The Australian

Going retro with cash grab

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WHEN our iron ore reserves were opened to development in 1961, Japan exported T-shirts and 30 million Chinese were being killed in Mao's Great Leap Forward. Yet entrepreneurs risked billions of dollars turning the Pilbara into a mining powerhouse, for very uncertain returns. Now the government wants to tax those returns more heavily by applying its resource super profits tax to existing mining projects.

Retrospective taxation (tax changes that seize part of the value of sunk assets) is rare, for good reason. Everyone gains if investors in long-term projects can count on tax stability.

That's why existing assets are so often grandfathered from changes that would substantially reduce their value. No such grandfathering is proposed for the new tax. Why? Because existing projects are where the money is. And being sunk, the investments can't flee the country.

The government, on the other hand, claims there are compelling public interest reasons for applying the tax to existing projects. These projects, it says, make so-called super profits; will benefit from lower royalties; and exempting them would be distorting. These arguments are unconvincing.

Start with the claimed super profits. Mines' lives often exceed 30 years. Their infrastructure (such as ports and rail links) lasts centuries. Much of the capital must be invested up-front. The uncertainties are as great as the time frames are long.

Given that, what is striking is just how low long-term rates of return have been. Since 1987, the nominal before-tax rate of return on capital in the mining sector has averaged 12.5 per cent, close to (or even below) the risk-adjusted cost of capital.

Why are returns so low? As the Oxford economist Herbert Frankel pointed out years ago, miners compete to find profitable projects and will incur costs up to the point where the game is no longer worth the candle. As a result, taking account of failures and successes, mining earns just enough in the long run to cover costs.

The high pay-offs to current projects are therefore not so-called super profits. Rather, given that there are also long periods of low prices, they are the mechanism by which large, risky, outlays can earn a normal return in the long run. Forcing returns on sunk assets below the levels that investors could normally expect in is neither fair nor efficient. All it does is discourage future investment. Treasury knows that. But its claim is that the tax won't have that effect.

This would be true if the tax matched the pure theory. In the theoretically pure tax, government takes 40 per cent of future returns but pays out 40 per cent of all past costs, leaving rates of return unchanged.

But even the galahs on Lake Burley Griffin now know that no such tax is on offer. Rather, miners are being asked to give up a high share of revenue while receiving little (and uncertain) compensation for costs. The government claims existing projects will nonetheless benefit as royalties, at present levels, can be offset against the new tax.

The theory is that royalties are an inefficient tax and reduce output. Replacing them with the new tax will make the community better off, as existing projects expand output.

This is fine in theory, but it is of little practical relevance. If the ships queued at our bulk export ports show one thing, it is that it is not royalties that are holding back production. At current prices, miners are extracting every bit they can.

But even if royalties do reduce output, the distortion is easy to remedy: structure the new tax so that it simply replaces current royalties, leaving the total tax take unchanged. That would secure the efficiency gain while not depriving investors in existing projects of returns they can legitimately expect.

In fact, payments under the proposed tax greatly exceed the present royalty take. Any efficiency gains from reducing royalties must therefore be balanced against the chilling effect on future investment of a retrospective tax grab. Calculating that balance is simple. Any expansion from removing royalties will be small and involve output that is marginal, that is, barely covers its costs. So those gains have little social value. In contrast, greater risk could increase the cost of all future projects. A smidgin of the latter will always swamp even liberal lashings of the former.

To make matters worse, the new tax encourages states to increase royalties. This follows logically if one accepts that royalties reduce production. As with other taxes, the extent of any such reduction will increase more than proportionately with the tax rate (so going from 0 to 2 per cent has a less distorting effect than going from 2 per cent to 4 per cent). But when the commonwealth absorbs existing royalties, it resets effective royalty rates to zero. From such a zero base, a state can increase royalties without causing anywhere near as much reduction in output as would have otherwise occurred.

The commonwealth's options for trying to prevent this are all fraught with difficulties. The new tax therefore increases the risk of compounding tax inefficiencies. The possible outcome: distortions both from chilling investment and from higher royalties.

Finally, what of the Treasurer's statement that exempting existing projects would distort investment between existing and prospective projects? If you accept the government's claims about the tax, this cannot be correct. After all, Ken Henry has said repeatedly that the proposed tax would not affect investment incentives. This is because it supposedly reduces miners' revenues and costs by the same proportion, leaving all rates of return unchanged. If that is right, setting it at zero on existing projects and at 40 per cent on new ones could not favour existing projects over prospective ones.

Exempting existing projects would not address the problems with the tax. But it would avoid what even supporters of the tax have called its expropriation of income from existing investments. As for those who entered into new projects, they would be consenting adults.

Mining taxation does need fixing. But there are far better ways to do it. The best would be as part of a comprehensive redesign of our collapsing fiscal federalism. Now that would be real, hard, reform. But it would take time. The pay-offs would be long term. And it would not raise huge revenues in the short run. This tax will. Need one say more?
