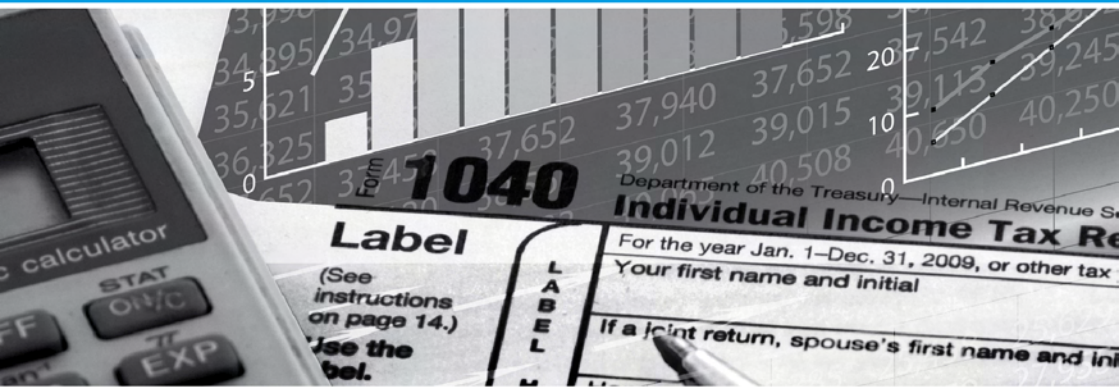


Tax Reform: For Economic Growth or Bigger Government?



Introduction by Robert Carling

Contributors

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Sinclair Davidson

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Introduction

This Policy Forum brings together the papers presented to a public forum on the review of Australia's Future Tax System (known as the Henry review) held by The Centre for Independent Studies in May 2010, shortly after the review report was released by the federal government. My paper takes a broad view of the implications for economic growth, while Sinclair Davidson focuses on one of the most controversial aspects of the Henry review, namely the reform of mining taxation. As the forum was held in May, the papers are based on the mining tax then proposed by the government—the 'resource super profits tax'—rather than the amended version—the 'minerals resource rent tax'—announced in July 2010.

Tax reform and economic growth

In 'Tax Reform and Economic Growth,' I point out that the Henry report recommends major changes to the mix of taxes but not to the overall level. The report does, however, suggest that the overall level of tax should rise in the long term to pay for the rising costs of health care and benefits and services linked to population ageing. While acknowledging that a change in the size and scope of government was outside the review's terms of reference, I argue that rather than laying the foundations for a larger tax burden, tax reform should aim to reduce the overall tax burden and public spending relative to GDP over time. There is much evidence that such a reduction would be beneficial to long-term economic growth. The way governments reform the tax system in response to the Henry recommendations will help determine whether the tax burden becomes heavier or lighter.

The restructuring of the tax system recommended by the Henry review encourages government to rely more heavily on economically efficient taxes and less on inefficient ones. 'Efficiency' in this context

means minimising the disturbance to incentives and economic behaviour from taxation, except when taxes are deliberately designed to compensate for market failure or to support social objectives. The focus on economic efficiency in the Henry report leads to proposals for more tax from consumption, land and resources and less from transactions and capital income. According to modelling undertaken for the review, the pay-off would be a conservatively estimated boost to GDP of 2–3% over a very long period, stemming from higher productivity and labour force participation.

I comment that while the notion of such a pay-off is plausible, it is difficult to quantify and is subject to significant qualifications. The modelling result depends partly on the dubious assumption that the recommended resource rent tax will have no detrimental effect on mining activity and will actually boost it. As discussed by Sinclair Davidson below, this is a difficult assumption to accept. Another qualification is that the modelling results exclude the recommended changes in personal taxation and transfer payments. While some of these could be beneficial, other changes would involve an increase in marginal tax rates on labour income for some people and, disappointingly, no reduction for most.

The review suggests, as indicative of an ideal personal income tax structure, a large increase in the tax-free threshold to \$25,000. This would help reduce the problem of high effective marginal tax rates at low incomes. This is combined, however, with an initial marginal rate of 35% above the tax-free threshold and a marginal rate of 45% at a higher income level. These rates represent an increase in the income range of \$25,000 to \$37,000 and little change at other income levels. Such a scale defies evidence that high marginal rates and graduated (or 'progressive') scales impose high economic costs through their damaging effects on labour supply, investment in human capital, and entrepreneurial activity. The review does at least accept the case for lower effective tax rates on capital income, with a uniform 40% discount on personal capital income (interest, net rent, and capital gains) and a reduction in the company income tax rate to 25%. Actual government policy, while taking small steps in that direction, shows no sign of going that far.

The report recommends sweeping reforms to state taxation. While these are generally welcome from an economic efficiency perspective, another important objective of reform should be to strengthen the fiscal autonomy of the states in order to preserve and strengthen competitive federalism. The Henry report recognises that abolishing a range of state taxes could undermine state autonomy and accountability depending on what is put in their place. It leaves the door open to a state personal income tax fully offset by a cut in the Commonwealth income tax, but does not go as far as recommending it. Unless this idea is taken up at some time in the future, the recommended reforms would strengthen Commonwealth financial power at the expense of the states, further shrinking the states' fiscal autonomy and undermining competitive federalism.

