Chapter 4

The Mineral Resources Rent Tax and expanded onshore Petroleum Resources Rent Tax

Introduction

4.1 The chronology of the mining tax's flawed development was set out in Chapters 2 and 3. As detailed in those chapters, the RSPT was replaced by the proposed MRRT and the onshore expansion of the offshore PRRT. The fundamental design features of the revised national mining tax arrangements were put in place by the Heads of Agreement, negotiated exclusively and in secret, between the government and the three largest miners operating in Australia.

4.2 This chapter examines the proposed MRRT and the expanded PRRT, as set out under the Heads of Agreement. It demonstrates that the new taxation arrangements do not meet the government's stated objective of being simpler and fairer than the status quo. The new arrangements increase distortions, are narrowly based and manifestly more complex. They are also unfair to large parts of the mining industry because of the competitive advantage the MRRT design gives to those three companies who were exclusively involved in the negotiations with the government. They are also unfair to those states and territories, like Queensland and Western Australia, whose 'own source revenue' includes a larger proportion of revenue from mining royalties. They are more heavily impacted by the Commonwealth Government's attempts to limit their capacity to make their own sovereign decisions about royalty arrangements into the future.

4.3 The cost of the government's related commitments to increase compulsory superannuation from 9 to 12 per cent over ten years, to reduce the company income tax rate and invest a small proportion of the anticipated revenue into infrastructure, are also assessed in this chapter. That assessment is particularly relevant given Treasury projections that MRRT revenue is expected to decline over the next ten years when the annual cost of those related commitments will continue to increase beyond the projected annual revenue from the MRRT.

The MRRT[1] – Increasing distortions

4.4 On 1 July 2010 the government signed a Heads of Agreement which detailed the broad features of the MRRT. In announcing the MRRT as a so called 'breakthrough agreement', the government explained that the 'improved' reforms (i.e. the MRRT) would focus on the most profitable resources, provide certainty to the industry, and in doing so, ensure that the government's 'central goal' to deliver a better

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1 The expansion of the petroleum resource rent tax to the onshore oil and gas industry is explored separately in this chapter.

return to the Australian people for the resources they own, was met.[2] But the proposed new tax on mining has been criticised on all fronts by the majority of stakeholders. Key aspects of the MRRT are outlined below:

Table 4.1: Key aspects of the Mineral Resources Rent Tax

Taxation feature	**Mineral Resources Rent Tax**
Rate	30%. [effective rate of 22.5%] An extraction allowance of 25% of the otherwise taxable profits will be deductible to recognise the profit attributable to the extraction process – this is to only tax the resource profit. Operators with MRRT assessable profits below $50 million per annum are excluded from the MRRT.
Application	To the mining of <u>coal and iron ore</u> within Australia. (The application of PRRT extended to oil and gas projects onshore (on top of state and territory royalties) from offshore (where no state and territory royalties apply in Commonwealth waters) including the North West Shelf. (The PRRT does not presently apply to the North West Shelf; rather petroleum royalties and crude oil excise apply.[3] Treasury have indicated that the existing royalty and excise arrangements will continue to apply to the North West Shelf project in the short term with liabilities being credited against the expanded PRRT. This is another unresolved area with longer term arrangements yet to be confirmed).[4]
Transferability	MRRT losses would be transferable to offset MRRT profits the taxpayer has on other iron ore and coal operations.[5] (Losses referred to here are those generated by having expenses larger than revenues. Transferability does not apply in respect of credits arising from royalties.)[6] Note: Although taxpayers will be able to transfer tax losses generated from expenses that exceed revenues to other iron ore and coal projects in Australia, transferability does not apply in respect of excess credits that arise from royalty payments.[7] In these circumstances, excess credits from the payment of

2 The Hon. Julia Gillard MP, Prime Minister, the Hon Wayne Swan MP, Deputy Prime Minister and Treasurer, and the Hon. Martin Ferguson MP, Minister for Resources and Energy, *Breakthrough agreement with industry on improvements to resources taxation*, Media Release, 2 July 2010.

3 These arrangements aim to provide a fair and reasonable return to the Australian community and at the same time provide an incentive for companies to explore and develop resources. Source: Department of Resources, Energy and Tourism, *Mineral and Petroleum Exploration and Development in Australia: A Guide for Investors*, p. 20.

4 Department of Treasury and Finance Western Australia, *Analysis of the Proposed Resource Rent Tax Regime*, July 2010, p. 12.

5 *Heads of Agreement*, p. 1.

6 Mr David Parker, Department of the Treasury, *Committee Hansard*, 22 November 2010, p. 16.

7 Mr David Parker, Department of the Treasury, *Committee Hansard*, 22 November 2010, p. 16.

	state and territory royalties are uplifted and carried forward to be applied to a project's future MRRT liabilities.[8]
Deductibility	An allowable deduction for income tax purposes.
Royalties	Remain payable. All State and Territory Royalties are creditable against any resources tax liability. Unused credits can be carried forward and uplifted but cannot be refunded or transferred.
Company taxation rate	2013-14: 29% Small companies would have tax rate reduced to 29% from 2012-13.
Superannuation Guarantee	9% to 12% by 2019-20.
Regional Infrastructure Fund	Allocated $6 billion to a Regional Infrastructure Fund over ten years.
Scope	Approximately 320 mining companies.

A distortionary 'top-up' tax

4.5 The Henry Tax Review proposed the introduction of a resource rent regime that would apply to all minerals and replace state royalties. The proposal of a replacement tax, however, was not pursued by the government. The tax model put forward by the government through its announcement of an RSPT did not envisage replacement of the existing state and territory royalty regimes.

4.6 The government's RSPT did not envisage technical replacement of the existing state and territory royalty regimes, although it proposed a refundable credit for such royalties.

> CHAIR—...It is fair to say that your recommendation was for the national resource rent tax to replace state royalties completely. That is right, isn't it?
>
> Dr Henry—Yes, that is correct.
>
> CHAIR—And under the RSPT the distorting effects of royalties were effectively removed because they were completely refunded—is that right?
>
> Dr Henry—That is correct.
>
> CHAIR—But under the MRRT they are not, are they?
>
> Dr Henry—No, clearly they are not.
>
> CHAIR—So the distorting elements of state royalties, to the extent that they exist, have not been removed, have they?
>
> Dr Henry—To the extent that there is not a full credit provided for those royalties under the MRRT, the royalties would be impacting on investment decisions.

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8 *Heads of Agreement*, p. 1.

CHAIR—Would be impacting on investment decisions?

Dr Henry—I would expect so, yes.

CHAIR—And, potentially, production decisions too, wouldn't they?

Dr Henry—Indeed.

CHAIR—Smaller projects that are not yet subject to the MRRT would continue to pay royalties?

Dr Henry—That is correct.[9]

4.7 Under the RSPT there was effectively a full refund of State royalties irrespective of whether any or how much RSPT was payable. In contrast, under the MRRT there is only a credit 'up to any MRRT liability' which is not transferable and not refundable. As a result, a mining project in the decline phase would have received a refund of royalties paid under the RSPT, but under the MRRT will only get a credit.

4.8 Given that once a project reaches its 'decline phase' it is never likely to make sufficient profit to incur an MRRT liability ever again, and the credits it has accumulated are not transferable between projects, those credits will be useless; the entity will not incur any MRRT liability against which the credits can claimed.

> ...With respect to royalties and companies' liability to bear the burden of royalties, there is a very significant difference between the original proposal—that is, the RSPT—which would have refunded those royalties to the companies, and the MRRT. The MRRT, instead of refunding the royalties in full to the companies, provides a credit against an MRRT liability. So as you say, Senator, if there is no MRRT liability then there would be no refund of royalties.[10]

4.9 It is this aspect of the design that makes the MRRT a top-up tax and makes the MRRT more distortionary than the status quo.

CHAIR—So we have just found a fourth area where the distorting effects, which Dr Henry has described as state royalties, will continue to play out—that is, within big companies, such as BHP, Rio or Xstrata, as well as within smaller companies, if I accumulate royalty credits within one project I cannot actually use those credits for other projects. Is that what you are saying?

Mr Parker—Yes, it is not a big company/small company issue at all.

CHAIR—With small companies the situation is very clear: if you have one project you accumulate them, you cannot offset them and you cannot get a refund, so they are distorted. We have already gone through that. But there

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9 Senator Mathias Cormann, Chair, Senate Select Committee on the Scrutiny of New Taxes and Dr Ken Henry, Secretary, Department of the Treasury, *Committee Hansard*, 22 November 2010, p. 8.

10 Dr Ken Henry, Department of the Treasury, *Fuel and Energy Committee Hansard*, 5 July 2010, p. 5.

is now a fourth element. What we said before is that the big companies which are likely to pay MRRT will actually also pay state royalties that are not creditable or refundable on projects within their portfolio of projects and will not be able to offset that against their MRRT liability. That is right, isn't it?

Mr Parker—That is right. There is a slight nuance here relating to the definition of a project, and that is a matter which is being worked on by the Policy Transition Group. You will see in the paper put out by the Policy Transition Group a discussion of the extent to which the concept of 'project' may cover more than one, if you like, mine.

...

CHAIR—...So whatever you might do to the definition of 'project' might help the BHP Billiton's, Rio's and Xstrata's; it will not help anybody else to soften the impact of ongoing state royalty payments on them.

Mr Parker—It is a basic feature of the tax that if the MRRT implicit liability is less than the royalty then there is no refund of the royalty. It is a basic feature of the tax. It is, if you like, a top-up tax at a lower rate than—

CHAIR—It is a top-up tax rather than a replacement tax.

Mr Parker—That is right—a top-up at a lower rate than the RSPT.

CHAIR—It is a top-up tax, but the RSPT was a replacement tax.

Mr Parker—That is right.

Dr Henry—That would have raised more revenue.

