Chapter Four

Tax Reform
The Resource Super Profits Tax and how not to do it

Keith De Lacy

What is reform?

Tax reform should always be guided by fundamental principles – it should be efficient to administer and, even more importantly, it should promote economic efficiency. Efficiency is almost always enhanced by reducing complexity and broadening the base.

The Resource Super Profits Tax (RSPT) did not get much of a look in on these principles; in fact, it was way down the other end of the corridor.

The trouble these days is that it does not seem possible simply to change a tax, or introduce a new tax, without claiming reform. Every tax grab becomes a tax reform. Not only that, it is usually dressed up by the PR team as if they were selling TVs, like selling a 42 inch HD PLASMA Vivo TV!

So we have the Resource Super Profits Tax (RSPT) instead of a Resources Rent Tax! or a Carbon Pollution Reduction Scheme (CPRS) instead of an Emissions Trading Scheme (ETS).

It is more about marketing than economic efficiency. It has been said that the Government spent more time with focus groups on how to sell the RSPT than they did consulting with the resources industry on its design and impact!

Incidentally, the sexy, new, focus-group inspired RSPT label backfired – the miners dropped the Profit part and referred to it more accurately as the Resources Super Tax, and all the retirees of Australia thought the Government was taxing their Super!

The CPRS branding could not have worked too well either because it has been likewise relegated to the scrap heap of history. There seems to be two morals here:

- Focus group wisdom does not equal policy; and
- The Australian people may not be quite as dumb as some believe.

The tax system is often used to pursue social and other so-called reforms, like greater fairness, or changing certain behaviours (that is, curbing alcohol consumption), and so on. However, in these cases, it should **never** be labelled tax reform, because it will inevitably offend against those principles of efficiency I outlined above. Whether it should be labelled social reform is problematical, too, because it will nearly always generate outcomes completely opposite to the intention, but that is another story.

The Resource Super Profits Tax (RSPT)

Ross Garnaut described the RSPT as an "elegant" tax –one was not sure if he was praising it or damning with faint praise, though he was one of the few who understood it because he was deeply involved with the PRRT introduced by the Hawke Government. I did note that Brian Toohey, in the *Financial Review* of 2 July 2010, wrote: "Whenever someone praises an economic theory for its elegance, reach for your shotgun". He claims aesthetics has no place in economics.

I am inclined to say the same thing, that is, reach for the shotgun when proponents claim a new tax will improve fairness, because it almost certainly means it is about redistributing wealth rather than creating it.

Twiggy Forrest from Fortescue Metals labelled it, more bluntly, a 40 per cent nationalisation, which was probably closer to the mark. You see, Ken Henry's "elegant" tax proposed to underwrite 40 per cent of the expenses and take 40 per cent of the profits, something like taking on a joint venture partner. This is what motivated him to muse, under questioning at a Senate committee hearing, that if it was 50 per cent it would make no difference to investment, or even at 70 or 80 per cent!

In order to retain its elegance, or its purity, he proposed, because the Government had not actually contributed its 40 per cent share of capital, to allow the company a return equal to the Long Term Bond Rate (LTBR) before the profits were distributed 60:40. Could you be fairer than that?

Well, yes, you could be.

- You see, they (that is, the Government) were proposing to come in free, that is, effectively appropriate 40 per cent of mature businesses, where in most cases all the risk had been removed – no losses to underwrite there.
- Then the use of the LTBR (approx 5.7 per cent) to determine the so-called allowable profit, which was to compensate the company for investing all the capital. So an allowable profit of 5.7 per cent, and everything above deemed a super profit, to be taxed at 40 per cent. Please, Dr Henry, 5.7 per cent, in a high risk game like resources, the boom and bust industry since time immemorial! No wonder Messrs Swan and Rudd had so much trouble selling it.
- But it was worse than this. This allowable profit was calculated on the written down capital (referred to as the RSPT capital account), not the market value, and in many mature mines this, the capital account, was almost negligible (I will come to Macarthur Coal as an example in a moment); and, finally,
- In calculating the actual super profits tax many expenses which most people would classify as normal, that is, acquisition costs, or interest, or head office expenses, were not allowable deductions. So it ended up a tax on much more than what we know as net profit.