No respect for super-profit taxation

The Henry report recommends replacing state mining royalties with a resource rent tax (RRT). In the government's initial response, this morphed into a resource super profits tax (RSPT) similar to the RRT. Royalties are to remain in place but are to be refunded out of the proceeds of the RSPT up to their pre-existing level. The Henry report claims that the RRT would lead to a more efficient use of resources and a boost to mining activity, thereby contributing to the estimated boost to GDP from the totality of its recommendations. This in turn rests on the claim that the RRT/RSPT is an 'efficient' tax in the sense that it will not distort mining industry investment and operations, whereas royalties are inefficient.

These claims are strongly contested by Sinclair Davidson in 'No Respect for Super Profit Taxation' in this volume. Davidson argues that while the theoretical arguments for a tax on rents are very powerful, the underlying assumptions of such a tax are invalidated in the real world. Thus, the RSPT is not an efficient tax as claimed. The modelling undertaken for the Henry review does not prove the RSPT to be a highly efficient tax with a zero deadweight cost, but merely assumes it to be.

The RSPT is based on the notion of ‘supernormal’ profits or ‘rents,’ which are the excess return over and above a firm’s risk-adjusted cost of capital. Davidson points out that even if rent exists in practice, there are practical problems in measuring them, and what the government is proposing to tax with the RSPT is not rent but normal returns on mining industry investment. This invalidates the claimed neutrality of the RSPT with respect to mining investment and ensures that firms will respond to it in the same way as they do to the company income tax, by attempting to pass it on to customers, employees and shareholders. Part of that response will be a lower level of investment.

Davidson argues that the RSPT fails the neutrality test on a number of grounds. For example, the loss offset mechanism is an integral component of the RSPT and is a key to the claim to neutrality, but neutrality requires that governments can credibly commit to redeeming tax credits for as long as they are generated and remain outstanding. As Davidson points out, no government can credibly make that commitment, and the introduction of the RSPT itself is a case of the government having changed the rules not only for new investments but for past ones as well.

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December 2010

Tax Reform and Economic Growth

Robert Carling

Three themes in tax reform

The final report of Australia's Future Tax System Review (or the Henry report, as it has come to be known), is like the curate's egg—good in parts. Some of its recommendations echo policies advocated by CIS authors over many years. But anything that is good only in parts must also be bad or indifferent in parts, and so it is with this report. I will not attempt to evaluate every aspect of the report but rather comment on three thematic issues that cut across many of the recommendations.

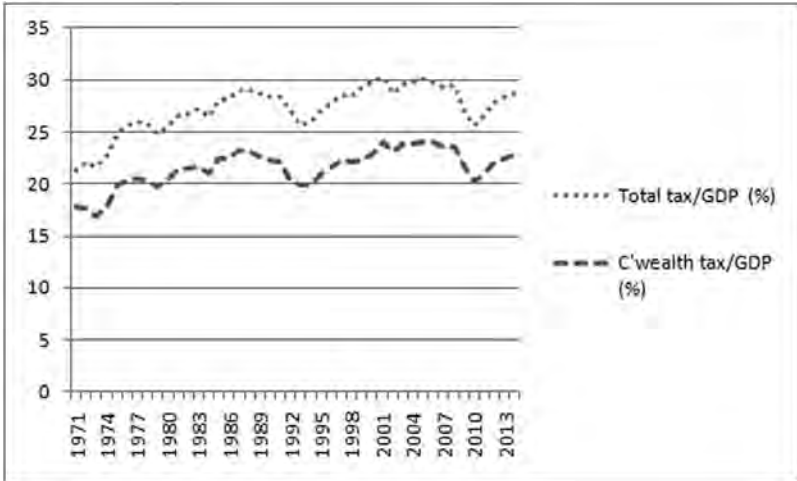
Implications for the overall tax burden and size of government

In all the commentary since the Henry report was released on 2 May 2010, little or no attention has been paid to one basic issue—the level of the overall tax burden. Can Australians look forward to any relief from the overall tax burden as a result of reform?

As recently as 2007–08, the tax burden (expressed as a percentage of GDP) was about as high as it has ever been (see Chart 1). It has since dipped due to the effects of the recession on tax revenue, but that is a temporary shift and it will rise again once the effects of the recession pass.

The 2010 Budget papers show that the Rudd government is relying on an increase in the tax/GDP ratio for precisely one half of the move back to budget balance over the next three years, the other half coming from a reduction in the spending/GDP ratio. Any increase in the Commonwealth tax/GDP ratio is subject to the constraint imposed by the government's commitment to keep that ratio within its 2007–08 level. That may sound like restraint

Chart 1: Tax revenue as a share of GDP (1971–2009 actual; 2010–14 projected).



Source: Commonwealth Budget papers 2010–11, BP1 Statement 10 ABS Cat. No. 5506.0 (Australian Bureau of Statistics, Taxation Revenue Australia).

but to put it in perspective, the 2007–08 level was close to the highest ever.

In the longer term, I doubt that tax reform will lower the overall tax burden or even stop it from rising to new heights. The future tax burden will be whatever governments want it to be or think they can get away with. Commitments to hold the tax/GDP ratio to a particular level tend to have short shelf life. It is significant that the government’s initial responses to the Henry report add up to a net tax increase, dominated by the new resource ‘super profits’ tax.