CHAIR—The RSPT was a replacement tax which would have raised more revenue, and this is a top-up tax where the Commonwealth raises a bit less revenue—

Mr Parker—Which raises less revenue, that is right.

CHAIR—but all of the complications and all of the features criticised in the royalty regime are still ongoing.[11]

4.10 What the Henry Tax Review recommended was a profit based tax which would replace production based royalties. What is proposed by government is a tax that will be inefficient and have a distorting impact on investment and production decisions.

4.11 According to the Heads of Agreement, under the MRRT:

[a]ll State and Territory royalties will be creditable against the resources tax liability but not transferable or refundable. Any royalties paid and not

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11 Senator Mathias Cormann, Chair, Senate Select Committee on the Scrutiny of New Taxes and Mr David Parker, Executive Director, Department of the Treasury, *Committee Hansard*, 22 November 2010, pp. 16–17.

> claimed as a credit will be carried forward at the uplift rate of the LTBR plus 7 per cent.[12]

4.12 By requiring the MRRT to operate in addition to the existing state and territory royalty regimes as well as the company tax regime, the proposed regime will be more complex and more distortionary than the status quo.

4.13 When questioned by the committee, Treasury acknowledged that as a top-up tax, the proposed MRRT would result in additional complexities.

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> CHAIR—It is a top-up tax rather than a replacement tax.
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> Mr Parker—That is right—a top-up at a lower rate than the RSPT.
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> ...
>
> CHAIR—but all of the complications and all of the features criticised in the royalty regime are still ongoing.
>
> Mr Parker—That is right. Of course, under the RSPT the replacement of royalties, as you mentioned, was a replacement in economic terms—that is, the royalty regime still existed; it was not replaced as a matter of law or as a matter of administration. It was replaced as a matter of economic effect. The complexity, which you have referred to, remained in place.[13]

4.14 This view was shared by Professors Henry Ergas and Jonathan Pincus, who identified that the requirement for existing royalties to interact with not only the company income tax regime, but also that of the proposed MRRT, would raise a 'myriad' of issues.[14]

> Royalties do discourage some economically valuable activity. A mine nearing the end of its useful life may get sales proceeds that cover the cost of extraction and marketing, but if it does not cover the royalty payments, the ore remains unmined. So the task of designing mining taxes is to find the best compromise between the desire of the tax collector to gather in

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12 The Hon. Julia Gillard MP, Prime Minister, the Hon. Wayne Swan MP, Deputy Prime Minister and Treasurer, the Hon Martin Ferguson AM MP, Minister for Resources, Energy and Tourism, Marius Kloppers, BHP Billiton, David Peever, Rio Tinto Australia, Peter Freyberg, Xstrata Coal, *Heads of Agreement*, p. 1.

13 Senator Mathias Cormann, Chair, Senate Select Committee on the Scrutiny of New Taxes and Mr David Parker, Executive Director Revenue Group, Department of the Treasury, *Committee Hansard*, 22 November 2010, p. 15.

14 Professor Henry Ergas, Professor of Infrastructure Economics, University of Wollongong, *Committee Hansard*, 30 March 2011, p. 7.

> pure rent and the desire not to discourage the effort, talent and risk involved.[15]

4.15 Professors Ergas and Pincus, together with economist Dr Mark Harrison of the Australian National University, also wrote in a recently published, peer reviewed journal article that:

> …the MRRT keeps the main inefficiencies of royalties and adds the inefficiencies of a rent tax. For example, royalties discourage production from mines near the end of their life, causing them to shut down too early. But that is precisely when profitability is likely to be low, so there are insufficient resource-rent tax payments against which to credit the royalty payments. Overall, the MRRT is likely to be an extremely inefficient tax, more distorting than the RSPT.[16]

4.16 Evidence received by the committee suggests that issues of complexity will be greater for smaller miners. The continuing application of royalties, in addition to the MRRT, and the fact that excess royalties are not transferable, will act as a disincentive. It will be a disincentive as royalties will be payable during both the slower start-up period, and the decline phase, during which times profits may not be realised, yet royalties will remain payable. This would not have been the effect had state and territory royalties been 'replaced' with a resource rent tax, as had been recommended by the Henry Tax Review.

4.17 The Henry Tax Review proposal was comprehensive and suggested not only that a Resource Rent Tax regime replace royalties but that the Commonwealth and state governments should negotiate the allocation of both revenues and risks from the regime.

4.18 Had the Henry Tax Review proposal been implemented, with state royalties being replaced by the proposed tax, during the less profitable phases (mine start-up and decline), taxation would only be payable on realised profits. In that situation, to the extent that there is a distortion caused by royalties, it would have been removed under the Henry Tax Review recommended resource rent tax; under the Gillard government's MRRT it is not. In fact the MRRT is more distortionary than the status quo.

4.19 It was the view of economists who appeared before the committee that, the application of both royalties and a rent tax, in the form of the MRRT, also has a negative effect on more risky projects.

> ...the reason the MRRT is going to tax risky investments is that if your project is a failure, the government does not want to know about it, is not going to pay you anything and gives you a credit that you can never use.

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15 Professor Jonathan Pincus, Visiting Professor, University of Adelaide, *Committee Hansard*, 30 March 2011, pp. 1–2.

16 Ergas, H. Harrison, M. and Pincus, J. (2010) “Some Economics of Mining Taxation,” *Economic Papers*, 29(4): pp.369-383, p 378.

> But if your project is a success, the government is going to take their share. That is where the disincentive to risk-taking arises. On that basis if you look at existing projects, in my view there is a strong element of expropriation; the government is effectively acquiring shares. It does not actually acquire the shares, so it avoids the legalistic definition of expropriation, but it acquires the stream of cash flows that give the shares their value. So, from an economic point of view, it comes to exactly the same thing—even if it does not from a legal point of view—at less than their market value.[17]

4.20 The economists who appeared before the committee shared the view that both the RSPT and its replacement, the MRRT, through their treatment of royalties would result in inefficiencies and distortions:

> The MRRT has many of the same inefficiencies as the RSPT but adds some further serious inefficiencies of its own. Like the resource super profits tax, it discourages cost reductions and revenue expansions by miners and, like royalties, it discourages production from mines near the end of their lives. In addition, it distorts the distribution of the rates of return from mining, thus differentially discouraging higher risk profits. The MRRT reduces the expected rate of return for risky projects by more than it reduces those for less risky projects. In other words, the realised tax rate on risky projects after the event turns out to be higher, maybe far higher than that on less risky projects.[18]

4.21 In fact, Professor Freebairn, one of the 20 economists who had previously signed a letter in support of a resource rent tax, explained that the MRRT on top of ongoing royalties puts miners in a much worse position than the status quo:

> Prof. Freebairn—...the MRRT clearly increases the risks faced by miners because all it is doing is taking gains if there are gains to be had, and if there are losses it is not sharing in those losses at all. The MRRT, as proposed, is an asymmetric tax treatment of wins and losses.
>
> CHAIR—So it increases risk for miners. In that sense, it has a distorting effect in its own right, doesn't it?
>
> Prof. Freebairn—Yes.
>
> CHAIR—This is on top of the distorting effects of the royalties, to the extent that they are there?
>
> Prof. Freebairn—Yes.
>
> CHAIR—Compared to the status quo, does the MRRT put us into a better or worse position?

17 Professor George Fane, *Committee Hansard*, 30 March 2011, p. 26.

18 Professor Jonathan Pincus, *Committee Hansard*, 30 March 2011, p. 2.

> Prof. Freebairn—It puts the mining companies into a more riskier position because they still get the same treatment if it is a dud and they lose more if it is a success.[19]

4.22 Professor Pincus explained, in practical terms, the potential negative impact on smaller mining companies:

> A whole series of efforts by mining companies may end up leading to tax liabilities on MRRT which, without the tax, they would have engaged in more fully—more exploration, more thoughts about research and development and reducing their costs. All of those things could add to the profits they make but they are not a consequence of the value of the ore in the ground; they are a consequence of their efforts to make a profit. A tax on profits discourages all those things which make profits.[20]

4.23 Professor Freebairn and Professor Rolfe were invited to give evidence to the committee at the request of a government Senator as they were two of the 20 economists who had signed a letter in support of a resource rent tax.

4.24 In that context, it is telling that both Professor Freebairn and Professor Rolfe told the committee that they did not support the MRRT and that they would not have signed such a letter if the MRRT had been the proposal at the time. According to Professor Freebairn:

> CHAIR—…You captured again that royalties are the worst of all taxes. But of course, as you have said, the MRRT in a sense is worst than royalties.
>
> Prof. Freebairn—Yes.
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> CHAIR—You say yes to that. When you signed the statement in support of a resource rent tax which would replace state and territory royalties, you would not have signed a similar statement in support of the MRRT as it is on the table?
>
> Prof. Freebairn—When we wrote that statement the MRRT was not actually out. It was the super profit resource tax which was going to be a replacement.
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> CHAIR—If you were asked to sign a statement supporting the MRRT, you would not sign it?
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> Prof. Freebairn—No.[21]

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19 Senator Mathias Cormann, Chair, Senate Select Committee on the Scrutiny of New Taxes and Professor John Freebairn, Ritchie Professor, University of Melbourne, *Committee Hansard*, 30 March 2011, p. 59.

20 Professor Jonathan Pincus, *Committee Hansard*, 30 March 2011, pp. 4 - 5.

21 Senator Mathias Cormann, Chair, Senate Select Committee on the Scrutiny of New Taxes and Professor John Freebairn, Ritchie Professor, University of Melbourne, *Committee Hansard*, 30 March 2011, p. 54.

