Government did not enter this debate about economic structure, however. A kind explanation is that it is hard to explain macroeconomic concepts. A politically realistic explanation is that the Government knows that the Australian economy, because of its dependence on commodity exports to a small number of markets, is fragile. The present Government would like to claim that Australia's escape from the recent financial crisis is due to good management; similarly the previous Government would like to say Australia's strong fiscal position is due to good management, but the reality both parties are avoiding is that we have been living off our capital – our non-renewable mineral resources and the planet's atmosphere. We aren't all that much different from the Greeks and Spaniards; in fact, we are not much different from Nauru which went spectacularly broke once it dug up its last phosphate – it's just that we can postpone our day of reckoning.

3. The RSPT as "equity"

Sometimes an extreme statement contains grains of truth. In echoes of the Cold War era we heard Queensland mining magnate Clive Palmer and others using the term "communist" to describe the RSPT.

The claim had some relevance, for the RSPT would have put the government into a position with some of the benefits and risks of passive equity holders, because it contained



concessions for unsuccessful ventures, which would have received the capital allowance as a tax credit.

Naturally, large and successful companies do not welcome changes that may act to the advantage of their less established competitors, and even industry associations, which inevitably get more funding from larger companies, find it difficult to represent all interests. To misquote Margaret Thatcher, there is no such thing as an industry: there are only individual companies.

One benefit of such risk-sharing is that it is counter-cyclical. In boom times it would collect a lot of tax, and when the industry is in the doldrums it would provide tax credits. Because of the pro-cyclical nature of the commodity cycle (See Figure 1) the RSPT would smooth out that economic business cycle.

In the MRRT compensation for losses has been abandoned to pay for higher thresholds and lower rates, but there will still be some counter-cyclical benefits. Resource rent taxes are designed to overcome a problem with royalties levied on a unit basis, such as tonnes of ore or megajoules of energy content. In general, as a mine is developed, each additional unit of mineral becomes more costly to extract, as the mine becomes deeper and as lower grade ore is exploited. A resource rent tax, by definition, is designed to tax what, by an agreed standard, is the excess profit over what is considered to be a “normal” profit.

The proposal to compensate for losses had other virtues, including a leg up for small companies in gaining market share, thus reducing the concentration in the industry, but it represented a major break with the past. Mining has traditionally provided uncertain returns to investors, and, among some of the smaller companies at least, there is something of a gambler’s culture. Many investors buy shares in startup mining companies with the same attitudes as punters who place bets on horse races. Punters would hardly welcome a government intervention that taxed winners and used the proceeds to compensate losers. The “insurance” mentality that underlay the original tax may be at odds with the culture of the industry.

These basic issues of industry structure and *de-facto* equity never got discussed. The Government dropped the RSPT on to the policy agenda as a complete package, in a process bound to raise conflicting claims, misrepresentations and anger – a process which crowded out the possibility of serious discussion of principles.

4. Good policy, ghastly process

It would be a fair guess that few people, other than academic economists and those involved in the industry and government, understand the principles which underpin the RSPT, let alone its workings. Should governments become more involved in the fortunes of the mining industry? How should mining companies pay for the minerals they extract? Should we try to slow down the industry to protect Australia from the swings of commodity prices, and to keep a more balanced economic structure? How do we discount future costs and benefits; are we willing to defer realisation of part of our mineral wealth?

These questions of principle were not put to the community. The development of the RSPT compared poorly with the process which preceded the Hawke-Keating Government's reduction in industry assistance, which involved the traditional mechanisms of a Green Paper covering the issues, and a White Paper with proposed policies, interspersed with many other mechanisms of engagement, such as various reports by the Industries Assistance Commission (now the Productivity Commission).

If a government is to undertake economic reform, it should start with a public debate about principles. Once there is some agreement on principles, technical design work can proceed. Ideally, in this case, this technical design should have been through an open process such as a Productivity Commission inquiry. That would have seen the theoretical models of resource rent taxes being compared with the evidence presented by interested parties. Of course the evidence would have had its biases, but it would have uncovered issues in practical design, such as the treatment of Onesteel's use of low quality iron ore. Furthermore, the Productivity Commission has the research capacity to do reasonably sound comparisons of international, historical and intersectoral tax comparisons. Such comparisons may not have generated a single bottom line, but they would have produced a much lower range of dispute than we had.