I remember saying, at the time, that if you were not confused by it, then you did not understand it!

RSPT impact on Macarthur Coal

Let me outline the impact it would have had on Macarthur Coal – and I can do this now as it is just empty theorising on what might have been. At this point, let me raise an important relevant point. Have you any idea how difficult it is for a listed public company to wage these battles against a proposed new tax, to spell out the implications?

There are two issues.

- Firstly, disclosure obligations. It is very difficult to talk about potential impacts on your company without being required to release detailed calculations to the ASX; and
- Secondly, if it is potentially very negative, you are talking down your own share price, and no company wants to do that deliberately and, perhaps, needlessly.

At Macarthur Coal our effective rate of taxation this year under the old system is estimated at 42.93 per cent (company tax plus State royalties). This is why we (and miners generally) bridle at the implication we are not paying a fair tax. An effective rate of tax of 43 per cent is among the highest in the world.

We did an exercise as though the RSPT had commenced in 2009-10. In this financial year, its second year of operation, we estimated it would have increased our total tax paid by $67 million, to 59.83 per cent (company tax plus RSPT, after refund of State royalties) – in round terms, an increase in effective tax from 43 per cent to 60 per cent.

You judge whether a 60 per cent tax rate is internationally competitive, or whether it makes a material retrospective impact on the parameters that applied when the decision to invest was made? This is why the issue of sovereign risk raised its ugly head.

Another point: our written-down capital base (capital account) as of 2 May 2010 was $195 million. This was the number on which we were allowed the LTBR, that is, 5.7 per cent of $195 million = $11 million. Well, thank you, Dr Henry. We had a market cap of $3 billion, but our shareholders were allowed a return of $11 million, or just 0.3 per cent, before the super tax applied.

In fact, only a few months earlier, Peabody had made a takeover bid for Macarthur Coal which valued us at a little more than $4 billion. Imagine if they had been successful? Dr Henry was going to allow them a return of $11 million on their $4 billion investment before declaring everything else a super profit and slugging it 40 per cent, to be followed by a 30 per cent company tax.

An elegant tax indeed! I also said at the time that it was a tax that could only have been devised by Canberra public servants who had never had dirt under their finger nails, and could only be accepted by politicians who had never been out in the real world!

It was based on the so-called Brown tax, devised by a Mr Cary Brown in the US in 1948. Yes, 1948, when, I think, it is fair to say socialism did look a viable alternative to many people after the horrors of the Depression and the Second World War. And what a wonderful pedigree it had, 62 years old and never had a child, anywhere in the world!

And what a wonderful gift to Australia in 2010! Especially the timing, with the world teetering precariously on the precipice of a double dip recession, and only the resources sector standing between us and Armageddon! Why not tax it into Armageddon!

Let me return to the proposed commitment to underwrite 40 per cent of expenses, and why this was scoffed at by the industry:

- It was not bankable.
- The industry is prepared to bear its own risk; it does not want a silent partner.
- On established projects, the owners had already borne the risk; and, finally,
- The Government was not going to pay 40 per cent of expenses anyway, just underwrite them, by definition when the company went broke. Can you imagine during the next big recession, with falling commodity prices, tax receipts down and welfare payments up, and the Government paying 40 per cent of accrued expenses so that all these companies could shut up shop and sack their workers! Splendid optics, splendid politics, about as sustainable as Kevin Rudd's approval ratings were!

There must be parts of Australia where it is still legal to smoke dope!

Mineral Resource Rent Tax (MRRT)

And, now, the Mineral Resource Rent Tax. The tax rate has been effectively reduced to 22.5 per cent (well, not literally, it is notionally 30 per cent because this does not sound like such a cave-in, but actually reduced by a strange beast called an extraction allowance, to net it out at 22.5 per cent).