4.25 According to Professor Rolfe:

> CHAIR—...Would you have signed a statement in support of the MRRT as it is on the table?
>
> Prof. Rolfe—I would not have, actually.[22]

4.26 Professor Freebairn made it clear that while he was in favour of a resource rent tax that replaced royalties, such as that proposed by the Henry Tax Review, he was not in favour of the MRRT.[23]

A further distortion – the market based valuation for establishing the starting base

4.27 The distortions that will arise as a result of the arrangements to credit royalties is but one of the distortions that will provide larger miners with a competitive advantage over their more junior counterparts. In addition, the arrangements that the government has announced in respect of determining the starting base will favour the well established three multi-national, multi-commodity and multi-project miners.

4.28 In the Heads of Agreement, the government announced that the starting base for project assets (defined to include tangible assets, improvements to land and mining)[24] can be determined using either:

(a) book value, excluding the value of the resource; or

(b) the market value of the project (as at 1 May 2010).[25]

4.29 The taxpayer is to elect which method of valuation they will apply.

4.30 Evidence given to the committee by smaller miners in respect of this feature of the MRRT highlighted their concern that this design consideration inherently favours their larger competitors:

> The definitional aspects of 'projects' seem to be biased towards BHP and Rio. There is the issue of possible treatment of black-hole expenditure, which is particularly relevant for companies that are trying to develop but may not meet the definition of a project at this point in time.[26]

4.31 The ability to choose a market based method of valuation delivers larger, more capital intensive companies, a bigger capital base and therefore, a larger pool of deductions to draw from before they are required to start paying the MRRT. Such a

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22 Professor John Rolfe, *Committee Hansard*, 30 March 2011, p. 59.

23 Senator Mathias Cormann, Chair, Senate Select Committee on the Scrutiny of New Taxes and Professor John Freebairn, *Committee Hansard*, 30 March 2011, p. 60.

24 *Heads of Agreement*, p. 1.

25 *Heads of Agreement*, p. 1.

26 Fortescue Metals Group Ltd, *Committee Hansard*, Monday 8 November 2010, pp. 21 - 22.

pool is a consequence of the large investments that mining companies have made in the past.

4.32 Many smaller mining companies are instead less capital-intensive and often pay for access to the infrastructure of larger companies. This means that they will not have access to as large deductions as the bigger mining companies. In addition, the payments they have made in the past to gain access to this infrastructure (and service the capital costs of the bigger miners) receive no recognition in terms of higher deductions for the MRRT. As commented by Mr Flanagan, Managing Director of Atlas Iron:

> Atlas is the classic example of those companies. We have gone in. We actually do not own our mining fleet. We do not own a railway line. We do not own a trucking fleet. So we do not get the benefit of the mine gate sale the way the majors do, where they can inflate the value of the service provided and those sorts of things, and that is a significant thing to point out. In this MRRT, effectively, for those companies which do not get the benefit of the transition provisions—and that is pretty much all of those iron ore companies that come after us now—they will not get the benefit of using market value of their assets and an accelerated write-off, which means that they can only use the book value to write off the assets.
>
> …… We will get caught in the transition provisions and we will get the benefit of the market value, but there are going to be a lot of companies to come in the future which are going to be penalised by only having access to that book value.[27]

4.33 Professor Ergas further pointed out that the greater risk involved in investing in smaller companies probably lowers their market values and hence limits the extent to which they have access to a tax shield.

> CHAIR—Would it be as advantageous for the smaller to mid-tier mining companies, having a market valuation method as part of the MRRT design?
>
> Prof. Ergas—Probably not because, their mining projects being typically more uncertain, it is likely that their current market valuations are relatively low and hence provide a much lower tax shield. Again, that is significantly affected by the precise way in which the depreciation provisions are ultimately crafted.[28]

4.34 Overall, although the market valuation method can protect against the government retrospectively taxing private investment, it is another design element which benefits larger companies, which had a voice inside the room, relative to the interests of smaller miners who were not even involved in the discussions.

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27 Atlas Iron Ltd, *Committee Hansard*, 8 November 2010, p. 2.

28 Senator Mathias Cormann, Chair, Senate Select Committee on the Scrutiny of New Taxes and Professor Henry Ergas, *Committee Hansard*, 30 March 2011, p. 10.

4.35 These smaller miners consider that the introduction of the proposed tax will impede their ability to innovate, particularly through the scrapping of the exploration rebate, and the changes to the starting base calculations which favour larger, well established operations.

4.36 The obvious competitive advantage to the three big miners as a result of the design of the MRRT and expanded PRRT is covered in more detail in Chapter 5.

The MRRT - A narrowly based tax, but for how long?

4.37 The Henry Tax Review recommended that resource taxation be reformed through the introduction of a uniform resource rent tax. The RSPT put forward by the government in May 2010 would have applied uniformly to all minerals. However, in the Heads of Agreement negotiated between the government and the three big miners in the shadow of a difficult election for the government, the proposed MRRT would apply only to coal and iron ore, excluding all other minerals.[29]

4.38 Under the MRRT, the government's revenue is generated by the coal and iron ore industries. The original Resource Rent Tax and the RSPT were far broader, encompassing other non-renewable resources rather than two arbitrarily chosen resources. The table below, sourced from Treasury through a Freedom of Information process, demonstrates the narrowness of the taxation base:

Table 4.2: A narrower tax base, revenue from the MRRT[30]

Year / Total	Iron Ore ($m)	Coal ($m)	TOTAL MRRT ($m)[31]
2012-13	3,500	500	4,000
2013-14	5,000	1,500	6,500
2014-15	4,500	2,000	6,500
2015-16	3,500	2,000	5,500
2016-17	2,000	2,000	4,000
2017-18	1,500	1,500	3,000
2018-19	1,500	1,500	3,000
2019-20	1,500	1,500	3,000
2020-21	2,000	1,000	3,000
Total	**25,000**	**13,500**	**38,500**

29 *Heads of Agreement*, p. 1.

30 Source: Treasury Freedom of Information release:: http://www.treasury.gov.au/contentitem.asp?NavId=087&ContentID=1936 (accessed 20 June 2011)

31 Source: Treasury Freedom of Information release: http://www.treasury.gov.au/contentitem.asp?NavId=087&ContentID=1962 (accessed 20 June 2011)

Table 4.3: A comparison of the revenue from the RSPT and the MRRT[32]

Year / Total	TOTAL MRRT ($m)[33]	TOTAL RSPT ($m)[34]	DIFFERENCE ($m)
2012-13	4,000	3,000	1,000
2013-14	6,500	9,000	-2,500
2014-15	6,500	12,500	-6,000
2015-16	5,500	12,500	-7,000
2016-17	4,000	12,500	-8,500
2017-18	3,000	14,500	-11,500
2018-19	3,000	13,500	-10,500
2019-20	3,000	11,500	-8,500
2020-21	3,000	10,000	-7,000
Total	**38,500**	**99,000**	**-60,500**

4.39 Table 4.2 also shows that while the MRRT has a narrow base, most of the revenue from the MRRT is expected to come from iron ore production. According to the Treasury modelling, about 65 percent of MRRT revenue will come from iron ore production over the next decade. Given currently 99 per cent of iron ore royalties nationally are generated in Western Australia,[35] that means about 65 per cent of the MRRT revenue over the next decade will be generated from iron ore production in Western Australia. Imposing one national tax which has such a disproportionate effect on one state economy raises serious equity issues.

4.40 Table 4.3 compares the revenue that would have been raised under the RSPT with that projected to be collected under the MRRT over the initial ten years. These figures, however, give no insight into the assumptions used to calculate the forecasts; assumptions that, to this day, remain secret.

4.41 Although the RSPT would clearly have collected more revenue, the forecast MRRT figures remain misleading given the government's changed commodity price assumptions on which they were based:

> Sources familiar with the Treasury forecasts confirmed...that the original resource super profits tax (RSPT) projections were based on significantly lower iron ore and coal price and volume assumptions than the revised minerals resource rent tax (MRRT). If the higher price assumptions the

32 Source: Treasury Freedom of Information release:: http://www.treasury.gov.au/contentitem.asp?NavId=087&ContentID=1936 (accessed 20 June 2011)

33 Source: Treasury Freedom of Information release: http://www.treasury.gov.au/contentitem.asp?NavId=087&ContentID=1962 (accessed 20 June 2011)

34 Source: Treasury Freedom of Information release: http://www.treasury.gov.au/contentitem.asp?NavId=087&ContentID=1962 (accessed 20 June 2011)

35 Commonwealth Grants Commission, *Report on GST Sharing Relativities – 2011 Update*, p. 42.

> government are now relying on are applied to the original mining tax, the result is that it would have raised more than $20 billion a year.[36]

4.42 This creates more doubt about the ability of the proposed tax to cover the cost of the related budget measures, thereby placing further pressure on the government's budget position.

4.43 The Organisation of Economic Cooperation and Development has identified the narrow and distortionary nature of the MRRT as a concern, specifically:

> As conceived, the MRRT is likely to distort investment incentives between mining projects of coal and iron ore and those on other resources that are not subject to the tax, regardless of their underlying merits.[37]

4.44 Indeed, Professor Ross Garnaut, an economic adviser to the government, suggested that the decision to exclude the tax from all minerals, except coal and iron ore, was arbitrary and had no economic foundation.

> CHAIR—...Resources, as you mentioned earlier, are the properties of the states and it is the states on behalf of the people in those states who sell those resources, for royalties, to those mining companies. A butcher would buy it in a private market but the principle is the same. Why is it appropriate for this sort of tax to be applied to iron ore and coal but not to uranium, nickel or gold? Is there an economic argument in favour of picking those two resources and excluding others?
>
> Prof. Garnaut—There is no economic reason. If two mines are equally profitable, are the same size, take the same length of time and the same amount of exploration to bring into production there is no economic reason to tax iron ore more heavily than uranium, for example.
>
> CHAIR—So why do you think the government has picked them? ... Is it fair to say, then, that it is an arbitrary choice?
>
> Prof. Garnaut—I think that is fair to say. In the public discussion there has been some suggestion that these happen to be very large and very profitable activities at the moment, but not every iron ore mine is large and profitable, and not every other kind of mine is small and unprofitable. So yes, I think you would be struggling to find an economic justification for the distinction.[38]

4.45 Further, apart from having no economic foundation, there is a real concern that the restricted application of the proposed tax on iron ore and coal will have a

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36 John Kehoe, 'Mining tax hole tops $100bn', *Australian Financial Review*, 24 February 2011, pp. 1, 8.