Rather than pursuing such a path, the Government was enslaved by the traditional budgetary process of secrecy to the date of announcement. Also, it should be remembered that the RSPT emerged from the Henry Review, which argues a clear case for the RSPT, but the Government announced its decisions on the Review at the same time as it was released, and confirmed these decisions just a few weeks later in its Budget.

Worse, the Government called the RSPT a “super profits” tax rather than a “rent” tax – the term used in the Henry Review. The term “super profit” can imply that the Government is considering attacking all high profits, while the term “rent” refers specifically to profit arising from entrenched privilege – low-cost minerals in this case. In being too lazy to explain the economics of the tax, the Government unnecessarily scared the horses.

The Government was criticised for breaking its own guidelines in embarking on an advertising campaign, but, having come to the point that the miners were bound to mount a strident and hysterical campaign, the Government had little choice other than to respond. Those who suggest that the Government was improper in using public funds in its response ignore the fact that the mining industry spent a large sum – possibly as much as $100 million – on advertising criticising the RSPT, and because such expenditure is tax deductible, something in the order of $30 million of public money has been spent by the industry, without an iota of public scrutiny. As voters we can easily find out how much of our money was spent on the Government campaign; by contrast as shareholders the mining companies treat us with

contempt: what have we sacrificed in dividends to pay for these advertisements? Also, it will not be until January 2011 or 2012 that we know what the industry spent on political donations and what pledges it made to political parties, almost certainly the huge portion of which would have gone to Coalition parties. It should be remembered that the Government's promises on paid government advertising were part of a package which included reforms on political donations – a reform package that was lost in the Senate on a combined vote of the Coalition parties and Family First Senator Fielding.

The Government's public response, however, was pitiful. Rather than explaining the RSPT and its justification – which the Henry Review did in 350 words and one graph – it used the patronising language of political spin.

The blame for poor process does not lie solely with the Government. The Opposition, rather than putting forward its own principles and constructive suggestions for reform, simply carped about a "big new tax". The Coalition parties, since the Abbott coup, have reverted to a tactic last used in the mid seventies, when they used their Senate numbers to render the country ungovernable, regardless of the consequences to the nation. It's an irresponsible but effective tactic, for it creates an atmosphere of chaos reflecting back on the Government, which can be characterised as incompetent and indecisive.

Rather than fighting back, however, the Government wilted under criticism. When an Opposition is behaving so badly, a government should differentiate itself by exposing the tactic and adhering to sound process itself. In yielding on the emissions trading scheme, on refugees, on electoral reform and many other issues it had demonstrated that it is weak on process and that it meekly gives in to bullying.

Those precedents boosted toe confidence of the mining lobby which, for the last 100 years, has proven itself a very hard negotiator. Perhaps this Government has forgotten the bitter conflict in 1909 between the Fisher Government (a Labor Government with a Queensland Prime Minister), when in response to a national wage decision, BHP closed its mining operations for two years. Perhaps the Government failed to realise that the Liberal Party, so badly out of favour with the business community, was desperately seeking a sponsor to replenish its depleted coffers.

We have a resource rent tax, but it is badly watered down, and it has been negotiated only with the big corporations; it is far from clear whether it represents the interests of the whole industry (but in this regard the smaller companies are paying the price themselves for yielding to bullying.) High commodity prices and high demand will probably cover the revenue shortfalls in the concessions, but the MRRT will be much weaker than the RSPT in terms of bringing a fairer way to tax mining profits and in terms of re-structuring the Australian economy to become less dependent on resource exports.

Without structural reform Australia's long term future is bleak – like that of an oil sheikhdom when the wells run dry, or closer to home, Nauru when the phosphate ran out, with a landscape of big holes in the ground and fading memories of past prosperity.

(In the interests of conserving space, the first three paragraphs under the heading “Is it far?” were not published in *D!ssent*. I have added them back in order to save the reader from needing to look up sources.)