The full list of recommendations of the Henry report contains a lot of pluses and minuses, but they all add up to no change in the overall tax take. The report hints that the tax burden should rise in the long term to pay for a rising share of government spending in GDP. The *Intergenerational Report* identifies a funding gap of 3% of GDP in 2050, mainly due to rising public expenditure on health and other benefits or services linked to population ageing.

The terms of reference instructed the tax review not to presume a reduction in the size of the general government sector, but it will be regrettable if over time the policy responses to the review do not lead to such a reduction, which would enable a lowering of the tax burden. There is a lot of evidence that government has expanded well beyond the size at which the economic cost of additional tax revenue exceeds the economic and social benefits of additional government spending.

Composition of the tax burden

If the report offers no prospect of a reduction in the overall tax burden, what benefits does it offer? The clue lies in the major restructuring of tax that would result from full implementation of the recommendations. There would be more tax from consumption, land and resources, and less from transactions and capital income (both personal and business). The authors of the report expect a pay-off to this restructuring in the form of higher labour force participation and productivity, leading to higher economic growth, a permanently higher level of GDP, and higher real wages than would be the case without reform.

This approach is a product of contemporary tax theory, which is known as the theory of optimal taxation. This theory leads policymakers to tax in ways that have the least disincentive effects on economic behaviour, subject to two constraints: that equity objectives are achieved and that, in some cases, taxes should deliberately aim to change behaviour to correct market failure or support social objectives. Optimal taxation represents a shift from earlier tax thinking, which was to tax income comprehensively and at uniform rates. Optimal taxation means moving away from taxes that have relatively high economic efficiency costs to ones with low efficiency costs.

A good example of this is the proposal to discount all personal income from savings by 40%, while leaving labour income to be fully taxed at marginal rates. Earlier thinking was that all income should be taxed at the same rates. Another example is the proposed resource rent tax, which is a higher rate of tax on one category of

corporate income and is claimed by its proponents not to produce disincentive effects.

The reshuffling from less efficient to more efficient taxes is estimated to bring an efficiency dividend in the form of higher GDP. According to the report, if all the recommendations were implemented, GDP would eventually be 2–3% higher than otherwise. While the notion of an efficiency dividend is plausible, it is subject to two major qualifications.

First, the modelling is open to doubt because it rests on the dubious assumption that the resource rent tax will not cause mining activity to be reduced, and in fact will boost it. Sinclair Davidson will have much more to say about this. Second, the Henry report casts aside the policy option of lower marginal rates on labour income, which would result in a higher efficiency dividend. The review panel apparently believes that marginal rates need to be set at 35% above \$25,000 and 45% above \$180,000 for revenue and equity reasons and that the disincentive effects are small enough to justify the trade-off. I question that judgment and believe that the absence of a recommendation to lower marginal rates is the most disappointing aspect of the report. Marginal rates of 35% and 45% would be higher than present rates at some income levels and about the same at other income levels. One wonders what became of the Rudd government's 'aspirational' income tax scale of 15%, 30% and 40%. The review does at least recommend that for capital income, marginal rates should be effectively discounted to 21% and 27%, but even this change would involve an increase in the effective rates on capital gains.

Even if reform succeeds in improving the efficiency of the tax system, it could turn out to be a double-edged sword. Reform can bring an efficiency dividend by reducing the drag on economic growth imposed by the tax system. But it can also make it easier for governments to increase the tax burden over time. If this happens, the economic dividend from a more efficient tax mix will be offset by the economic cost of a higher overall tax burden. Growth in the tax burden becomes even more likely if reform leads to simplification and reductions in compliance and administration costs.

The GST is a good example of this. The GST was less distorting and easier to collect than the taxes it replaced and it produced an efficiency dividend; it also made it easier for the tax burden to grow over time, or at least to be higher than it would have been in the absence of GST. The resource rent tax also needs to be seen in this light: it may be more efficient if designed properly, but it is also more conducive to the growth of government.

In an ideal world we would have smaller government and simple, efficient taxes, but in the real world of government as leviathan, if tax reform makes tax collection easier for government, then it also makes it easier for government to expand. I have no solution to this quandary, but I hope it does not mean we have to bear the costs of a dysfunctional tax system in order to curb the growth of government.

State taxes and the Commonwealth/state divide

Another dimension of the restructuring proposed by the Henry report is the Commonwealth/state divide. The recommended reforms in state taxation would make the tax system more rational and efficient in one sense, but they could also strengthen Commonwealth financial power at the expense of the states, further shrinking the states' fiscal autonomy and undermining competitive federalism.

The issues are how much power the states should have to set their own taxes and which taxes are best assigned to them. The Henry report sees a trade-off between tax efficiency and government accountability. It believes that efficiency generally requires more centralised taxes or at least harmonisation across states. Accountability requires that spending and revenue-raising responsibilities be matched at each level of government. Within a federation, this implies a degree of tax decentralisation with each state free to set its own tax rates, if not its tax bases as well.

Events in the history of Australian federalism have resulted in much more weight being given to the advantages of centralised taxation than to the advantages of accountability and devolution of tax powers. The Henry report, on the face of it, would take us even further in that direction. Not a single state tax escapes criticism.