37 Organisation of Economic Cooperation and Development (2010), *OECD Economic Surveys: Australia November 2010*, p.8.

38 Senator Mathias Cormann, Chair, Senate Select Committee on the Scrutiny of New Taxes, Professor Ross Garnaut, *Committee Hansard*, 19 November 2010, pp. 30–31.

distorting effect on investment in these two sectors as minerals other than coal and iron ore become more attractive to investors:

> Looking at the status quo, the answer has to be it makes these other minerals not touched relatively more attractive than the ones that are now facing a slightly higher tax bill.[39]

4.46 Professor Ergas concurred with this view:

> What is more likely to happen is that it will shift the focus of efforts of expanding the supply of coal and iron ore, a greater share of those efforts will ultimately go to other jurisdictions [overseas jurisdictions].[40]

4.47 The government's decision to limit the application of the MRRT to coal and iron ore production reduced the number of affected companies from 2,500 to approximately 320.[41]

4.48 There are however serious question marks as to how long other minerals and resources would be excluded from the scope of this new mining tax if it was passed by the Parliament. In evidence to the committee the Construction, Forestry, Mining and Energy Union (CFMEU) submitted that:

> The RSPT was a more consistent and fairer proposal than the MRRT. The MRRT is at best a useful starting point for fairer taxation of the resources sector and for greater returns to the Australian community...[42]

4.49 In evidence before the committee the CFMEU argued that:

> The Resource Super Profits Tax was a broader and better proposal than the MRRT. The MRRT represents a compromise with the mining industry that is undesirable with respect to its impact on fiscal policy, community benefit and overall economy-wide impacts. The MRRT is restricted to coal and iron ore. While these are hugely profitable industries and prime candidates for resource rent taxation, they are not alone in that respect and a more consistent tax would be applied more broadly.[43]

4.50 Senator Cameron, a government member of the committee, also recently argued that the minerals resource rent tax should be increased, flagging that an increase in the minerals resource rent tax will be proposed at this year's Labor Party National Conference:

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39 Professor John Freebairn, *Committee Hansard*, 30 March 2011, p. 60.

40 Professor Henry Ergas, *Committee Hansard*, 30 March 2011, p. 11.

41 The Hon. Julia Gillard MP, Prime Minister, the Hon Wayne Swan MP, Deputy Prime Minister and Treasurer, and the Hon. Martin Ferguson MP, Minister for Resources and Energy, *Breakthrough agreement with industry on improvements to resources taxation*, Media Release, 2 July 2010, p. 1.

42 Construction, Forestry, Mining and Energy Union, *Submission 13*, p 2.

43 Construction, Forestry, Mining and Energy Union, *Submission 13*, p 5.

> Labor's Left faction will demand an increase in the amount of money raised by the proposed mining tax, a challenge to the authority of the Gillard government's leadership... "We should have another look at whether the mining industry is paying their fair share, and whether the community is getting a fair outcome from it," a national convenor of the Left, Doug Cameron, told the *Herald*.[44]

4.51 Others argued that the limited application of the proposed tax to iron ore and coal will discriminate against these particular sectors of the mining industry:

> 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.[45]

> The Washington-based IMF, in a report on the Australian economy, said the mining tax should be broadened beyond coal and iron ore to other commodities to help reduce inflationary pressure, and many have pointed to the injustice of just targeting iron ore and coal, particularly when other commodities such as copper and gold have enjoyed and are forecast to continue enjoying meteoric price rises. Since the MRRT agreement gold and copper prices have continued to escalate.[46]

The MRRT - Uncertainty and compliance burdens

4.52 The proposed MRRT would be imposed on top of existing resource royalty and other taxation arrangements. Evidence before the committee indicates that the government has not adequately resolved issues with the interaction between the proposed MRRT and state and territory royalties. Resource royalties are only one aspect of Australia's current taxation arrangements applicable to the mining industry. In determining the impact of the proposed minerals resource rent tax, the cumulative effect of royalties, company tax and all other taxes needs to be considered. Investors are concerned not only with the applicable royalty rate but the effective rate of overall taxation.[47] The specific royalty regimes and implications for federal-state financial relations from the proposed mining tax are discussed in more detail in Chapter 6.

4.53 However, as identified, the Henry Tax Review recommended the replacement of state and territory royalty regimes with a uniform resource rent tax regime. This is not what the government has proposed to do with its MRRT/expanded PRRT. The

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44 Peter Hartcher, 'ALP Left takes on Gillard', *Sydney Morning Herald*, 14 June 2011, p. 1.

45 Prosper Australia, *Submission 1*, p. 5.

46 Australians for Northern Development and Economic Vision, *Submission 5*, p 10.

47 Otto, J. et al, *Mining Royalties – a global study*, World Bank, 2006, p. 32.

fact that the proposed MRRT will apply in addition to existing royalties rather than replacing those state and territory royalty arrangements has been the focus of much criticism during this inquiry.

4.54 Because the government had not taken the time to make the effort to engage with state and territory governments on genuine tax reform, it had to come up with a work-around in relation to the issue of royalties. The three big mining companies which were involved in the government's negotiations on the MRRT, were particularly sensitive about this issue. In their evidence to the committee, they indicated on a number of occasions, how central the treatment of royalties under the MRRT was to their ultimate agreement.

> We are concerned with the recent comments made by some parties seeking to move away from all royalties being creditable. It was clear from the context of discussions we had with government and later with Treasury that ‘all’ meant all, current and future. The ‘all’ is essential for the MRRT to set a maximum rate of tax on the earnings of the iron ore and coal operations which, combined with the proposed company tax rate, is approximately 45 per cent. Any departure from this point would undermine a critical design feature of the MRRT.[48]

> What I will say is that the heads of agreement entered into by the then government and the three mining companies in our view begins the process of rebuilding Australia’s reputation as a predictable place to invest.
>
> On this basis Rio Tinto has recently made a number of significant investment decisions. These reflect our expectation that the terms of the heads of agreement entered into with the government will be honoured in full. This includes the crediting of all state and territory royalties including future increases. This is absolutely vital to ensure that the overall rate of taxation remains internationally competitive over the long haul.[49]

4.55 Xstrata Managing Director, Mr Peter Freyberg, went so far as to say that if the government had not addressed the issue of state and territory royalties they would not have signed the MRRT Heads of Agreement.

> For us the statement 'all royalties' is very clear. We would not have signed the agreement had we thought it was ambiguous.[50]

4.56 In the Heads of Agreement signed on 1 July 2010, the government committed the Commonwealth to crediting all state and territory royalties:

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48 Mr Gerard Bond, Group Head of Human Resources, BHP Billiton, *Committee Hansard*, 8 December 2010, pp 5–6.

49 Mr Mark O'Neill, Chief Adviser Taxation, Rio Tinto, *Committee Hansard*, 8 December 2010, p. 37.

50 Mr Peter Freyberg, Chief Executive, Xstrata Coal, *Committee Hansard*, 13 December 2010, p. 20.

> All state and territory royalties will be creditable against the resources tax liability but not transferable or refundable. Any royalties paid and not claimed as a credit will be carried forward at the uplift rate of LBTR plus 7 per cent.[51]

4.57 Following the public release of the Heads of Agreement on 2 July, the arrangement regarding royalties received widespread attention. It came under particular scrutiny following speculation that, despite the statement made in the Heads of Agreement, the government would not credit future royalty increases but only those royalties that were in place at the time the announcement was made. Such speculation caused widespread concern:

> Mr Edwards—If there is uncertainty of the crediting of state royalties or if state royalty rises are not credited what will happen is the maximum effective tax rate companies pay will increase. That will lead to uncertainty and they will face a double tax whammy. What we are looking for is certainty in that all royalties are credited so investors in the resources industry know the maximum effective tax rate that they will be paying. If you do not credit royalties, they will not know. It could go up and up and up.
>
> CHAIR—The Commonwealth would say two things though. First, they would say, 'We do not want to erode our own revenue by states increasing their royalties'. The second thing is that if the states were to increase their royalties now that would essentially be an unexpected increase in your tax burden as well. What is the difference?
>
> Mr Edwards—We would ask for the same process that we are asking the federal government in that we would sit down with the state government and understand what the impact of those royalty increases is going to be. Until we fully understand that, do not increase the royalty rate.[52]

4.58 The mining companies who had been involved in the exclusive and secret negotiations with the government in relation to the MRRT, raised their concerns in relation to the government's unwillingness to confirm their commitment to credit all state royalties against the resources tax liability with the committee:

> For the MRRT to be successful, all of the elements of the heads of agreement need to be delivered. On the treatment and crediting of state royalties, it was made very clear by Xstrata, BHP Billiton and Rio that our understanding was that all state royalties would be credited and refunded under the MRRT. The wording of the signed heads of agreement was quite specific for that reason. From Xstrata's perspective, all means all.[53]

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51 *Heads of Agreement*, p. 1.

52 Senator Mathias Cormann, Chair, Senate Select Committee of the Scrutiny of New Taxes and Mr James Edwards, Executive Officer, Economics and Tax, Chamber of Minerals and Energy Western Australia, *Committee Hansard*, 8 November 2010, pp 47–48.

53 Mr Peter Freyberg, Chief Executive, Xstrata Coal, *Committee Hansard*, 13 December 2010, p. 18.

The 'big three mining' companies

4.59 When giving evidence to the committee, Xstrata Coal indicated that the crediting of all royalties was a critical issue necessary for their support of the tax.

