Rudd's great big mining myth

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The proposed Resource Super Profits Tax is generating considerable interest and debate. I wrote an article which was published in The Australianon 25 May, despite being somewhat reluctant to become involved in the debate, having retired some time ago from corporate life. However, I was motivated to write the article because of my concern that the consequence of implementing the new tax, as currently proposed, could lead to a change in the way external investors and lenders view Australia in relation to sovereign risk. Australia has enjoyed a very good reputation over many decades. Any downgrading from this strong position will have consequences, not just for the mining industry, but for the Australian community generally.

Where sovereign risk is perceived to be an issue, two consequences follow. Capital becomes more difficult to obtain to fund activities in the nation generally, and it becomes more expensive, including for the funding of budget deficits, because the perception of sovereign risk gets priced into financial transactions. It is this factor that mostly concerns me because of its implications for the community over a lengthy period into the future.

Collecting a higher level of taxation from the mining industry for government to disburse for other worthwhile purposes may be perceived as a positive contribution to the Catholic principle of the 'common good'. However, if a badly designed and executed change results in much reduced government revenue in the future and a higher cost of funds that Australia, as a capital importing country, requires, then the contribution to the common good is negatively affected. Such an outcome would impact on the whole community, because borrowing will be more expensive.

Governments have the power to change regulations, including taxation, and to trade off future investment and jobs for a larger tax take in the shorter term. But the consequences need to be understood and appreciated, and the community needs to be fully informed about them.

There are flaws in the currently proposed model that will have unnecessary adverse impacts on future activity in the mining and associated industries. While markets remain strong, current mines would continue to operate under the proposed new tax arrangements because the capital is already sunk. But future capital expenditure will be constrained because only very rich ore bodies will be viable with an effective tax rate of 57 per cent, and only if funding, which depends on the confidence of lenders, can be raised for such projects. Also, exploration expenditure will fall, further restraining future investment growth.

The Government's model is a theoretical approach that does not stand up to scrutiny in the real world. It is based on the so called 'Brown Tax' concept developed in 1948 in the USA, but never implemented.

Essentially, the Brown model proposes that governments share in the natural resources of the nation by taking a 40 per cent joint venture interest in every mining development. Government would contribute 40 per cent of the capital required for development and construction, receive 40 per cent of profits and bear 40 per cent of losses. This arrangement would not affect the return on capital to the mining company on its 60 per cent investment, but merely reduces the size of the investment available to it from 100 per cent to 60 per cent.

The model proposed by the Australian Government is that the Government would take 40 per cent of profits over the bond rate and underwrite losses to the extent of 40 per cent, if these are incurred subsequently. This is perceived as sharing the losses as in the Brown Tax but there is a fundamental difference between the two proposals. Under the current Government proposal, the mining company has to find the funding for 100 per cent of the project versus the 60 per cent envisaged by Brown.

There is another crucial difference between the view adopted by the Government and its advisors, and the value of this arrangement to the industry. The Government's theoretical approach is that its underwriting of future losses is equivalent to the Brown sharing in the risks associated with the investment. They clearly felt that this would be regarded favourably by smaller operators and make it easier for them to raise funds.

But the companies live in the real world and realise that, in fact, the opposite is true. The potential partial underwriting of losses would not come into the calculation of return on investment, nor in the assessment of economic viability by financial institutions, but the tax rate of 57 per cent would, and it would make it that much more difficult for all companies, but small companies in particular, to raise funds for development.

So what is apparently seen as a positive by the Government is not regarded as such by the companies. Thus, it would seem to be sensible, and in everybody's interest, to eliminate this complicated element from the proposal.

It would also, in the event of a downturn in the economy leading to losses in the mining industry, eliminate the possibility of the Government facing the unpalatable prospect of having to make substantial payments to mining companies at a time of belt tightening in the rest of the economy, with pressure already on government revenues at the same time. Another flaw in the model is the claim that the level of future investment would be insensitive to the RSPT, irrespective of the rate at which the tax was imposed. It was astonishing that this should be an outcome of the modelling, until KPMG Econtech, the consultants engaged by Treasury to do the modelling, explained that they were instructed by Treasury to make this assumption and include it in the model.

Currently mining companies generally pay royalties to State governments on an ad valorem basis. The proposal is to replace the royalties with a tax based on profits. State governments have favoured royalties based on revenue because there is less volatility than there would be if they are based on profits. In principle, most industry participants would prefer a profit based system, provided the rate was seen to be reasonable, in preference to an ad valorem based system, because it lowers the investment risk. The issue for the Government in such a change is that its revenue would be subject to greater volatility. In economic downturns, it could be receiving less additional tax than it would be disbursing to rebate royalties paid to the States.

An incidental point worth noting, is that members of superannuation funds have a substantial part of their funds invested in the Australian resource industry. While current mining operations will continue, the additional RSPT payable will reduce the capacity of companies to pay dividends. The lower profits and dividends will also negatively impact the market value of these investments, as will the lower growth expectations. It is not only the foreign and local direct investors who will feel these impacts, so will employees who are members of superannuation funds.

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