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WA Mining Tax Proposal

Counting the economic cost

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The expenditure responsibilities of many Australian states and territories are growing at a faster rate than inflation and their revenue bases – affected by growing spending requirements on health and education. While all Australian jurisdictions are seeking to build budgetary resilience, Western Australia is under particular strain. The State is challenging the prospect that they will receive a reduced share of GST revenues at the same time that their mining royalty revenues continue to decline.

While the Western Australian Government has managed to secure 'top up' funding from the Commonwealth Government over the last few years, and Prime Minister Turnbull has announced the introduction of a minimum floor in GST distribution, the details and the timing of this arrangement remains unclear.[1] It is therefore not surprising that proposals have emerged which seek to address, at least in part, the current fiscal challenge.

Most recently, the Western Australian Nationals leader, Brendon Grylls, has proposed changes to the royalty regime in the State; specifically that which applies to iron ore producers.

Western Australia has a three-tiered royalty system, with the rate payable subject to the form in which the mineral is sold and the level of processing. For iron ore producers, royalties are set at 7.5 per cent of the royalty value for ore and 5 per cent if the iron ore is concentrated.[2] In 2015, just over $5 billion in revenues was collected from mineral and petroleum producers in Western Australia, and almost three-quarters of this was from the iron ore industry.

Certain iron ore producers are required to pay an additional 'rental payment' of 25 cents per tonne on top of their royalty payment. This rental payment was introduced in the early 1960s and is linked to recouping the Government's infrastructure investment in the region. The payment only applies to companies that have been operating for more than 15 years and currently applies to BHPB, Rio Tinto and Cliffs Natural Resources. A number of iron ore companies which began production during the late 2000s are not expected to be covered under the arrangements for at least another eight years.

The rental payment has largely been fixed at 25 cents per tonne since its introduction.[3] The proposal seeks to 'update' the rate – increasing it to $5 per tonne – as a means to improve the State's budget situation.

Recent estimates indicate that the three iron ore producers by the rental payment arrangement paid around $120 million from the lease rental payment in 2015-16. Increasing the rate to $5 per tonne would have raised around $2.4 billion for the State in 2015-16.[4]

The economic cost of royalties

While referred to as a rental payment, these arrangements are another form of royalty, and therefore generate the same efficiency concerns related to impacts on incentives for mining companies to invest and employ staff.

Analysis performed as part of the Henry Tax Review found that a five percent increase in royalties had the greatest marginal welfare loss when compared to other taxes – including insurance taxes and stamp duties, and corporate income tax – at around 70 cents per dollar of additional revenue raised.[5] If this estimate of marginal welfare loss is applied to the proposed uplift in the iron ore rental payment (estimated using 2015-16 output volumes), an increase in the rental payment rate

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1 Baines, R (2016) 'Changes to GST carve-up 'some years' away, Malcolm Turnbull says', *ABC Online*. Available at: http://www.abc.net.au/news/2016-09-25/changes-to-gst-carve-up-'some-years'-away,-malcolm-turnbull-says/7874784. [Accessed on 24 November 2016].

2 The royalty value is broadly calculated as the quantity of the mineral in the form in which it is first sold, multiplied by the price in that form, minus any allowable deductions. In some cases an alternative to 'royalty value' applies e.g. nickel.

3 The rental payment was initially two shillings and sixpence per tonne, but was revised to 25 cents per tonne when the currency was decimalised.

4 Kagi, J (2016) 'WA mining tax explained: Why are Rio Tinto and BHP in the crosshairs?' *ABC Online*. Available at: http://mobile.abc.net.au/news/2016-10-06/wa-mining-tax-explained-why-are-rio-tinto-and-bhp-targeted/7908544?pfmredir=sm. [Accessed on 9 October 2016].

5 Commonwealth of Australia (2010) *Australia's future tax system - Report to the Treasurer*, The Treasury, Australian Government. Available at: http://taxreview.treasury.gov.au/com. [Accessed October 2016].

would result in a reduction of consumer welfare by approximately $1.6 billion and a total output loss to the Australian economy of around $2.7 billion.[6]

This economic cost is linked to how these royalty payments are levied and the mobile nature of capital. As the mining sector is capital intensive, an increase in taxes on production, such as royalties, can lead to lower capital spending, reducing productivity and increasing the cost of production. The mining sector is also trade exposed, with limited scope to increase its prices. Where production costs increase as a results of additional taxes, companies will face a reduced rate of return. Higher costs of capital also flow through to higher consumer prices, lowering the real wage. Hence, while the proposed increased rental payment will be levied on certain iron ore producers, the economic incidence or final burden of the tax falls on labour – through a reduction in the real wage either directly through reduced salaries and wages, or indirectly through higher consumer prices.

Similar to royalties, the rental payment paid by iron ore producers would be deductable from their corporate tax liability. While this reduces the direct impact on iron ore producers, it means that the Commonwealth Government would fund part of any additional rental payment through reduced corporate tax receipts.

The additional revenue generated from increasing the rental payment rate would also be taken into account by the Commonwealth Grants Commission in their determination of the GST allocation for Western Australia. Any additional revenue collected by the Western Australian Government under this rental payment arrangement would be offset at least to some degree by a reduced GST payment.

The proposal is inconsistent with a key principle of taxation; that the rate of tax should be low and apply to as broad and comprehensive a tax base as possible. While the rental payment arrangement currently applies to an extremely narrow base (comprising just three iron ore producers), the rate is relatively low and hence the economic cost is not as significant. Raising the rate of the rental payment would increase the distorting impact, because the economic cost of tax increases more quickly as the rate of tax is increased.[7] It also has equity implications, given the rental payment does not currently apply to all iron ore producers.

Proposals such as these, which can appear ad hoc and reactionary, can erode certainty and the desirability of Australia as a destination for investment. In a highly competitive global market for iron ore production this degree of sovereign risk along with increased costs of doing business, could drive a re-direction of investment to Australia's competitors.

The need for comprehensive tax reform

Australian governments need to undertake steps to improve budgets by looking at both spending and revenues measures. However, on-going ad hoc or piecemeal changes to taxes, can undermine trust and may not fully address budgetary pressure.

A broad reform agenda is required to support economic growth and protect our way of life. This will include identifying those reforms which will address current impediments to innovation, productivity growth, employment, workforce participation and investment. Comprehensive tax reform is an important part of this process and should look at the range of revenue levers open to state and territory governments, including their efficiency, equity and revenue implications, to support the identification of a sustainable path to budget repair.

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6 This estimate is developed by taking the uplift in revenue, multiplying it by the estimated marginal welfare loss, and then dividing this by the share of the economy made up of consumption to determine the total output loss.

7 Commonwealth of Australia (2008) *Architecture of Australia's tax and transfer system*, The Treasury, Australian Government. Available at: http://taxreview.treasury.gov.au/com. [Accessed October 2016].