> Mr Freyberg—For us the statement 'all royalties' is very clear. We would not have signed the agreement had we thought it was ambiguous. One of the big subjects discussed during the consultations was the issue of sovereign risk. The fact that the spectre of sovereign within the Australian resource sector had now been opened up made us argue the point that, given that this was an increase in tax, we needed certainty for the future and hence argued for the point of all royalties being credited. This went a very long way to addressing the sovereign risk issues that we were concerned about, particularly with reference to investments we want to make in the future...
>
> CHAIR—So this was not just an incidental discussion; it was a significant focus of the discussions with the government.
>
> Mr Freyberg—The discussions were comprehensive on a number of issues: retrospectivity, sovereign risk, royalties and so forth. We saw the heads of agreement as a complete set of criteria against which the MRRT needed to be detailed.[54]

4.60 BHP Billiton was also of the view that their discussions with government had been very clear concerning the issue of royalties.

> CHAIR—There is a well publicised dispute now...between the government and principally BHP Billiton and Rio...about the mining tax and the treatment of state royalties. Are you certain that under the agreement you reached with the government on the MRRT all state royalties would be credited and refunded, including future increases?
>
> Mr Bond—Yes, I am.
>
> CHAIR—Why are you so certain?
>
> Mr Bond—The discussions we had in relation to the proposed MRRT tabled by the government centred round prospectivity and competitiveness as threshold issues. The tax as designed is a top-up tax and by definition it sets the maximum rate of tax that would be levied on these two products. A top-up tax only operates when the royalties are credited in full. The point around prospectivity and competitiveness as it pertained to the royalties was paramount to that discussion. This was not a wedge tax; this was a top-up tax and the government made it very clear that the royalties would be credited against the MRRT liability in full.
>
> CHAIR—Including future increases?
>
> Mr Bond—That goes to the point of prospectivity and competitiveness.

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54 Senator Mathias Cormann, Chair, Senate Select Committee of the Scrutiny of New Taxes and Mr Peter Freyberg, Chief Executive, Xstrata Coal, *Committee Hansard*, 13 December 2010, p. 20.

> CHAIR—So how much discussion was there on this point in your discussions with the government?
>
> Mr Bond—The discussions extended for many hours on a range of matters.
>
> CHAIR—Sorry, on this matter: was it an incidental discussion?
>
> Mr Bond—I do not believe it was incidental. The point was also discussed with the Treasury representatives when we reviewed the document referred to as the heads of agreement.[55]
>
> CHAIR—...How important was your understanding that all state royalties, including future increases, would be credited?
>
> Mr Bond—It is very important and it was also very clear. The mere absence of any other wording pertaining to the royalties, such wording that that did exist in relation to the RSPT, also evidences in our opinion that the points of discussion on the point have been fully reflected in the heads of agreement: all means all.[56]

4.61 When asked to explain their understanding of the agreement they had struck concerning royalties, Rio Tinto also advised:

> Mr O'Neill—Our view is that the words in the heads of agreement accurately reflect the understanding that we reached in the discussions at least from our point of view. We signed that agreement on the basis that that issue had been resolved. I know that there has been some doubt cast on that, but our very clear view is that those words were carefully chosen and they are an important part of the agreement.
>
> CHAIR—You say that it is your view that the words in the agreement accurately reflect this. So are you certain that under the agreement that you reached with the government all state royalties, including future increases, would be credited? Are you certain that, under the agreement that you reached with the government, that would be case?
>
> Mr O'Neill—From our point of view, the answer would be yes.
>
> CHAIR—What makes you so certain? Was there a specific focus on this point in the discussions that led you to the conclusion that there was a clear understanding? When this particular passage in the heads of agreement was put together was there a particular discussion around the specific wording?
>
> Mr O'Neill—I cannot recall clearly the exact moment at which this was agreed, other than to say that all of the wording in the heads of agreement was extensively discussed—every clause. That included this particular section.

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55 Senator Mathias Cormann, Chair, Senate Select Committee of the Scrutiny of New Taxes and Mr Gerard Bond, Head of Group Human Resources, BHP Billiton, *Committee Hansard*, 8 December 2010, pp. 11–12.

56 Senator Mathias Cormann, Chair, Senate Select Committee of the Scrutiny of New Taxes and Mr Gerard Bond, Head of Group Human Resources, BHP Billiton *Committee Hansard*, 8 December 2010, p. 13.

CHAIR—So every clause was extensively discussed, including this particular section. If this particular section had not been part of the heads of agreement would Rio Tinto have signed up to the agreement?

Mr O'Neill—...it was a key point for us, so I believe that it would have created significant difficulty for us in signing.[57]

The Treasury

4.62 The Treasury, however, took a different view:

Dr Henry—It is my understanding that there would be no credit provided under the MRRT for those future increases.

CHAIR—No credit. So that means that companies would be subject to paying the MRRT as well as the increases in state royalties moving forward?

Dr Henry—That is my understanding.

CHAIR—...Once a mine becomes less profitable towards the end of its mine life, presumably it might fall out of the MRRT liability situation...

Dr Henry—That is correct.[58]

4.63 The discussion continued:

CHAIR—Thank you. You mentioned earlier that future state and territory royalty increases will not be creditable against the mining tax liability, but the heads of agreement is pretty clear, isn't it? It does say:

> All State and Territory royalties will be creditable against the resources tax liability …
>
> Why is there any argument about this?

Dr Henry—Well, I could point out that it does not say 'all future royalties', for example.

CHAIR—What limitation is there on 'all'?

Dr Henry—Obviously, as my colleague Mr Parker indicated earlier, there is some dispute, which you are obviously well aware of, among various parties about the meaning of that particular phrase, and that suggests—

CHAIR—But 'all' is pretty all-encompassing, isn't it?

Dr Henry—'All' is obviously all-encompassing. I think that is a tautology.

CHAIR—Indeed.

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57 Senator Mathias Cormann, Chair, Senate Select Committee of the Scrutiny of New Taxes and Mr Mark O'Neill, Chief Adviser Taxation, Rio Tinto, *Committee Hansard*, 8 December 2010, p. 41.

58 Senator Mathias Cormann, Chair, Senate Select Committee on the Scrutiny of New Taxes and Dr Ken Henry, Secretary, Department of the Treasury, *Committee Hansard*, 22 November 2010, pp. 8–9.

> Dr Henry—But does it refer to all things in existence now or all things in existence at any point in time? That is the question.[59]

4.64 Treasury disputed that the reference in the Heads of Agreement that all State and Territory royalties would be credited did not mean 'all future royalties.'

> Dr Henry—Well, I could point out that it does not say 'all future royalties', for example... But does it refer to all things in existence now or all things in existence at any point in time? That is the question.
>
> ...What I am suggesting to you is that there was a lot that was in people's heads that is not captured in that document [the Heads of Agreement]...when the MRRT is legislated you will see, quite possibly, hundreds of pages of legislation to give effect to that agreement. You should not expect, I suggest, that that agreement captures all of the detail that you as a senator would want to see in a piece of legislation you were scrutinising.[60]

4.65 While the Heads of Agreement clearly stated that 'all state and territory royalties' would be 'creditable against the resources tax liability', the government continued to dispute that 'all' meant 'all'. So it was left to the Policy Transition Group to consider and resolve this issue.

4.66 The PTG has since made its recommendation to the government.[61] In its report,[62] it confirmed the government should comply with the terms of the Heads of Agreement and credit all royalties, including future increases in royalties:

> ...the PTG recommends that there be full crediting of all current and future State and Territory royalties under the MRRT so as to provide certainty about the overall tax impost on the coal and iron ore mining industries. Equally, the MRRT should not be used as a mechanism to enable States and Territories to increase inefficient royalties on MRRT taxable commodities.[63]

4.67 The PTG did however suggest that, in crediting all current and future royalties, the Australian Government:

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59 Senator Mathias Cormann, Chair, Senate Select Committee on the Scrutiny of New Taxes and Dr Ken Henry, Secretary, Department of the Treasury, *Committee Hansard*, 22 November 2010, p. 12.

60 Dr Ken Henry, Secretary, Department of the Treasury, *Committee Hansard*, 22 November 2010, pp. 12–13.

61 Policy Transition Group, *Report to the Australian Government – New Resource Taxation Arrangements*, December 2010.

62 The PTG's report to government was delivered in December 2010. That report made 98 recommendations (94 concerning the mining tax and four concerning exploration incentives).

63 Policy Transition Group, *Report to the Australian Government – New Resource Taxation Arrangements*, December 2010, Commonwealth of Australia, p. 17.

> ...put in place arrangements to ensure that State and Territory governments do not have an incentive to increase royalties on coal and iron ore. This would limit their negative impacts, while allowing the Australian Government's taxation regime to maximise the return to the community during the highpoint of the resources cycle, so achieving the balanced outcome described above.[64]

4.68 On 24 March 2011, the Treasurer and Minister for Resources announced that the government had accepted all 98 of the PTG's recommendations. In making that announcement the Treasurer and the Minister for Resources specifically stated that the government accepted the PTG's recommendations in relation to royalties:

> We're pleased to accept all 98 recommendations of the Policy Transition Group (PTG)....The Government supports the recommendation that all current and future royalties be credited, and that all levels of government should ensure the taxation of Australia's resources preserves our international competitiveness. We agree with the PTG that the Mineral Resource Rent Tax is a more efficient way to provide Australians with a return on their mineral wealth and that we shouldn't give a green light to the states to increase their royalties.[65]

4.69 Just how the government will ensure that the states and territories are not given a 'green light' to increase royalties has yet to be clarified. Treasury suggested to the committee, however, that such action might occur through the payment of tied grants.

