And Nonsense from Penny Wong Too

Interviewed on last night's 7:30 Report, Penny Wong repeated the claim that because there are some free permits, the initial carbon price is not as high as it seems. This is complete nonsense – as with any tax, what counts in terms of its economic effects is the tax rate at the margin. At $23 per tonne, an Australian firm, operating in a trade-exposed, carbon intensive sector and contemplating an increase in production will still face a carbon price more than twice that in Europe and ten to twenty times that in our resource competitors.

Indeed, it was on that basis that both the Garnaut report and Treasury argued that even with free permits, the incentives to reduce emissions would remain – and in trade-exposed, carbon intensive industries, that will happen largely by reducing output below the levels it would otherwise have reached.

Wong's misleading statements did not end there. She repeated the canard that the MRRT, as a profits based tax, is more efficient than royalties. Even the Henry Report, which was based on 1960s economics, made a weaker claim: that royalties are more distorting than a pure Brown tax (i.e. a cash flow tax). But of course such pure Brown taxes are not of this world – there isn't a single one in place globally. And real-world profits taxes, such as the MRRT, can be far more distorting than a royalty.

This is for the simple reason that a royalty is typically a fixed amount per tonne: so the miner still has a strong incentive to reduce costs. That cost reduction provides a gain for society on the whole of the output it affects: in economists' terms, a rectangle. At the same time, of course, the royalty may reduce output at the margin – for instance, it may lead to the early shut down of barely profitable mines. But precisely because those mines are barely profitable, the social loss from that shut down is small.

In contrast, a profits-based tax such as the MRRT weakens the incentives for cost reduction, which causes a welfare loss on all output produced. In fact, that incentive is especially strong in the MRRT, as it treats downstream assets (such as rail and ports) as if they were a regulated utility, providing services to the upstream asset, i.e. the mine. This means each $1 increase in the costs of the downstream assets is partially offset by a reduced MRRT liability (as MRRT is levied on upstream net revenue).

However, in theory at least, the virtue in such a tax is that it need not distort incentives at the margin, so avoiding the loss caused by royalties. In other words, because marginal mines would earn no profits, they wouldn't pay MRRT and hence would not be induced to shut down earlier than they otherwise might.

But the MRRT doesn't even have those virtues. Rather, it is deeply distorting, for two reasons.

First, because it taxes all profits above a threshold rate of return, it involves a high effective tax rate on risky projects, which require a high return to offset their high risk: so the MRRT discourages risk taking and the development of the next generation of Australian mines. In that way, it distorts at the extensive margin, i.e. the margin of new project and resource development.

Second, the MRRT does not replace royalties – it merely allows those mines that are liable for MRRT to credit them against the tax that is payable. As a result, smaller, riskier projects are hit twice: by the high effective tax rate on risky projects built into the MRRT (as that affects their cost of capital); and by royalties. So the royalty distortion at the margin remains, while a new, inframarginal distortion (i.e. a distortion on what output is produced) is introduced. The effect of the MRRT is therefore to make the taxation of our mining even less efficient. How Penny Wong can say otherwise with a straight face is beyond me.

As for Penny Wong's claim that these issues will be dealt with in the GST review, that makes no sense. The GST review is limited to making recommendations on the carve-up of the GST; it has no coverage of Commonwealth-State tax relations, which are at the heart of reforming minerals taxation. Dealing with those would require sitting down with the states and discussing these issues in good faith. That is something Wayne Swan has shown himself incapable of doing. No surprise then that we are in such a mess.