So we have a situation where the tax rate is almost halved, there is a substantially more generous uplift rate (LTBR + 7 per cent), there is an option to use full market value for depreciation purposes, and a dramatically reduced line-up of victims (from 2,500 to 320).

A convincing win for the miners but, surely, a revenue debacle.

But, no, the Treasurer has found the magic pudding! He releases advice that the two-year forward

estimates for the revenue from the tax would only be reduced from $12 billion to 10.5 billion, or just 12.5 per cent.

But not everyone believes in miracles. Under pressure he was forced to admit that the Treasury was using a new set of upgraded commodity price forecasts.

Oh, I see. If you used those assumptions in your original estimates, what would be the impact of the RSPT?

Well, if you insist on indulging in these hypotheticals, $24 billion in the first two years – this, instead of the original $12 billion, and do not forget the first two years are still the ramp-up years.

Wow! So you were really proposing to appropriate something like an additional $20 billion a year from Australian miners, and you variously labelled them bullies, and greedy, and fundamentally dishonest, for not rolling over and saying thank you?

Back to Macarthur Coal. Our calculations on the incomplete information before us indicate that the MRRT will increase our effective rate of tax by one or two per cent, to 44 or 45 per cent at today's price of coal – still high by international standards, but a far cry from 60 per cent under the RSPT – hence the wry silence from the hitherto vocal miners (with a few exceptions) as the Treasurer and the Treasury descended into a paroxysm of spin and fiddle over the forward estimates!

Mind you, I have to say it does not bode well for our country when we measure the acceptability of a tax on the basis that it does less damage than the one it replaced!

In the Queensland coal industry we pay State royalties based on the value of sales, and a progressive one at that. It is 7 per cent on the first $100 per tonne, and 10 per cent after that. And, as it turns out, there is not very much difference between this percentage of total value of sales, and 22.5 per cent of profits (depending on what shenanigans the Treasury and the Australian Taxation Office get up to when they start re-defining profits). In fact, if we used the long term forecasts for coal prices, State royalties would be greater than the MRRT, that is, the Federal Government could be notionally rebating more than it was collecting.

The Economics of Taxation

I know there are some people – Bob Brown comes to mind – who think that there is no limit to the level of taxes you can levy (on someone else, that is!). But even 5th grade economics would teach you that you reach a point where:

- it becomes internationally uncompetitive; and/or
- it encourages self-defeating and, very often, irrational behaviour.

These same big tax proponents say a resource like coal or iron ore is not internationally mobile. True, but the investment capital certainly is!

And, when you do it retrospectively, you increase sovereign risk – not a good idea in a capital importing country such as Australia. In this respect, I noted recently a survey of more than 400 mining executives around the world by the Fraser Institute in Canada. The survey showed Australia's reputation as an investment destination falling on average from 18th to 31st of 51 jurisdictions.

This survey was completed before the compromise that was the MRRT, but I am not sure this matters much. There is still the global perception of a new tax. And, sad to say, sovereign risk is exactly that, sovereign risk; it does not confine itself to resources.

There has been a suggestion that the industry had asked for a profits-based royalty tax. I doubt this is the case. They simply saw the writing on the wall. Be that as it may, I personally have some serious reservations about a profits-based royalty, because it is not possible to distinguish rents from efficient management. Every time you save a quid you pay a quid as it were.

To a certain extent it encourages the exploitation of more marginal projects at the expense of more efficient ones.

The Accounting Miasma

At the outset I said tax reform should be guided by the principles of simplicity and efficiency. Yet tax changes always seem to add another layer of complexity. In this regard the RSPT was a doozy, and the MRRT no better.

We may now have to prepare a new set of **MRRT accounts**, which will be very complex, with a new set of valuations, expense and depreciation issues to be addressed, probably also independent expert valuations. This on top of our **statutory accounts** based on international accounting standards, **taxation accounts** which have a whole range of different schedules to statutory accounts. Then there are **royalty accounts** because we still pay State royalties even though they will be refunded, and our own **management accounts** so that we can understand what the hell is going on.