> CHAIR—Would the Commonwealth be able to force states and territories into a position where they cannot either charge or increase state royalties?
>
> Dr Henry—Of course the Commonwealth could, if it wished...
>
> The Commonwealth has the power, and it has used it on occasions to have the states do things or not do things. Principally the Commonwealth's power comes through the state's reliance on the Commonwealth for such a large proportion of their funding. The Commonwealth is pretty much in control of that funding. I say 'the Commonwealth' because I am talking about the Commonwealth parliament, since mostly what I am talking about is appropriations made by the Commonwealth parliament to the states. If the Commonwealth parliament decided the states should do something they are not presently doing, or stop doing something they are presently doing,

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64 Policy Transition Group, *Report to the Australian Government – New Resource Taxation Arrangements*, December 2010, Commonwealth of Australia, p. 17.

65 Joint media release, Deputy Prime Minister and Treasurer, the Hon Wayne Swan MP and the Minister for Resources, Energy and Tourism, the Hon Martin Ferguson MP, *Government accepts Resource Tax Recommendations*, http://minister.ret.gov.au/MediaCentre/MediaReleases/Pages/GovernmentAcceptsResourceTaxRecommendations.aspx (accessed 21 April 2011).

> the appropriations power affords the Commonwealth parliament a fair degree of leverage.[66]

The Western Australian Treasury

4.70 The Western Australian Treasury department sought advice about the interaction of the state royalty regime with the proposed MRRT and expanded PRRT. Their requests for clarification, however, went unanswered:

> Mr Marney—We have sought clarification as to how future increases...would be treated. We are yet to receive clarification.
>
> CHAIR—Since you appeared before the previous Senate committee on 13 July, have you had any in-depth discussion with federal Treasury on how the mining tax and interaction with state royalties is to operate?
>
> Mr Marney—No, we have not. We have a number of pieces of correspondence in to them and we are awaiting a response.
>
> ...
>
> Mr Marney—We have had one meeting with the Policy Transition Group. Many of the issues we have sought clarification on fall outside the terms of reference of that group.[67]

MRRT – Less fair, royalty credits which are non-refundable, non-transferable

4.71 Although the PTG has now settled the issue of crediting all future royalties, the fact that royalties will be creditable but not transferable or refundable means that distortions and disincentives will remain under the proposed MRRT model.

4.72 The distortions and disincentives occur because, in some circumstances, credits will accrue but will not be able to be used. Economists who gave evidence to the committee identified this as an issue:

> CHAIR—...the mining tax deal between the government and the big three miners that all state royalties will be credited against the mining tax. The mere fact that they are going to be credited does not actually mean that they are going to be refunded, does it?
>
> Prof. Pincus—No. They are only credited and not refundable. If no MRRT tax is paid you do not get a refund from the Commonwealth.
>
> CHAIR—So if your project is in the decline phase, as has been said—and royalties supposedly accelerate the closure of a mine—presumably you are

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66 Senator Mathias Cormann, Chair, Senate Select Committee of the Scrutiny of New Taxes and Dr Ken Henry, Secretary, Department of the Treasury, *Committee Hansard*, 22 November 2010, pp. 11–12.

67 Senator Mathias Cormann, Chair, Senate Select Committee of the Scrutiny of New Taxes and Mr Timothy Marney, Under Treasurer, Department of Treasury and Finance, Western Australia, *Committee Hansard*, 8 November 2010, p. 66.

at a stage of your mine life where you are never again going to be sufficiently profitable to be subject to the mining tax. Whatever credits you accumulate will not serve any purpose whatsoever, will they?

Prof. Ergas—That is correct. In the simple case of an entity which operates a single mine and where there is no scope to transfer the liabilities associated with royalties or the credits associated with royalties across projects, then the royalties will have whatever distorting effects they have at the moment. The situation may be more complex if you are an entity that is operating multiple projects and can transfer.

CHAIR—Is it? In the heads of agreement it says very clearly that royalty credits are not transferable between projects. So even if you have got multiple projects, if you cannot transfer—which, as I understand it, you cannot—then the problem is still there. If you are a mine in the decline phase, you are not any better off; in fact you are probably worse off because you have got to go through the administrative processes of the mining tax.

Prof. Ergas—That is indeed the case. The point we make in the article is that the risk is that you will accumulate the distortions associated with the royalties with the distortions associated with what is effectively a profits based tax.[68]

4.73 The government's proposed MRRT, as a top-up tax, not only results in complexities due to its interaction with the existing state royalty regimes, but, by treating royalties as creditable but not transferable or refundable, the government has perpetuated a further distortion through the proposed 'carry forward' arrangements that can be applied. Although the government views the 'carry forward of unused credits' feature as a solution to the problem of potential double taxation, if it results in a change in taxpayer behaviour, distortions may in fact be compounded.

4.74 Submitters to the inquiry identified that this feature of the proposed MRRT may in fact result in two different distortions. In some instances, smaller miners will be discouraged from investing in riskier projects as credits for royalties paid will accumulate but may not be able to be used whereas, on the other hand, a larger miner with larger operations may choose to delay or restrict production volumes to future years in an attempt to capture the gains that can be realised as a result of the uplift factor that will be applied to carried forward credits.

The 'carry forward' arrangements for royalty credits

4.75 Under the Heads of Agreement, credits accumulated (for royalties paid) but unable to be transferred or refunded are to be carried forward for future use. The government announced that these credits would be carried forward at the uplift rate of the long term bond rate (LBTR)[69] plus 7 per cent.

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68 Senator Mathias Cormann, Chair, Senate Select Committee of the Scrutiny of New Taxes and Professor Henry Ergas, *Committee Hansard*, 30 March 2011, p. 9.

69 The long term bond rate in Australia is currently around 5.5 per cent.

4.76 The application of an uplift factor to the carried forward credits is appropriate in order to recognise the effect of the passage of time on the value of money; however, the uplift factor to which the government has now agreed (of the LTBR plus 7 per cent) is considered by some to be far too generous and a source of further distortion:

> On the one hand, the treatment of tax credits by the government is mean in the sense that, if the project fails, you cannot use them. So there is the disincentive to taking risk. On the other hand, the treatment of the tax credits by the government is too generous. They are being accumulated at 12 per cent tax-free, whereas they should be accumulated at five per cent and pay tax—in other words, at 3½ per cent tax-free. I do not think that produces an incentive to minimise profits. You still want however much of the profits the government takes and still want more rather than less as long as the tax rate is less than 100 per cent. But it gives you an incentive to develop a mine more slowly than you would if the tax credits were being carried forward at 3½ per cent.[70]

4.77 This treatment of unused royalty credits, as set out in the Heads of Agreement, differs from the treatment of royalties proposed under the original RSPT model as, under that model, taxpayers would have received a refundable credit for state royalties paid. There would be no carry-forward required.

4.78 Professor Fane identified the possibility for distortion that could arise from the proposed carry forward provisions. Professor Fane suggested that the ability to carry forward unused credits at such high rates would encourage those within the mining industry to develop more slowly because by doing so they would avoid some taxation:

> CHAIR—...You talked about how, because of the crediting arrangements, there is an incentive to delay projects and hold credits because there is a 12 per cent risk-free return, effectively, by just holding the credits. Can you talk us through that in a bit more detail?
>
> Dr Fane—Under the Brown tax, suppose that in a particular period a company has no receipts and it spends $2 and there is a 50 per cent tax. Under the Brown tax, the government would give it $1—or $1 billion if we wanted to make it large numbers. Under the Henry proposal, the government is going to give it one dollar's worth of government bond. If it really gave it one dollar's worth of government bond the company would have to pay tax on the interest on that bond.
>
> CHAIR—So it is a tax-free return?
>
> Dr Fane—But in the case of the Henry proposal, the idea was to give them a tax-free government bond.
>
> CHAIR—I am interested in the MRRT.
>
> Dr Fane—It has a still larger effect because instead of giving them a tax-free government bond that pays five per cent, they will give them a tax-free

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70 Professor George Fane, *Committee Hansard*, 30 March 2011, p. 41.

government bond that pays 12 per cent. A company that have been given a government bond that pays 12 per cent and is tax-free have an incentive to hold onto that bond. They cannot sell it to somebody else; they want to keep it as long as possible. To keep it as long as possible, they want to delay earning the revenue against which they will eventually use it. This is because the way in which they are going to get their return is by taking their credit and offsetting some receipts in the future.

CHAIR—Of course, the MRRT would not apply. They will not be paying additional tax on the 12 to 13 per cent that they have received from the uplift factor the credits. That is right?

Dr Fane—It is free of company tax.

CHAIR—It is free of company tax, but would they pay any tax on it?

Dr Fane—No, they would not. It is going to be used as a credit against future payments of resource rent tax.

CHAIR—Which would be less because the credits have been escalated. What you are really saying is that by holding those credits and not incurring the tax you can have a risk-free and tax-free return of 12 to 13 per cent, which you would not be able to get anywhere in the market?

Dr Fane—That is right. But if you earn the revenue next year that you have to pay this against, then the party is over next year. But if you wait for two years the party goes on for two years.

CHAIR—Is it compounded?

Dr Fane—Yes.

CHAIR—So a compound return of 12 to 13 per cent, tax-free, does provide quite a perverse incentive to not go ahead with making profits.

Dr Fane—It is an incentive to develop more slowly or extract the resources more slowly.[71]

4.79 To address this issue, Professor Fane suggests that a much more appropriate uplift rate at which to carry forward unused credits would be 3 per cent:

The point that the Henry committee did not make, but it should have made, is that it is the long-term government bond rate after tax. Because if you give a company a government bond it is paying interest, if you want to have a neutral tax system, the company should be paying tax on that interest. So the appropriate interest, unless the implicit interest on the tax credits is included in company tax, which I am confident it will not be in Australia, then the appropriate interest rate is not, let us say, five percent of the government bond rate it is that minus the company tax rate, so it is a number like three per cent which is the appropriate carry forward interest rate.[72]

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71 Senator Mathias Cormann, Chair, Senate Select Committee of the Scrutiny of New Taxes and Professor George Fane, *Committee Hansard*, 30 March 2011, pp. 28 - 29.