The report argues that the conditions for accountability can be satisfied provided the states have sufficient flexibility at the margin to make their own expenditure and tax choices. According to this view, the states do not need to raise enough revenue from their own sources to cover every dollar they spend on their own functions but just enough so they can make their own choices regarding marginal variations from average state expenditure efforts on each state function.

There are two problems with this narrative. First, state taxes do not have to be inefficient and there does not have to be a trade-off with accountability. Second, the proposition that the states only need fiscal autonomy at the margin if they are to behave as fully accountable and independent sovereign entities is open to challenge. They have a degree of autonomy at the margin now, but that does not stop them from behaving like dependants of the Commonwealth. Almost half their revenue comes from Commonwealth grants.

While state taxes do not have to be inefficient, the report makes a good case that the present ones are. Payroll tax, land tax (in its current narrow form), stamp duties, gambling taxes, and mining royalties (which are not technically taxes), all come in for criticism for their distorting effects, complexity, high compliance costs, or poor design. The solution put forward by the report is to get rid of payroll tax, stamp duties, and mining royalties; redesign and greatly broaden the scope of land tax; and revamp gambling taxes. These actions would contribute to the economic growth dividend discussed above. The report recognises, however, that these reforms would deprive states of a large part of their revenues and that a substitute source of revenue would have to be found.

The report favours what it calls a 'simple cash flow tax' on business, which is a value added tax by another name or a way of approximating an increase in the GST without saying so. As the cash flow tax would be a Commonwealth tax at a uniform rate, substituting it for existing state taxes would involve the states surrendering some of the limited fiscal autonomy they now have. They would be left with just a broad land tax, gambling taxes in some form, and taxes on motor vehicle usage and operation such as registration fees.

Recognising that these leftovers would not be enough to give the states sufficient fiscal autonomy even at the margin, the Henry report leaves the door open to states sharing the personal income tax base or, in other words, to a state personal income tax on top of the Commonwealth one. This has often been floated as a way of strengthening the states' revenue base but has always been resisted by Commonwealth governments with one exception: the Fraser government offered limited income tax power to the states in the mid-1970s. But on that occasion, the Commonwealth made no attempt to reduce its personal income tax take to make room for the states, whereas the Henry report recognises that making room would be a necessary precondition. The federal government has not said that it will allow the states into the income tax field, but at least the idea of a state income tax was not included in the government's 'never ever' list.

In contrast, the government did reject the notion of a land tax on the 'family home,' reflecting well-established opposition to this idea, even if it was accompanied by the abolition of stamp duty. This resistance to a broad land tax and the Commonwealth's traditional refusal to readmit the states to the income tax field illustrates that it will always be challenging in the context of tax reform to protect even the current limited degree of state fiscal autonomy, let alone strengthen it.

It is easy to agree with the Henry report that the current array of state taxes leave much to be desired. But in finding a replacement, it is important not to throw the baby (accountability and state fiscal autonomy) out with the bathwater (economic inefficiency of state taxes) if Australian federalism is not to be further undermined.

No Respect for Super-Profit Taxation

Sinclair Davidson*

Introduction

Tax policy should be based on known principles. Many of the often articulated principles on tax, however, are little more than rules of thumb or tax folklore—such as having a ‘broad base and a low rate’ and ‘a dollar is a dollar.’ The latter principle suggests that not taxing everything in sight results in various distortions in the economy. It also creates the problem Australia has: 125 different taxes, yet 90% of the revenue is raised by just 10 taxes.¹ And if that weren’t bad enough, the final report of Australia’s Future Tax System Review (the Henry report) has recommended an additional tax on the so-called resource rents.

The Henry report identifies five different tax bases: personal income, business income, private consumption, economic rents, and Pigouvian taxes.² The Henry report excludes taxes on transactions from the list but suggests abolishing them. The federal government has accepted the report’s recommendation to impose a tax on mineral rents and will introduce the Resource Super Profit Tax (RSPT) from 1 July 2012. In this paper, I investigate some of the

* This paper is based on a presentation to The Centre for Independent Studies given on 17 May 2010. In the write-up, I have included material post-lecture to the extent that it is consistent with arguments I made at the lecture. There is some reference to Ross Garnaut’s lecture on 20 May 2010 but not a full critique of his argument.

The Resource Super Profit Tax has since been abandoned as government policy. That change in government policy simply emphasises the arguments made in the paper about lazy policy—the federal government was unable to convince the community as to the promised benefits of the tax largely because the government hadn’t consulted broadly before announcing the tax and hadn’t prepared for a debate on the need for new taxes.

claims made about the proposed tax on economic rents as applied to the mining industry.

