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Kevin 7/11 needs to think long term

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ONE of the few empirical regularities in politics is that bad policies often lead to policies that are even worse. The resource super-profits tax is a case in point.

The problems with the proposed tax were glaringly obvious from the start. Its architecture may have been elegant, but the engineering was poor and the plumbing nonexistent.

Faced with the predictable backlash, the government is scrambling to shore up its position. As with the emissions trading scheme, it has resorted to spending promises aimed at creating a constituency with a vested interest in the tax proceeding.

And as with the ETS, those spending promises only make a bad proposal worse.

Consider the Mackay ring road, which the Prime Minister repeatedly dangles as a carrot for voters in north Queensland. This is hardly a new proposal, having been examined in Queensland's transport plan and more recently submitted for funding to Infrastructure Australia. That in each case it failed to make the cut is unsurprising, as its benefits fall far short of its costs. It is therefore also no surprise that the government, in setting investment criteria for the special fund from which this project would be financed, has excluded the requirement for any cost-benefit test.

Using the tax for such projects adds the pure waste associated with unjustified public spending to the economic harm the tax will cause. The distortion, rather than reduced, is squared.

At the same time, ways of making the proposed tax more palatable are being considered. From an efficiency perspective, these look even worse than what is now on offer.

Take the option of shifting to a tax similar to the petroleum resource rent tax. Applied to existing projects, such a tax has all the transition problems associated with the RSPT and then some.

And imposing a resource rent tax on existing projects is no less retrospective and no less likely to increase Australia's sovereign risk than the RSPT. Moreover, at least in theory, the RSPT need not distort investment in new projects. In contrast, a resource rent tax would distort both investment and production. This occurs because of important differences between the two taxes.

In a pure Brown tax (the model for the RSPT), government covers (say) 40 per cent of costs and takes 40 per cent of revenues. This reduces the cash investors get from profitable projects (as the government takes 40 per cent), but does not change investors' rate of return (which is determined by the ratio of revenues to costs and hence stays unchanged as both are reduced by 40 per cent).

Nor does it change the statistical distribution of investors' expected rates of return: if the rate of return on a project will be negative, it will still be negative, while if the project will earn a high rate of return it will still do so. Hence the tax's much touted neutrality.

In contrast, a resource rent tax changes all of these. Although the mechanics are complex, its essence is that the commonwealth takes 40 per cent of profits above a specified rate of return. This means that the profitability of highly profitable projects is reduced, while that of less profitable projects is unchanged. Both the average rate of return and the distribution of rates of return therefore move to lower levels.

From this stem a wide range of inefficiencies.

For example, because the tax cuts in above a threshold rate of return, investment will shift from high-risk to low-risk projects and ways of carrying out projects, a phenomenon known as a distribution distortion. This occurs because investors will prefer a high chance of a low return, taxed at a low rate, to a low chance of a high return, which would be taxed at a high rate.

Additionally, depending on the tax's specifics, it can become profitable to smooth costs and revenues over time, minimising the periods when the allowed rate exceeds the threshold, even if this increases total costs and reduces total revenues. And with more of any productivity gain going in tax payments, management will slacken efforts to cut costs, reducing efficiency. These distortions are likely to be particularly large in mining, with its complex, multistage and incremental paths of investment and extraction.

Tax interaction effects then make matters worse. Because a resource rent tax does not refund costs, less profitable projects would continue to pay royalties, distorting their output decisions at the margin. For more profitable projects, on the other hand, the effects noted above come into play, especially with the combination of resource rent tax, company taxes and royalties leading to high effective marginal tax rates.

These distortions, far from being offset, compound, making the potential economic cost very large indeed. It seems hardly sensible to thus undermine our most important industry. But the government needs revenues and it needs them soon. It needs them because it has increased spending by so much during its first term and wants to continue increasing spending in future. At the same time, it wants to vaunt its fiscal responsibility, and views an early return to budget surplus as essential to its credibility. But it is reckless to introduce a tax with enormous long-term consequences for such short-term objectives. If the government wants to demonstrate fiscal responsibility, let it bring spending under control.

As for reforming minerals taxation, it should write this episode off and start again, properly involving industry and the resource states

This would be a difficult decision for any government. It is especially hard for this one. As I wrote in these pages two years ago, the hallmark of this government is impetuous action combined with an angry obstinacy in pursuing that action when problems emerge. This, I suggested, is a recipe for policies that yields diminishing and then negative returns, as sheer exasperation, combined with a presidential style of decision-making, impedes careful consideration of options and consequences. No matter how worthy the ambition, the result could only be ultimate disappointment, with much unnecessary grief along the way. As that happened, Kevin 24/7 ran every risk of fading into Kevin 7/11. That assessment still stands. But the stakes are now very high. Getting this wrong could undermine prosperity for years to come. A statesman, Bismarck famously observed, is a politician who thinks of his grandchildren. Whether Kevin Rudd meets that test is what now needs to be seen.