72 Professor George Fane, *Committee Hansard*, 30 March 2011, pp. 24 - 25.

MRRT – More complex and administratively burdensome, the $50 million profit threshold

4.80 The MRRT and expanded PRRT are designed so that taxpayers with low levels of resource profits would not have to pay the tax. The threshold at which liability to the tax commences has been set at $50 million. Concerns have been raised that the $50 million threshold increases compliance costs of the proposed tax, adds complexity and further discriminates. In addition to these concerns, confusion remains in regard to how the threshold would operate:

> CHAIR—Have you made a decision on the $50 million threshold, how it will operate—as to whether the MRRT will apply to $51 million or to the $1 million et cetera above $50 million?
>
> Mr Parker—That is a matter that the PTG is consulting on. We will be making a recommendation to the government, and the government will make a decision.[73]

4.81 Smaller miners raised concerns that the calculation of the threshold would only occur after the end of the financial year and, therefore, they would incur a complex administrative compliance burden in order to ascertain their liability. Because of this, they have advocated for the threshold to be raised:

> Mr Bennison—I think it is fair to say that there are some concerns about how it is going to apply.
>
> CHAIR—Do you know how it is going to apply now?
>
> Mr Bennison—No, we do not. We put a tax-free threshold at that mark. We have obviously asked for it to be increased from $50 million to $250 million and we want a tax-free threshold up to that point.
>
> CHAIR—Has anybody been able to explain to you how they determined the $50 million?
>
> Mr Bennison—No.[74]

4.82 The Chamber of Commerce and Industry of Western Australia agreed with the view put forward by small miners that the $50 million threshold may not be appropriate:

> Mr Richards—...I think the problem there is that we do not know where that $50 million figure comes from, and that is why our comments in that area have been fairly limited. We do not really know what assumptions and calculations went into actually calibrating that threshold. What is clear in our minds is that the threshold ought to serve primarily the issue of tax

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73 Senator Mathias Cormann, Chair, Senate Select Committee of the Scrutiny of New Taxes and Mr David Parker, Executive Director, Department of the Treasury, *Committee Hansard*, 22 November 2010, p. 49.

74 Mr Simon Bennison, Chief Executive Officer, Association of Mining and Exploration Companies, *Committee Hansard*, 8 November 2010, p. 11.

efficiency in order to protect smaller miners and also to ensure the government is not allocating resources unnecessarily where they are going to have a small tax intake from that particular part of the sector. So our feeling is very much that that threshold ought to be calibrated around the issue of tax efficiency to ensure that smaller miners are protected and administrative efficiencies are achieved in the tax so that the government is not exerting too many resources.[75]

4.83 Their concerns were shared by the Chamber of Minerals and Energy Western Australia who say that the threshold would be particularly detrimental to miners of low value/grade minerals:

> The chamber has significant concerns over the quantum of the threshold, how it was arrived at, whether $50 million is adequate and also how it is operating. We advocate it operates as a tax-free threshold. The chamber also has significant concerns with regard to low-value resources, which usually require significant processing to value add and whose operators will be required to undertake significant and costly compliance measures even though they will be paying minimal or no tax under the MRRT. These concerns also apply to junior developers trying to get their projects up and running.[76]
>
> Mr Edwards—As I have said before, the MRRT does go some way to providing competitive neutrality. Having the taxing point at the mine gate to some extent addresses that. Having a tax-free threshold goes some way to addressing that. Getting your full realisation of your downstream assets when valuing your resource goes to an extent to get competitive neutrality. However, our argument is: is the $50 million threshold adequate to provide that neutrality? We do not know; the government has not modelled it.
>
> Senator MARK BISHOP—We are talking about the principle. You and I both know that financing costs and the taxation imposts are different between a gold mine, a coal operation and a high-quality iron ore proposition. None of those are competitively neutral. So how do you reconcile the two?
>
> Mr Edwards—A higher valued resource will pay more tax. That is fine. But what I am saying is that the impact of the tax relative to each of the commodities must not adversely affect that...[77]

4.84 The Magnetite Network, a lobby group representing magnetite miners, (magnetite is a low value mineral that requires extensive processing to produce a

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75 Mr Noel Richards, Senior Policy Adviser, Resources and Energy, Chamber of Commerce and Industry of Western Australia, *Committee Hansard*, 8 November 2010, p. 83.

76 Mr James Edwards, Chamber of Minerals and Energy Western Australia, *Committee Hansard*, 8 November 2010, p. 46.

77 Senator Mark Bishop and Mr James Edwards, *Committee Hansard*, 8 November 2010, p. 50.

saleable good),[78] confirmed that their inclusion in the tax regime would result in substantial compliance costs:

> Ms Megan Anwyl—...when it is mined magnetite has a very low value and it is very difficult to even track this because it has not traditionally been sold as raw ore. It is really only after the beneficiation process that magnetite has a value. We note that the beneficiation process is similar to some other base metals that have been exempted from the tax and we will come back to that shortly. We also think that the taxation of magnetite concentrate is contrary to the policy intent stated by the Prime Minister and a range of other senior ministers...
>
> Mr Mackenzie—...Essentially, our case is for exclusion of the production of magnetite concentrate.... Less than two per cent of Australia's iron ore is produced as magnetite concentrate and that is because we are well endowed with the direct shipping stuff. The USA, China, Canada and Brazil have extensive deposits of magnetite, which they are mining and concentrating into magnetite concentrate and using as feedstock into their steel business...[79]

4.85 The concerns raised by industry stakeholders were acknowledged by the government through the PTG which, through its terms of reference, was asked to consider the issues that had been raised, and develop a workable exclusion for taxpayers with profits of less than $50 million. The PTG was asked to develop an exclusion that would address the concerns of smaller miners in regard to increased compliance costs even though they would not be liable to pay the tax.

4.86 In response, the PTG advised government that although the existence of the threshold would be unlikely to reduce compliance costs for taxpayers (as they will still be required to maintain records and undertake the full MRRT calculations regardless of whether they are above or below the threshold), to avoid a large change in their MRRT tax bill as they cross the $50 million threshold and changes in production behaviour, the PTG recommended phasing in a taxpayer's MRRT liability from an annual MRRT profit of $50 million.[80]

4.87 Further, in recognition of concerns raised by smaller miners that they would be required to account for the MRRT but never be liable to pay the tax, the PTG recommended that tests be designed to identify those taxpayers and provide them with a low cost compliance option.[81]

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78 Magnetite Network (MagNet), *Submission 25*, pp 3–4.

79 Ms Megan Anwyl, Executive Director, Magnetite Network, Mr William Mackenzie, Chairman, Magnetite Network, *Committee Hansard*, 8 November 2010, p. 94.

80 Policy Transition Group, *Report to the Australian Government – New Resource Taxation Arrangements*, December 2010, p. 16.

81 Policy Transition Group, *Report to the Australian Government – New Resource Taxation Arrangements*, December 2010, p. 16.

The Petroleum Resource Rent Tax

4.88 The government's revised mineral taxation framework also included changes to the existing PRRT regime. The existing PRRT is a profit-based tax, which is applied on a project basis - each entity with an interest in a PRRT liable project is liable for the PRRT.[82]

4.89 The existing PRRT is levied at a rate of 40 per cent of a project's taxable profit (that profit being calculated for PRRT purposes). Taxable profit is the project's income after all project and other exploration expenditures have been deducted from all assessable receipts. PRRT payments are deductible for company income tax purposes.

4.90 Under the proposed changes, the PRRT will be extended and be payable by all onshore and offshore oil and gas projects including the North West Shelf.[83]

4.91 The extension of the PRRT to onshore projects will involve:

(a) the tax's continued application at a rate of 40 per cent;

(b) a range of uplift allowances for unused losses and capital write-offs will be offered;

(c) all expenditure can be immediately expensed;

(d) the tax value of losses can only be transferred in limited circumstances;

(e) all state and federal resource taxes will be creditable against current and future PRRT liabilities; and

(f) transitional arrangements will be provided for oil and gas projects moving into the PRRT.[84]

4.92 Since the government's announcement of the changes to the MRRT and PRRT however, there has been little focus on the extension of the existing PRRT regime to onshore oil and gas. Despite this lack of attention, there remains concern within the industry that broadening its application would have significant detrimental impacts on domestic gas production. The concerns that have been raised by industry participants have focused on two main issues:

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82 Source: http://www.ret.gov.au/resources/enhancing/taxation/prrt/Pages/PetroleumResourceRentTax(PRRT).aspx (accessed 3 May 2011).

83 Australian Government, *Fact sheet - A new resource taxation regime: improved resource tax arrangements*, 2 July 2010, p. 2.

84 The points identified as key features of the PRRT have been sourced from the Government's fact sheet, *A new resource taxation regime: improved resource tax arrangements,* 2 July 2010, pp 2 - 3.

(a) the extension of the PRRT to onshore oil and gas would have a detrimental effect on domestic energy supply and lead to increased costs for consumers; and

(b) the application of both royalties and the PRRT would add administrative complexity and costs.

4.93 There is a view amongst the onshore oil and gas industry that the lack of attention that has been given to their concerns in relation to the extension of the PRRT is due to the industry's small size compared to the offshore industry:

> CHAIR—Most of the focus in the public debate on this mining tax package, which was announced on 2 July, has centred around the MRRT. There has not been much discussion on the impact of the onshore expansion of the PRRT. Why is that?
>
> Mr Streitberg—We are the most active onshore explorer in Western Australia, and my staff who can focus on these things are me and my CFO.
>
> CHAIR—You are saying there are not enough people who are able to dedicate the time to hit the drum on it.
>
> Mr Streitberg—Absolutely.[85]

The impacts of the expanded PRRT

4.94 The DomGas Alliance[86] is concerned that Australia's limited domestic energy supply would be put under further strain as a result of the changes leading to higher prices for consumers:

> We believe that any proposal to extend the PRRT to onshore and near onshore projects could have serious unintended consequences for supply...our studies show that a 40 per cent PRRT could make some of these projects uneconomic. It could also lead to high energy prices. If this were able to be passed through to customers we believe that such a pass-through would be contrary to the principle of the tax on resources and therefore it should not flow through to the customers. Our preference would be that domestic production of gas should be exempt from the PRRT. ...there are other options available.[87]

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85 Senator Mathias Cormann, Chair, Senate Select Committee on the Scrutiny of New Taxes and Mr Eric, Streitberg, Executive Director, Buru Energy, *Committee Hansard*, 8 November 2010, p. 113.