It is not clear which tax principles the Henry report had in mind in formulating its recommendations. The proposed RSPT violates at least one of Adam Smith's four principles of taxation—it does not 'take out and keep out of the pockets of the people as little as possible.' Contrary to the claims made by the Henry report and the government, the RSPT is not an 'efficient' tax; rather, it has some fundamental problems associated with it that ensure that the theoretical elegance of the tax will not be realised in practice.³

The taxation of rent

Economic rent is usually defined as being a return over and above the minimum return necessary to keep a factor of production in employment; in other words, what economists refer to as a 'super-normal return' or an 'economic profit.' In accounting terms, economic profit, or super normal profit, is revenue less all costs including a 'normal return' to the entrepreneur. That normal return compensates entrepreneurs for the risks they take, their time and effort, and so on. It is their opportunity cost. James Buchanan, however, argues that entrepreneurial opportunity cost can't be measured.⁴

It is possible to estimate the cost of capital to firms undertaking particular projects. Estimating the cost of debt is fairly straightforward; however, estimating the cost of equity usually involves the application of an asset-pricing theory. The most well-known asset-pricing theory is the capital asset pricing model. This model employs estimates of the risk-free rate (normally a government bond), the risk-premium (estimates vary from about 4–8%), and a measure of actual risk (called beta) for the firm or project. Mining companies can be expected to have high levels of risk. Applying the capital asset pricing model to mining firms would indicate that equity returns would need to be very high to compensate shareholders for the risks they take.

Let me elaborate. Assume a mining project financed only by equity, the long-bond rate at 6%, and the market risk premium also at 6%. Being risky, a mining project might have a beta of 1.4.

Applying these figures in the capital asset pricing model gives an expected or normal return of 14.4%. If the mine earned more than 14.4%, then that excess return would be called a supernormal profit. In principle, it is that supernormal profit that the government proposes to tax. In practice, that is not what the government proposes to do.

Taxing rent has some pleasing *theoretical* characteristics. In a narrowly defined sense, it is an efficient tax. By that economists mean that the tax has no deadweight losses associated with it. Deadweight losses occur as a result of people modifying their behaviour to avoid a tax. Lost economic output is a cost over and above the revenue that a tax raises and must be factored into policy decisions. Ideally, a tax would raise a lot of revenue but have small deadweight losses. In theory, a tax on rent would have a zero deadweight loss. This is because the entrepreneur has already earned a normal return—on an after-tax basis, the entrepreneur is still better off compared to taking the next best project. So the same amount of investment will occur and the government will have collected revenue. In physics, this result would be described as a perpetual motion machine; in economics, it is called a free lunch.

Rents are often associated with a monopoly power. It is argued that miners have monopoly powers associated with minerals, which are immobile and have locational rents associated with them.⁵ To the extent that this is correct, the incidence of a tax on rent is known and the economic and legal incidences coincide. Tax incidence is about who bears the ultimate burden of a tax. It is unclear, for example, who bears the burden of corporate tax. The legal incidence is the firm that writes the cheque, but firms are theoretically able to pass on the burden of taxation to customers in the form of higher prices, to employees in the form of lower wages, and to shareholders in the form of lower returns. The actual ability of firms to pass on tax burdens and upon whom those burdens fall is a matter of much debate; it is clear that the economic incidence of the tax and the legal incidence do not coincide. Due to inelastic supply curves arising from monopoly power, however, the incidence of a tax on rent is known and the economic incidence coincides

with the legal incidence. The owner of the immobile resource being taxed bears the legal and economic incidence of taxation.

From the government's perspective, a tax on rent also has pleasing fiscal illusion characteristics. Jean-Baptiste Colbert, finance minister under Louis XIV, famously said, 'The art of taxation consists in so plucking the goose as to obtain the largest possible amount of feathers with the least possible amount of hissing.' In modern terms, skilful goose-plucking is called *fiscal illusion*, a suite of techniques for minimising resistance to taxation. Fiscal illusion gives government opportunity to distort their citizens' fiscal consciousness, in particular, to create the impression that taxes are not as onerous as they appear. This way, big government can raise more tax revenue than it otherwise could. Taxes on rent can be populist and target 'lucky' and 'undeserving' winners. John Stuart Mill, for example, argued that nineteenth century landowners earned rents 'as it were in their sleep' from their holdings and that a tax on them would be quite appropriate.⁶ Since the release of the Henry report, Australians are being told that a tax on mining companies would be appropriate because they are taking resources owned by all Australians and should therefore pay for those resources; that mining companies are very profitable anyway; and that in any event, the mining companies are all foreign owned and take the profits offshore. These statements are somewhat exaggerated and almost certainly not true. Yet senior government ministers, including the Prime Minister, made similar comments but were not challenged in the media or by the media.

In the context of a tax on land rent, Friedrich von Hayek said, 'If the factual assumptions on which it were based were correct ... the argument for its adoption would be very strong.'⁷ These theoretical arguments for the adoption of a tax on rent are very powerful; yet as Hayek suggests, the underlying assumptions of a tax on rent are not supported in real world conditions.