Federal Treasury – the Sad Victim

One of the greatest tragedies in this whole fiasco is the immense damage it has done to the credibility of the Federal Treasury. The most common pejoratives abounding in the Board rooms of Australia are that they are naive and ideological, or that they have found God or, more simply, that they have lost the plot.

Which is not altogether fair, because there is much in the Henry review which is very worthy – although you would not know this because of the RSPT fiasco.

This credibility hit was probably inevitable because the whole tax reform process was set up to fail in the first place. As the architect of the review, Ken Henry became its chief advocate, seriously compromising his and the Treasury's independence. Who was left to provide the independent advice – apart from the enlightened adolescents in ministerial offices?

Is it any wonder that Treasurer Wayne Swan was reduced to quoting from an unpublished Californian undergraduate paper to support his fantasy that Australian miners were only paying 17 per cent tax, or that the MRRT revenue assumptions were conveniently based on a different set of resource price assumptions to that of the RSPT two months earlier?

It is all very sad.

System-wide Tax Review – Some Rules

Let me give you some simple, home-spun KDL rules for wide-ranging tax reform:

- Keep it independent. Then the Treasury can fulfil its time honoured role of providing independent advice to Government, to do all the necessary independent checking and modelling and scoping, and so on.
- Do it in the good times. There will always be winners and losers and it is easier to accommodate the losers when you are flush with revenue.
- Do not do it in an election year!
- Consult with the real world.
- Stick to the principles of efficiency and simplicity I outlined at the beginning.

Intergenerational Equity

Apart from the class war rhetoric embodied in the phrase, *a fairer share for all Australians*, there was, and there still remains, a more plausible argument that we are exploiting our non-renewable resources at the expense of future generations.

But, if you accept this argument, you must equally accept that all of the resource rental revenue must go into a sovereign wealth fund the capital component of which is inviolable. You do not do

anything for intergenerational equity by imposing a resource rent tax and then, if you will pardon the French, pissing it up against the wall.

Which is what we have been doing:

- The States with their royalties since time immemorial.
- The Howard Government, with its middle class welfare using revenue from the mining boom – you know, the family tax benefits, baby bonuses, health insurance rebates . . . The splendid irony in all this was that Kevin Rudd accused Howard of splurging the $360 billion of extra revenue generated by the resources boom. He was right.
- But Rudd never took his own advice. He doubled the tax but never scheduled any of it for a wealth fund – it was to pay back the deficit, more middle class welfare . . .

Which brings me to my final point but one, albeit a bit irreverent.

Why do governments always think that they can spend taxpayers' money better, or more productively, than taxpayers can – you know the attitude embedded in the tabloid phrase, *a fairer share for all Australians*? If a mining company increases profit we either invest it in new capacity or return it to shareholders in the form of dividends. Can you spend it better than that?

Tom Albanese from Rio, in Brisbane in August 2010, said that over the last five years Rio had Australian earnings of $36 billion but they had invested $37 billion in new capacity.

But we get into the debate about big government, and that is for another time.

The Virtues of Mining

I am proud to be a miner, although it is seen as politically incorrect in the leafy suburbs. I started off life as an underground miner, with a jack hammer and a hand shovel. I am still there, albeit a bit further from the coal face! Or the hand shovel!

- Mining generates enormous primary wealth – the rest of the economy lives off the primary wealth generators.
- Whilst the absolute number of employees is not great, I read an American study which showed for every job generated in mining 11 were created in the rest of the economy.
- We create jobs, commerce and wealth in regional areas – away from the over-crowded cities.
- We pay good wages.
- We, and our employees, pay very large taxes.
- Our exports greatly contribute to funding the nation's current account.
- And, while there is a downside as our exports put upward pressure on the Australian dollar, this is ultimately a measure of our wealth, and standards of living, *vis à vis* the rest of the world.
- Mining is a very sophisticated industry in which Australia has expertise, technologies and equipment which gives us a competitive edge and which we also export to the world.
- And we are good blokes!

The industry is tolerated rather than appreciated. The RSPT saga proved that. But Australians to a person are infinitely better off because of our contribution in so many ways.