86 The DomGas Alliance was formed in 2006 in response to serious gas supply shortages in Western Australia. Members include: Alcoa of Australia, Alinta, Burrup Fertilisers; Dampier Bunbury Pipeline, ERM Power/NewGen Power, Fortescue Metals Group, Horizon Power, Newmont Australia, Synergy, Verve Energy and Windimurra Vanadium. Source: DomGas Alliance, *Submission 6*, p. 9.

87 Mr Anthony Petersen, Chairman DomGas Alliance, *Committee Hansard*, 8 November 2010, p. 33.

4.95 There is a concern that the extension of the PRRT to onshore gas has not been fully thought through, that its extension has been based on a simplistic understanding of the operation of the offshore model, yet, in comparison to offshore gas, onshore supplies are smaller and much more costly to extract.[88]

> As you are aware, the onshore oil and gas business has been subject to the royalty regime and then, to our astonishment, we were told that we were going to be pulled in under the PRRT regime. That raises a significant number of issues for us. It is both in relation to what the tax burden might happen to be and also the fact that we are trying to force a tax that was designed for the offshore into the onshore where the structure of the industry is quite different, and that raises all sorts of issues for us...apart from the other coal seam gas producers on the East Coast, the rest of the onshore industry is relatively small.[89]

4.96 Stakeholders who will be affected by the extension of the PRRT to onshore oil and gas have identified that the changes will raise significant issues. They have identified particular concerns with the administration of the PRRT, and how it might interact with royalties.

> The revenue from the application of PRRT to the small onshore explorers is likely to be very small but it will bring a compliance burden that is extremely difficult for us. It is a complex tax. Nobody really understands it very well. It is not administered particularly effectively by the ATO [Australian Taxation Office]. We have a very small number of people in the company, as do most small companies, and the compliance burden is going to be very onerous for us.[90]

> ...it is an extraordinary administrative burden. We do not really understand how it all works because there is only a handful of companies that pay PRRT at the moment—the Chevrons, the Woodsides et cetera—and most of the PRRT expertise is actually inside those companies, so it is very difficult to find it, even amongst the consultants. We have had to make a lot of assumptions about how all this stuff will work.[91]

The PTG's findings in respect of PRRT

4.97 The concerns raised by stakeholders who would be affected by the extension of the PRRT to onshore oil and gas were, however, recognised by the PTG. As a result, although the PTG's limited terms of reference restricted it from making recommendations, it did acknowledge there were problems in the proposed design of

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88 Mr Anthony Petersen, Cahir Domgas Alliance, *Committee Hansard*, 8 November 2010, p. 33.

89 Mr Eric Streitberg, Executive Director, Buru Energy Limited*, Committee Hansard*, 8 November 2010, p. 110.

90 Mr Eric Streitberg, Executive Director, Buru Energy Limited *Committee Hansard*, 8 November 2010, p. 110.

91 Mr Eric Streitberg, Executive Director, Buru Energy Limited*, Committee Hansard*, 8 November 2010, p. 112.

the expanded PRRT and suggested that the government consider improving the design of the tax:

> The PTG's terms of reference are limited to providing advice to Government on the extension of the PRRT. There is no PRRT equivalent of the MRRT Heads of Agreement that outline design features of the transition so the PTG has looked to the principles already in place in the PRRT... While it is not within the PTG's terms of reference to make recommendations on these matters, in several instances, the PTG considers there is merit in improving the design of the PRRT as part of its extension to transitioning petroleum projects. This could include modernising the PRRT Act and aligning it with the tax code.[92]

4.98 Whilst appearing before the committee, Alliance members drew the attention of the committee to what they consider to be an inconsistency between the government's decision to extend the PRRT to onshore gas, and actions taken by government in Western Australia to provide incentives to domestic gas suppliers to encourage supply to the domestic market:

> ...in Western Australia, where we face a shortfall for domestic gas in the coming years. We also recognise that the government here in Western Australia has relaxed royalties on tight gas from 10 per cent to five per cent to encourage this investment in tight gas exploration and development, and we would ask that the committee make sure that there is no contrary effect by the PRRT on these royalties to incentivise domestic gas production.[93]

Committee comment

4.99 The committee is concerned that with the MRRT and expanded PRRT the government has not put forward genuine and well thought out tax reform proposals, but rather went for a quick and opportunistic grab for additional cash.

4.100 The MRRT and expanded PRRT are top-up taxes which will increase complexity and increase distortions in the market.

4.101 When it comes to the treatment of royalties, the MRRT, structured as a top-up tax, was always going to expose either the mining companies or the Commonwealth Government's budget bottom line to additional risks. Either the mining companies liable to pay the new tax would still face ongoing exposure to state and territory royalty increases; or the Commonwealth Government had to carry the risk to its budget bottom line that state and territory governments may increase their royalties on iron ore and coal production in the future.

4.102 As it turned out, the three big mining companies had enough leverage over a government facing a difficult election and exhausted from two months of intense

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92 Policy Transition Group, *Report to the Australian Government – New Resource Taxation Arrangements*, December 2010, p. 89.

93 Mr Anthony Petersen, Chair, Domgas Alliance, *Committee Hansard*, 8 November 2010, p. 33.

public fighting over the RSPT. They obtained a commitment that all state and territory royalties would be creditable against any MRRT liability.

4.103 The recent decision by the Western Australian Government to remove a royalty concession on iron ore fines is the first practical consequence of the Commonwealth Government's failure to think through the implications of the mining tax for royalty and GST sharing arrangements. The Western Australian Government's decision to remove that concession has already blown a $2 billion hole in the federal budget over the current forward estimates. Other states could make similar decisions about royalty arrangements in their jurisdictions and there is nothing the Commonwealth could do about it. Every time a State government decides to increase its royalties, federal revenue from the mining tax would be reduced. Yes, there would be implications for GST sharing arrangements; but all that would do is share more GST revenue across all states and territories, not return any of the additional revenue to the Commonwealth.

4.104 The committee considers that the government has only got itself to blame for this outcome. The promise in the mining tax deal to credit 'all state and territory royalties' was always going to expose the federal budget to this risk.

4.105 The committee is at a loss to understand how the federal government ever thought they could 'reform' resources taxation and royalty arrangements without actively engaging the states and ultimately reaching agreement with them. The government knew they needed to negotiate with the states, as the Henry Tax Review had recommended it. It seems they never even tried.

4.106 Yet when the Prime Minister and the Treasurer signed the mining tax deal, they went ahead and committed the Commonwealth to crediting all state and territory royalties against any national mining tax liability. That was always going to expose the federal budget bottom line to future royalty increases in any state or territory.

4.107 The Commonwealth Government ought to have known that under our Constitution, changes to royalty rates are the exclusive prerogative and responsibility of the states.

4.108 The committee is not surprised the government failed to deliver on its stated commitment to a simpler and fairer tax system given the inadequacies of its policy development process. The evidence received by the committee is clear – distortions of investment and production decisions under the MRRT would be worse than under the status quo. That is the conclusion not only of mining industry stakeholders, but also of two economists who appeared before our inquiry having previously signed a statement in support of resource rent taxes. The proposed new tax is not competitively neutral and it would have a disproportionate impact on resource rich states like Western Australia, Queensland, New South Wales and the Northern Territory.

4.109 When the Henry Tax review was commissioned it was supposed to be root and branch reform to deliver a simpler and fairer tax system. The government has failed spectacularly to deliver on that objective.

4.110 The government's decision to pick up the Henry Tax Review recommendation to introduce a resource rent tax, change it, pursue it in isolation of everything else and without consultation, was never going to work. The government chose not to engage in the more difficult and challenging processes, such as negotiating with the mining industry as a whole or engaging with the states and territories, reaching agreement on necessary related changes to federal-state financial relations. The policy and political mining tax mess the government is faced with today is the inevitable conclusion of the government's mismanagement of the issue and a deeply flawed process.

4.111 In summary, the MRRT and expanded PRRT would impose more economic distortions than the existing royalty arrangements. The MRRT is imposed on a narrow base which penalises some resource sectors (iron ore and coal). Negotiations were rushed which led to an ambiguous agreement and degenerated into a semantic argument over the definition of 'all'. Moreover, these new taxes would impose substantial compliance costs even on sectors which may not necessarily have a large liability (such as the onshore gas and petroleum sector). Overall, the government's response to the Henry Tax Review has exposed the Commonwealth Budget to a higher degree of risk. The government has proposed various associated measures which will become increasingly costly over time to be funded by a tax which could be dramatically impacted at any time by increases in royalties by state governments. These deficiencies completely refute the government's argument their proposed changes create a more efficient tax system.

4.112 In the committee's view the design of the MRRT and expanded PRRT is irretrievably broken. Any attempt to 'fix' the defects in these taxes would sucker a government into a series of quid-pro-quos with affected companies which could never be the foundation of enduring taxation reform. Instead, the government should scrap its first but failed attempt to respond to the Henry Tax Review and start again.

Recommendation 6

4.113 The committee again recommends that because the government's proposed MRRT and expanded PRRT would impose more economic distortions than existing royalty regimes, the Parliament not support any plans by government to pass legislation to give effect to these proposed new taxes.