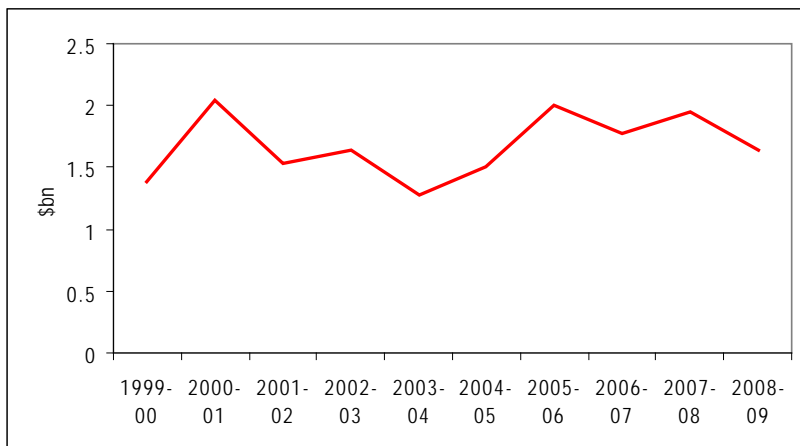
Resource rent taxes

At present, only the federal government levies anything that could be described as a tax on resource rents. The state governments, which

own the mineral rights within their own jurisdiction, levy a range of royalty charges depending on the mineral being mined. The federal government levies a Petroleum Rent Resource Tax (PRRT) on offshore oil and gas extraction, excluding the north-west shelf developments.

Figure 1 shows the dollar value of the PRRT revenue from 1999–2000 to 2008–09. These data are collected from the Australian Taxation Office in its annual Taxation Statistics publication. As can be seen, the PRRT is a steady earner but does

Figure 1: Revenue raised from the Petroleum Resource Rent Tax



Source: ATO Taxation Statistics 2007–08.

not raise a lot of revenue. Given that the overall tax revenue has increased over time, the proportion of revenue raised from the PRRT has fallen.

The PRRT is based on a tax that had been (re)invented by Ross Garnaut and Anthony Clunies Ross in two papers published in the mid- to late 1970s and in a book published in 1983. The basic idea—that returns in excess of an allowable return are taxed at some rate—is a variation of a tax proposed by E. Cary Brown in a paper in 1948. The allowable return includes a return on capital invested and exploration costs and outlays. In the case of the PRRT, 40% of profits in excess of the long-term government bond rate plus five percentage points is paid in tax.

In recent times, a number of major claims have been made on behalf of the PRRT. The Prime Minister made the following comments in Parliament during question time on 13 May 2010.⁸

I would also draw people's attention to what happened in our national debate in the mid-eighties, when we brought in the petroleum resource rent tax. Everyone at that stage predicted doom and gloom and the collapse of the entire offshore mining industry. It did not happen. It has produced, instead, one of the most vibrant exploration and production platforms that we have seen in the Australian resources sector in the last quarter of a century, including our largest resources project, the Gorgon Project—also under a tax at 40 per cent ...

It is true that the offshore mining industry has not collapsed—yet it is also dubious that the industry has thrived, as the Prime Minister claimed. On 9 May 2010, Treasurer Wayne Swan released a graph purporting to show that oil and gas exports had grown substantially since the introduction of the RPPT in the late 1980s.⁹ This ignores the fact that most of that growth came from the north-west shelf, which is exempt from the PRRT. The following excerpt from the *Weekend Australian* disputes the claim that the industry has prospered in the last 25 years under a resource rent tax.¹⁰

Both Kevin Rudd and Wayne Swan have told the public and parliament through the past two weeks that oil and gas production in Australia has remained strong under the Petroleum Resources Rent Tax scheme, a central tenet of which is a 40 per cent tax rate.

But industry and ABARE data shows that just about every tonne of extra gas production has been generated by the North West Shelf gas project and it is not covered by the PRRT regime.

Further, the data shows that oil production in Australia has declined pretty consistently since 1987, while production from fields not covered by the regime (Bass Strait and Timor Sea) consistently rose to a peak at the turn of the century, although they now appear to be in natural decline.

In the early 1980s, The Centre for Independent Studies published a policy monograph by Ray Ball and John Bowers criticising the PRRT.¹¹ That critique remains as pertinent today as it did then, and the criticisms it makes of the RPPT are just as relevant to the RSPT. Ball and Bowers argued that the PRRT would discourage new investment, distort investment, and stifle innovation, which also amounted to an expropriation of value. All of these arguments are inconsistent with the PRRT having low deadweight costs. They did argue, however, that a tax offset system could prevent the PRRT from inhibiting risk-taking if the government paid a cash refund on projects with negative economic earnings. Yet it is that very model that the Henry Review rejects in favour of a model that allows tax losses to be carried forward; Ball and Bowers describe that proposal as being, ‘the least neutral offset system.’¹² As part of the Henry report, KPMG Econtech estimated deadweight losses for various Australian taxes.¹³ The modeling indicates a low deadweight loss associated with the PRRT. This result is not a consequence of a rigorous modeling exercise but rather a function of the assumptions underpinning the whole exercise.¹⁴

Petroleum Resource Rent Tax (PRRT) is *modelled* to have a marginal excess burden of zero, because it is applied to a tax base that is *assumed* to be completely immobile—oil resources.

Although Australia has had a resources rent tax for some 25 years, the impact of this tax on the industry is not clear. The government claims the industry has thrived, yet the evidence to support that claim is disputed and the major benefit of such a

tax—low deadweight costs—is assumed in an analysis designed to prove that very point.

The Henry report recommended applying a form of rent resource tax to the whole of Australia.¹⁵

A uniform resource rent tax should be set at a rate of 40 per cent. It would use an allowance for corporate capital system, with taxable profit associated with a resource project equal to net income less an allowance for undeducted expenses or unused losses. The allowance rate would be set by the long-term government bond rate, as the government would share in the risks of projects by providing a loss refund if the tax value of expenditure is otherwise unable to be used.

The government immediately accepted the recommendation and labeled the new tax as Resource Super Profit Tax. The RSPT is not the same type of resource rent tax as the PRRT despite their similar objectives. The RSPT is a modified Brown tax—instead of refunding firms in cash each year, the government's share of the investment accumulates at the long-bond rate and is offset in future years or paid out when the project terminates. It is important to realise that many projects will terminate as they are not economically viable.

The government also released results of modeling suggesting that mining investment will increase as a result of the new tax. The Prime Minister told the Parliament:¹⁶

I also say to the Leader of the Opposition that if he looked at the independent modelling provided by the Treasury on the impact of the tax measures that we have proposed he would see that they in fact result in an increase in overall activity in the mining sector.

This statement raises a number of issues. Treasury is hardly independent of government and has almost certainly made the same assumptions as did KPMG Econtech—that the deadweight costs of the RSPT are zero. So it is hardly surprising that mining

activity would increase. The modeling assumes that royalties with high deadweight losses are substituted with an RSPT with a zero deadweight loss. That result, however, is not the outcome of the modeling but an assumption of the modeling. Treasury has assumed the result that needs to be proven.

In his analysis of this modeling, economist ‘Henry Thornton’ made this devastating point:¹⁷

Then there is the ludicrous claim that the great big new tax-and-subsidy plan will increase investment in mining. This is based on an ‘elegant algebraic model’ that makes one’s head ache—thus violating the vital principle for reformers that the proposals should be comprehensible to real people.

When even highly regarded economists like ‘Henry Thornton’ are so critical of the proposed benefits of the tax, it is clear that the proposed tax needs substantial explanation, modification, or even abandonment.

Criticisms of rent taxation

Rent is an assumption, and even if it did exist in practice, there are practical problems in measuring it. The federal government is claiming that it is taxing rent, yet it is actually taxing ordinary income. To the extent that rent is not being taxed, the central claim of neutrality is incorrect. Firms will exhibit exactly the same behavioural response to the RSPT as they do to the corporate income tax.

The RSPT is a modified Brown tax and requires the federal government to commit to writing cheques to mining firms once they abandon a project or close down. In his analysis of the RSPT, Ross Garnaut identified two issues that go the heart of the matter.¹⁸

Will investors come to see the loss offsets, and companies’ capacity to carry them forward with interest and to redeem them in cash in the case

of failure of an investment, as a reliable and permanent feature of the taxation environment? And is it really the case that, with all their imperfections, Australia's financial institutions will fund delayed credits at the Commonwealth's borrowing rate?

Garnaut was clear that these questions were vitally important to the success of the tax. If government could not credibly commit to redeeming tax credits, the tax would not be neutral. It is clear from Garnaut's comments that he did not believe such a commitment could be made. Similarly, the tax relied on a perfect information assumption when providing financing—that sort of assumption should be fatal to any policy proposal. What is particularly interesting is that Garnaut had made similar comments in his 1983 book.¹⁹

A disadvantage of the Brown Tax (BT) is that ... it entails the greatest risk to the government. On a very large project, this risk might be unacceptable ... subsidising a project for making losses might also be difficult to 'sell' politically, even though the subsidies would not in principle convert the losses into gains for the investor ... A final possible disadvantage is on grounds of stability of the fiscal regime, as seen by the investor. It may be difficult for investors to be completely confident that subsidies to future capital outlays will continue to be paid at some very high rate. Thus investors may just possibly react to a BT system as one involving greater risk or a higher expected tax burden than its formal character justifies.

The success of the RSPT relies heavily on the ability of the government to commit not to change the rules in future. Yet no government can credibly make that commitment; indeed, the introduction of the RSPT itself is viewed as the government having changed the rules.

From the government's perspective, this type of tax creates a situation where revenue is pro-cyclical. As the mining sector booms, and by implication the economy booms, tax receipts will increase. In case of a mining bust, however, not only do tax receipts fall but the government is required to write cheques to cover mining losses as mining projects either fail or are abandoned. This adds substantial volatility to public finance and could well require a higher risk premium on Australian public debt.

Another criticism of the RSPT is that it effectively operates as a maximum allowable rate of return regulation. These regulations are well known to generate incentives for firms to over-invest in the capital base (known as the Aversh-Johnson effect) to increase the allowable return. To the extent that this occurs, the RSPT would not be neutral.

Conclusion

We should be suspicious of any policy proposal that offers a free lunch. This tax proposal offers the prospect of massive revenues with no deadweight losses. It is remarkable that such an efficient tax has never before been implemented anywhere in the world. Of course, there is good reason for that; this policy proposal does not deliver on its promise.

The RSPT does show the extraordinary arrogance of bureaucrats and theoreticians. As James Buchanan emphasises, economists often offer advice as if they were advising an omnipotent dictator instead of a democratic government.²⁰ Bureaucrats should not be in the business of imposing their own expectations of appropriate costs of capital on entrepreneurs. One of the more extraordinary claims in the Henry report was that the RSPT would not constitute an increase in sovereign risk.²¹ Yet as even Ross Garnaut makes clear (and first emphasised more than 25 years ago), government credibility and sovereign risk lie at the very heart of this sort of tax.

The Henry report was always going to be compromised. Despite his long history in the tax reform debate over the past generation, Ken Henry should never have been the chair of the review.

He could have and should have given advice to the review and his department could have offered secretarial and research support, but the government's chief economic advisor cannot be the head of an 'independent review' of tax policy. Who will now advise the government on the Henry report? Surely not Henry himself.

Even worse, however, has been the lazy politics practised by the Rudd government. John Hewson's GST birthday cake is now folklore on how not to sell a tax, yet the government has fared little better in explaining what a super-profit is and how its tax is meant to work. The argument that the minerals belong to 'all Australians' is simply wrong. We should also recognise that mining royalties are not a tax; they are a purchase of rights to mine minerals. The Commonwealth is simply trying to cash in on state government property. The notion that mining firms are not paying enough for the minerals is an unproven assertion. To be fair, the Henry report makes that assertion and the government simply copied it.

The Henry report is a disappointing document containing little in the way of sound principles of a tax system. It relies on assertion and assumption, and for an almost 1,000-page document that took 18 months and \$10 million to produce, the taxpayers should have gotten something a lot better.

Endnotes

- ¹ *Australia's Future Tax System* (the Henry report), Part One Overview (2010), 12. The 10 taxes are: personal tax, company tax, GST, payroll tax, fuel excise, local government rates, conveyance stamp duty, superannuation, tobacco excise, and land tax.
- ² These are taxes introduced to correct so-called market failures.
- ³ The RSPT has been described as being 'elegant' by Ross Garnaut.
- ⁴ James Buchanan, *Cost and Choice: An Inquiry in Economic Theory* (Indianapolis: Liberty Fund, 1999–2002), 133–134.
- ⁵ This, in principle, gives rise to an inelastic supply curve. I am not convinced that this is true.

- ⁶ John Stuart Mill, *Principles of Political Economy* (Augustus M. Kelley, 1848), 817–818.
- ⁷ Friedrich von Hayek, *The Constitution of Liberty* (Routledge, 1960), 305.
- ⁸ HANSARD (13 May 2010), 47.
- ⁹ Treasurer’s Economic Note 018.
- ¹⁰ Matthew Stevens, ‘Throwing petrol on resource super-profits fire,’ *The Weekend Australian* (Business) (15 May 2010).
- ¹¹ Ray Ball and John Bowers, *The Resource Rent Tax: A Penalty on Risk Taking*, CIS Policy Monograph No. 5 (Sydney: The Centre for Independent Studies, 1984).
- ¹² As above, 15–16.
- ¹³ KPMG Econtech, *CGE Analysis of the Current Australian Tax System, Final Report* (7 May 2010).
- ¹⁴ KPMG Econtech, as above, 2 (emphasis added).
- ¹⁵ This is not the formal recommendation (recommendation 45) but it does capture the important elements of the tax as recommended by the Henry report.
- ¹⁶ HANSARD (13 May 2010), 43.
- ¹⁷ Henry Thornton, ‘Super-profit tax will damage Australia’s “safe for business” reputation,’ *The Australian* (21 May 2010). Henry Thornton is a pseudonym for a well-known Melbourne based economist.
- ¹⁸ Ross Garnaut, ‘The new Australian rent resource tax,’ Lecture at the University of Melbourne (20 May 2010), 18.
- ¹⁹ Ross Garnaut and Anthony Clunies Ross, *Taxation of Mineral Rents* (Oxford; New York: Clarendon Press, 1983), 100. Quoted in Ross Garnaut, as above, 9.
- ²⁰ James Buchanan, ‘Public Finance and Public Choice,’ in *Debt and Taxes: The Collected Works of James M. Buchanan*, Volume XIV (Indianapolis: Liberty Fund, 2001).
- ²¹ Henry report, Part Two Vol. 1 of 2 (2010), 224.



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Tax Reform: For Economic Growth or Bigger Government?

The report on Australia's Future Tax System (the 'Henry review') was released by the government in May 2010. Shortly afterwards, The Centre for Independent Studies held a public forum to discuss the report and the government's initial response. CIS authors have written extensively on tax reform over the years, and the forum brought together some of those authors to voice their perspectives on the Henry review. This publication is a compilation of the papers presented at the forum on 17 May 2010. Robert Carling discusses the implications for economic growth, and Sinclair Davidson presents a critique of the Resource Super Profits Tax that the government was then proposing to implement.

Robert Carling is a Senior Fellow at The Centre for Independent Studies. He was Executive Director, Economic and Fiscal, at the NSW Treasury from 1998 to 2006. Prior to that, he was with the Commonwealth Treasury, the World Bank, and the International Monetary Fund. He holds academic qualifications in economics and finance from the London School of Economics and Political Science, Georgetown University, and the University of Queensland.

Sinclair Davidson is Professor in the School of Economics, Finance and Marketing, at RMIT and a Senior Fellow at the Institute of Public Affairs. He has written extensively on taxation policy in Australia and is a regular contributor to public debate. His opinion pieces have been published in *The Age*, *The Australian*, the *Australian Financial Review*, the *Sydney Morning Herald*, and the *Wall Street Journal Asia*. He has also published in a number of national and international academic journals.



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